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Hans Hoogervorst
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Berlin, 12 November 2012

Dear Hans,

Review Draft "Hedge Accounting"

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the IASB Review Draft (RD) "Hedge Accounting". We are aware that the IASB did not intend, by publishing this RD, to receive comments or suggestions with respect to the requirements that have passed the due process, but to detect fatal flaws that might arise.

Taking this into account, our IFRS committee has performed a first read of the RD, which, owing to its length, needs more time to fully digest. In order to early submit our findings, we provide the following remarks which we deem to illustrate fatal flaws, i.e. inconsistencies within the text, or inappropriate wording, or imperfect structure.

Introduction

In general, we acknowledge that the RD comprehensively incorporates all IASB decisions made during the re-deliberation process for general hedge accounting. It appears that, by and large, the proposed requirements are an improvement over the current literature contained in IAS 39. Specifically:

- the abolishment of the 80-125% effectiveness corridor;
- the eligibility of hedging portions of non-financial items; and
- the greater alignment with risk management practices

are seen as a significant step in the right direction and will lead to more decision-useful information.

Nonetheless, there are a number of technical issues that justify further consideration. Also, we are not convinced the RD, in its entirety, having appropriate wording and being well structured.

<u>Major issues</u>

1. Accounting for Credit Risk

The hedge accounting ED prohibited hedge accounting for credit risk. Respondents to the ED commented that hedging credit risk is a common risk management strategy and, therefore, a solution was needed. In the review draft, the IASB permits hedge accounting for credit risk using the fair value option.

Whilst it is acknowledged that the IASB wanted to address constituents' concerns regarding hedging of credit risk, we do not believe that a robust case has been made as to why using the general fair value hedge accounting model would lead to less decision-useful information for users than the modified fair value option. On the contrary, the proposed method adds extra complexity, is inconsistent with the general requirements surrounding that option and does not lead to an answer that is conceptually superior. If the arguments above are agreed on, then there seems to be no valid reason why entities should not be allowed to rely on the general fair value hedge accounting model (perhaps with the same safeguards put in place for inflation risk) instead of tweaking the fair value option.

Hence, it is argued here that the IASB should discard its proposed alternative and make credit risk an eligible risk factor just as any other risk factor. This would also ensure that the accounting could keep in line with new developing credit markets and practices as they evolve. If, nonetheless, the Board were to keep the alternative treatment, the conditions for applying the fair value option in this context should be tightened such that requirements equivalent to those introduced for the general hedge accounting model (i.e., as regards necessary documentation, a proven relationship to risk management practices, etc.) can be put in place.

2. Accounting for Sub-LIBOR-hedges

Hedge accounting is not permitted for sub-LIBOR risk although this is a common risk management strategy applied by banks in practice. We do not believe that prohibiting hedge accounting for sub-LIBOR issues is consistent with the overall principle in the general hedge accounting model which is to better align hedge accounting with an entity's risk management strategy. This is especially true in current times when entities seek to invest more in less risky and high quality financial instruments, esp. AAA-rated government bonds.

Given that many entities are currently engaging in sub-LIBOR hedging, the EU has placed a carve-out on the respective requirements in IAS 39 which, should the prohibition survive in the final standard, is likely to be imposed on the relevant paragraph in IFRS 9, too. When the IASB started developing new requirements for hedge accounting, one of the expectations of the European constituents was that the IFRS 9 requirements would be capable of being applied without an EU carve-out. The sub-LIBOR issue could lead to an EU carve-out of IFRS 9 which would not be desirable and could result in delays to the endorsement process. We do not believe that such outcome would be necessary, if the IASB acknowledged that entities do hedge sub-LIBOR risk in order to eliminate the variability in interest rate risk stemming from fluctuations in LIBOR.

3. Effectiveness when hedging basis risks

We are aware of situations in which hedge accounting may lead to inappropriately presenting ineffectiveness because of "basis risk" included in economic FX hedges. This arises when cashflow hedge accounting is applied to an economic hedge on FX risk, e.g. a FX funding liability and a cross currency swap with actually exchanging currencies (sometimes called "funding swap"). Such swaps usually include a charge for the FX exchange. Therefore, a basis spread would be included when discounting the hedging instrument, but not the hedged item. This causes volatility during the life of the hedge. The hypothetical derivative method, when used for determining the effectiveness, does not allow for inclusion of such features like basis spread risk (see B6.5.5). This would lead to recognising ineffectiveness that is not considered as such from an economic perspective.

4. Co-existence of hedge accounting requirements in IFRS 9 and IAS 39

We see major conflicts between the new hedge accounting requirements to become part of IFRS 9 and those hedge accounting requirements of IAS 39 that will not be replaced (yet). We are aware that selected requirements in IAS 39 need to remain in place as soon as IFRS 9 (hedge accounting section) is finalised, in order to maintain the accounting for portfolio fair value hedges of interest rate risk. This is the case for IAS 39.81A, 89A and AG114-132 – see reference in RD 6.1.3.

However, inconsistencies are caused by other references in the RD (e.g. 5.2.3, 5.3.2, 5.7.1(a)), referring to IAS 39.89-94. In addition, but not necessarily in line with this, the consequential amendments to IAS 39 (RD, App. C, C40) make evident that some hedge-related paragraphs in IAS 39 will be deleted, some will be amended, and some ought to remain unchanged. Apart from not being fully certain about how the amended IAS 39 will finally read, we wonder when and how those remaining paragraphs would apply. This is particularly unclear, since there are analogous but different new requirements, e.g. IAS 39.88 vs. RD 6.4.1 (qualifying criteria), or IAS 39.91 vs. RD 6.5.6 (discontinuation), or IAS 39.83 vs. RD 6.6.1 (groups as hedged item).

One issue arising from this is that it remains unclear whether "old" IAS 39 portfolio fair value hedges shall comply with the "old" hedge accounting criteria and "new" IFRS 9 hedges shall only comply with the "new" hedge accounting criteria, or whether "old" portfolio hedges shall instead comply with the "new" hedge accounting criteria (e.g. relaxed effectiveness test, rebalance but no voluntary discontinuation, etc.).

Another issue around this co-existence needs further reflection. The RD is meant to also cover some macro hedging strategies, i.e. closed portfolio strategies. Even though, the portfolio fair value hedge accounting in IAS 39, once introduced to cover a broad range of macro hedging strategies (i.e. closed as well as open portfolio strategies, however, restricted to the interest rate risk component), will remain in place. Given this, we see two ways how to account for such closed portfolio hedges: macro hedges of interest rate risk for closed portfolios may – at free choice – be accounted for either as a portfolio fair value hedge (under IAS 39) or as a fair value hedge with a net position as hedged item (under the RD) – both under different conditions for eligible items, effectiveness, rebalancing, discontinuation, etc. This seems arbitrary or, at least, raises some confusion as to how such economic hedges should be accounted for in the future. Another example is how to account for layer components. Whereas under IAS 39 the layer eligibility is restricted to a percentage layer, the RD is more relaxed for designating layer components. Again, there is a free choice between two ways how to designate, and account for, layer components.

Other issues

5. Scope of IFRS 9 and hedge accounting requirements

Generally, we see difficulties around the scope of the standard that are mostly forwarded from IAS 39 to IFRS 9 and increase with the RD. First, the scope of IFRS 9 is inappropriately determined by reference to IAS 39 only. Second, there is an increasing set of non-financial items that are "scoped-in" (i.e. loan commitments, or own-use contracts, see RD 6.7.1, App. C, C36, ref. to IAS 39.5A). Third, some instruments are scoped-out while generally meeting the financial instrument's definition (e.g. leases, financial guarantees, pensions). Fourth, and most important, the scope for the subset of hedge accounting is different from the general scope, while not even made explicit within the standard. Moreover, it seems implicit – but with a good piece of uncertainty – that the hedge accounting section applies to any non-financial item which has been designated as hedged item (subject to certain conditions for its eligibility). In the light of this, it remains unclear which non-financial items (e.g. real estate investments, leases, insurance liabilities, IAS 37 provisions) actually qualify as hedged item.

6. Synthetic positions (e.g. net positions, aggregated exposures) as hedged item

We detected some inconsistencies with regard to synthetic positions as hedged items. Aggregated exposures consist of an <u>exposure</u> and a derivative (RD 6.3.4); however, "exposure" is not clearly defined. If, as we understand, an exposure is any item covered by RD 6.3.1, which would include derivatives, there is a circular reference. Further, the distinction between <u>qualifying items and designated items</u> is not entirely clear. For instance, an aggregated exposure (RD 6.3.4) may be interpreted as a qualifying item (see subtitle before 6.3.1), or as a designated item (see wording of RD 6.3.4, 1st phrase). As a result, it remains open whether a component from an aggregated exposure may be designated (if the aggregated exposure is "only" a qualifying item) or not (if the aggregated exposure is a designated item). In the case of nil net positions, we even deem a particular requirement – that is, designating a hedging relationship not including a hedging instrument (RD 6.6.6) – to contravene one of the qualifying principle in RD 6.4.1(a) (which is ackowledged in BC6.343). Considering this a rare event (BC6.345) does not rectify such shortcoming.

7. Partial designation of options and forward contracts

We remember that allowing to designate only the intrinsic value of an option as well as only the spot element of a forward as hedging instruments, aims at treating alike two instruments, that are comparable from an economic as well as from an accounting perspective. To our surprise, this rationale is not mentioned in any part of the RD (or its BC). Given our correct understanding, we wonder why accounting for the time value of an option (changes in OCI) is a requirement ("shall", see RD 6.5.15), while it is optional in the case of a forward element ("may", see RD 6.5.16). We deem this a drafting mistake.

8. Hedge ratio and rebalancing

When considering the requirement for determining the hedge ratio and its potential rebalancing (RD 6.4.1(c)(iii), 6.5.5), it is entirely unclear how both have to be applied or interact with each other. To be more detailed, it is first not obvious how an "imbalance of the weighting" can arise, given the requirement of a hedge ratio being the same as the (economic) quantities is met. Second, and consequently, it is not clear why and how any such imbalance can lead to an "accounting outcome ... inconsistent with the hedge accounting purpose", the latter even not being defined. We also fail to understand B6.4.8-10, which suffer from the problem of numerous cross references between RD, and AG, and BC. Third, the case of a hedging relationship ceasing to meet the "hedge ratio" requirement while risk management remains unchanged (RD 6.5.5) is also unclear to the extent that we wonder whether and how an (unchanged) effective economic hedge may lead to a (partly) ineffective hedging relationship or vice versa. Thus, we do not see the ground for when, and how, rebalancing shall be performed. To conclude, the entire idea of a hedge ratio and its rebalance is not comprehensible at all.

Further, we have difficulties in understanding the difference between rebalancing (RD 6.5.5) and partial discontinuation (RD 6.5.6). Whereas we acknowledge different preconditions – rebalancing if the criterion in 6.4.1(c)(iii) is not met anymore, (partial) discontinuation of any of the criteria in 6.4.1 is not met anymore –, the consequence in either case is a change in the hedge ratio.

9. Transition and early application

When evaluating the transition requirements, we bear in mind the current respective requirements in IFRS 9. Those allow for early application of the 2009 or the 2010 version, at a choice. This is leading to potential incomparability and also to a logical distortion of allowing the first part of the new classification concept (assets side) to be applied without its second part (liability side), but not vice versa. As the RD proposes the same principal when this chapter, saying 2012 version, is finalised, the issue increases to three versions in parallel. As the IASB has developed a new idea for early application – which is: the latest version for "initial early adopters", but any version for "already before adopters", this supposed to be put in place with the final IFRS 9 version only – we simply propose to implement that idea with the 2012 version.

We also see inconsistencies resulting from the prospective application of the hedge accounting requirements in conjunction with other parts of IFRS 9. If hedge accounting is applied prospectively, but the requirements for classification and measurement (phase I) are applied retrospectively, this raises the question of how to account for existing IAS 39 hedge relationships. In the example of a hedged item measured at amortised cost under IAS 39 (e.g. LaR) which shall be reclassified into FV-OCI under IFRS 9 retrospectively, both independent sets of transition rules would contradict each other. Thus, we imagine other examples raising the same issue, and therefore suggest to fully consider the entire transition concept again.

10. Further findings

Finally, we like to mention some issues that might be considered not having a fatal flaw character but to amend, after proper due process, the proposed requirements themselves. Noting this, we are convinced that they cover economic situations when an entity's risk management activities are not eligible for hedge accounting. As such, hedge accounting is not in line with risk management and, thus, the objective of hedge accounting is only restrictedly fulfilled.

A <u>net position for risks other than FX</u> (i.e. commodity price risk) does not qualify for cashflow hedge accounting (RD 6.6.1). Using <u>internal derivatives</u> is common practice but still excluded from hedge accounting. It seems that a <u>partial term</u> is not considered a component of a hedged item (RD 6.3.1, 6.3.7) in a cashflow hedge. If so, this would be a change to IAS 39 (IG.F.1.13, F.2.17), which we deem an unintended consequence.

To conclude from these examples, we expect that the new requirements as well as its accompanying guidance (AG, BC, IE) might result in other particular situations not being covered. Overall, we expect a good piece of further guidance to be developed subsequently over years, thus, leading to a similar outcome as the extensive hedge accounting guidance accompanying IAS 39.

If you would like to discuss any aspects of this letter in more detail, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President