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Accounting Standards Committee of Germany
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EFRAG
Françoise Flores
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Berlin, 19 February 2013

Dear Françoise,

Consultation on the transition from IAS 39 to IFRS 9 for macro-hedging practices

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on EFRAG's Consultation on the transition from IAS 39 to IFRS 9 for macro-hedging practices issued by EFRAG on 22 January 2012.

Whilst we do agree with EFRAG that practice seems to be coming to a different conclusion than the IASB as to what constitutes 'macro hedging', we tend to disagree with the messages conveyed and the measures suggested as regards existing hedge accounting practice under IAS 39. Our key points, which we lay out in some more detail in the Appendix, are as follows:

- IAS 39 never contained any macro hedge accounting concept. The standard uses a transaction-based approach which is often depicted with the label 'micro hedge' (accounting).
- As the current version of IAS 39 does not contain any macro hedge accounting concept, the IASB cannot take anything away from its constituents by shifting the requirements to IFRS 9. Hence, the message contained in the last paragraph on p.1 of the letter is factually wrong – "EFRAG believes that the revised wording […] does not allow the IASB to […] maintain[ing] the status quo of macro hedge accounting."
- The authority of Implementation Guidance is exaggerated as it is non-authoritative, non-mandatory literature only by which nothing is added to or taken away from the pronouncement. IGs exemplify how the standard is intended to be applied in dealing with practice issues.

As we see it, the issue highlighted by some in EFRAG's field test (as well as those that have made similar comments vis-à-vis the IASB) seems to be a per-ception issue: There seems to be a different understanding by the IASB and some entities as to what constitutes a macro hedge and what does not. Percep-tions cannot be right or wrong, so one cannot accuse anyone or being accused by anyone for having them – which is why we think the letter conveys the wrong message. The issue is not that the IASB, by shifting the paragraphs into IFRS 9, has changed the literature; rather, the issue is that some entities think what their accounting people are doing is apply macro hedging – which, technically speak-ing, is not the case. Therefore, we do not believe that the issue can be resolved in the way that EFRAG suggests.

Having said this, we agree with EFRAG that it would be preferable not to make entities change their hedge accounting approach twice within a relatively short time period, ie upon finalisation of the general hedge accounting requirements and again when the macro hedge accounting projected is completed.

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

Yours sincerely,

Liesel Knorr

Appendix

From a technical point of view, IAS 39 never dealt with macro hedge accounting, and we believe it is important for EFRAG's constituents to acknowledge and understand this fact. The standard states that, for purposes of hedge accounting, the hedged item must be an individual existing, committed or forecast transaction, so it is a transaction- and not a (net) position-based concept; this becomes obvious right from the first paragraph in the section on hedge accounting:

> *"If there is a designated hedging relationship between **a** hedging instrument and **a** hedged item […]." (cf. IAS 39.71; emphasis added)*

In IAS 39.78 lit. (b), the IASB clarifies that, instead of hedging a single item, entities are allowed to bundle items into a hedged item, provided they share similar risk characteristics. The IASB goes on to state in IAS 39.83 that items may be aggregated only

> *"if the individual [items] share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items."*

In essence, this means that an aggregate can never be a net position of assets and liabilities since it would otherwise violate the second condition of proportionate changes in fair value. For the avoidance of doubt this is made explicit in the following paragraph where the IASB states that

> *"comparing a hedging instrument with **an overall net position** (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, **does not qualify for hedge accounting**." (IAS 39.84; emphasis added)*

The only exception from the prohibition to bundle assets and liabilities in order to hedge a portion was introduced in March 2004 as of when the IASB decided to allow entities to designate

> *"a portion of the portfolio of financial assets and financial liabilities that share the risk being hedged." (IAS 39.78 lit (c))*

This is the so-called <u>portfolio</u> hedge of interest rate risk. However, even though it sounds as if it was a net position hedge, de facto, it is not which is made clear in IAS 39.81A stating:

> *"Designation of a net amount including assets and liabilities is not permitted."*

Entities, and financial institutions in particular, whose risk management operates under a net position regime experienced significant difficulties in aligning their practices with the transaction-based accounting approach envisaged by IAS 39. The three items in the Implementation Guidance in question were developed to address this issue – see the lead-in question in IG.F.6.1:

> *"If a financial institution **manages** interest rate risk **on a net basis**, **can its activities** potentially **qualify for hedge accounting** under IAS 39?" (emphasis added)*

The answer given – "Yes." – may have led entities to the (false) assumption that the IASB caters for net position hedging. The contrary is the case, as the two sentences immediately following demonstrate:

> *"However, to qualify for hedge accounting **the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position** […]. **It is not possible to designate a net position as a hedged item under IAS 39** […]." (emphasis added)*

In other words, what the IASB is stating here is that an entity must use a transaction-based approach for purposes of accounting in order to present the effects of a (net) position-based approach used by risk management – micro hedge accounting is used as a (compliant) tool to present something that is effectively non-micro hedging.

So when the IASB states in BC6.12 in the Review Draft that it decided not to deal with macro hedging as this stage, all they are saying is that the status quo is maintained: The new hedge accounting section in IFRS 9 will not contain any reference to macro hedging, at least not initially. As is correctly stated in the Consultation, macro hedging is being considered as part of a separate project that was divorced from IFRS 9 in order not to hold back publication of that standard. Currently, the outcome of the macro phase is uncertain due the early stage of the project and the many technical difficulties to be solved and potential compromises to be made. Given this, the IASB could have equally shifted the entire section on hedge accounting from IAS 39 to IFRS 9. The reason they decided not to do so was the existing 'portfolio hedge' as per IAS 39.78(c)/.81A. Though by concept still a variant of a micro hedge, its accounting logic is somewhere in between a full macro hedge accounting solution and the conventional micro hedge accounting.

If entities rely on section F in the Implementation Guidance today they should, at first sight, be fine under IFRS 9 as well, since the IASB copied all the existing paragraphs from IAS 39 to IFRS 9, so the IGs that relate to this section today should equally be available in the future. Having said that, as we see it, an issue arises where entities apply an approach – whether cash flow or fair value hedge accounting – to portray what is being done in risk management, but where they cannot demonstrate the link to risk management practices in a way mandated by IFRS 9. As illustrated by the excerpts from IG.F.6.1 above, entities following that approach deliberate use a gross approach to map a net position, ie they are deliberately picking and choosing hedge relationships that are part of the overall net position, but not the only (few) items being hedged. For some, the IASB's decision taken at the January 2013 meeting to allow for proxy hedging might help (though it needs to be fleshed out in clearer terms, we suppose), for others it might not, and it is this latter group for which practice is indeed changing. However, that has nothing to do with whether you call this micro or macro hedging; rather, it is a techniques that the IASB concluded in its deliberations is no longer appropriate to be used henceforth.

Provided the IASB was willing to rethink its tentative decision in order not to change current practice for these entities twice in a relatively short timeframe, we believe that the best cause of action would be not to follow EFRAG's approach and change IAS 39 beyond the changes envisaged by the IASB, but to embed an exemption in IFRS 9 for entities following such a 'macro' technique. We would think the exemption to work such that these entities need not demonstrate the link to risk management in the way currently envisaged by IFRS 9 (but would nonetheless provide some sort of documentation and disclosure). We acknowledge that this alternative has the shortcoming of sacrificing a newly developed and widely praised principle for a subset of entities. However, we believe that the subset of entities which would be eligible to use the exemption would (a) be fairly confined and limited and (b) temporary in nature, as such exemption would expire as and when the IASB finalises its project on macro hedging. The advantages of going this route would be to retain IAS 39 only to a minimum and not as a quasi-alternative to IFRS 9. Further, from a technical perspective, we believe that changing IAS 39 to re-introduce the current model would require much more than just reinstating the Implementation Guidance. Implementation Guidance (IG) is non-mandatory guidance and, thus, non-authoritative by nature – which is why it is not endorsed in Europe. It is there to demonstrate the principles and requirements of the main body of the standard by identifying practice issues and applying the standard to them.