EFRAG

European Financial Reporting Advisory Group

11 March 2011

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam,

Re: Exposure Draft Hedge Accounting

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft on *Hedge Accounting* ('the ED') that the IASB issued on 9 December 2010. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission, on the endorsement of the definitive IFRS in the European Union and European Economic Area.

The hedge accounting model proposed in the ED provides a number of significant improvements that will make hedge accounting more accessible. EFRAG agrees with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of an entity's risk management activities. We believe that this approach has the benefit of being consistent with the role of the business model in the classification of financial instruments. However, the IASB should consider strengthening the objective of hedge accounting by explicitly stating that when an entity applies hedge accounting, the resulting financial reporting better reflects the economic effects of the risk management activities than would otherwise be the case.

Eligibility

The proposals remove a number of the restrictions to hedge accounting in IAS 39 *Financial Instruments: Recognition and Measurement.* In EFRAG's view, there are important improvements relating to assessing hedge effectiveness – the possibility to designate derivatives, risk components and net positions as hedged items, and the possibility to apply hedge accounting to components of non-financial items. These proposals make the hedge accounting model significantly more flexible and will help to increase the appropriate use of hedge accounting.

That said, we believe that certain remaining restrictions (which could otherwise create inconsistencies with risk management practices) should be lifted. These include the eligibility of:

(a) instruments at amortised cost as hedging instruments;

(b) non-contractually specified inflation risk as a hedged item;

(c) credit risk as a risk component;

(d) other risks not affecting profit or loss; and

(e) a benchmark component in hedging a debt instrument with a negative indexation to the benchmark (the sub-LIBOR issue).

In addition, we observe that entities may have valid risk management activities in place, that might not be represented under the proposed hedge accounting model, either because the economic hedging relationship does not meet the qualifying criteria for the application of hedge accounting or because the strategy is neither strictly a fair value hedge nor a cash flow hedge (for example, in float-to-float swaps and offsetting positions that lock in a net margin). The IASB should further consider how these risk management strategies could be represented in the financial reporting.

Hedging groups of items

While we believe the proposed general model for hedge accounting is a reasonable approach to hedging individual items, we are not able to comment more fully on the proposals relating to groups of items until we gain a better understanding of the Board's direction in respect of macro hedging. Given the importance of macro hedging, we believe that the IASB should not finalise a standard on the general hedge accounting model prior to developing a model for macro hedging. We present in Appendix C some issues that we believe the IASB should consider in developing the model for macro-hedging.

New concepts and definitions

The proposals introduce an approach to hedge accounting that significantly differs from the current requirements. The proposals bring in important new concepts and definitions that are not well understood by constituents in the way they are currently drafted. This creates considerable uncertainty around the operationality of the proposed new model. To address these concerns and to make the future standard more robust, we believe the IASB should consider:

(a) clarifying the drafting of the key concepts (for example the documentation of risk management objectives, rebalancing and their links with discontinuation) and definitions (for example, 'unbiased result' and 'minimise expected hedge ineffectiveness');

(b) making the redrafted proposals publicly available to constituents for comments; and

(c) testing the operationality of the proposals in practice.

The IASB has recently indicated that having June 2011 as an objective for the finalisation of a certain number of its active projects would not be met at the expense of the quality of the final requirements. We believe that the above steps are essential to make the new approach proposed by the IASB a full success and that they should not be sacrificed because of undue time pressure.

That said, in EFRAG's view, mandatory rebalancing and prohibition of voluntary discontinuation are the necessary conditions to support a hedge accounting framework that is designed to better represent the effects of an entity's risk management activities. Without such requirement and prohibition, the proposed hedge accounting model would provide undue flexibility in the measurement of financial instruments and this would be detrimental to the quality of financial reporting. However, we believe that the final standard should clearly state that applying hedge accounting does not trigger any limitation in the hedging strategies that an entity can implement to fulfil its risk management objective, including relying on natural hedges after having, for example, at an earlier stage applied a strategy based on the use of derivatives.

Furthermore, economic hedging and risk management activities are not straightforward. Reporting for these activities therefore has an inherent level of complexity. In EFRAG's view, the proposals have introduced new complexities, particularly in the rebalancing of hedge relationships. However, we believe that the benefit of the new approach outweigh the cost and complexity.

Disclosures

EFRAG believes that disclosures play a fundamental role in complementing financial information derived from the principles-based proposals in the ED. The proposals require application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the overall risk management strategies of an entity. We believe that the proposed disclosure objectives are appropriate, but have certain concerns about their prescriptive nature. In addition, we find it difficult to understand how the proposals would interact with the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*. We urge the IASB to consider these issues in finalising disclosures that would meet the objectives set out in the ED.

Assessing IFRS 9 as a whole

The IASB has split the revision of IAS 39 into a number of phases. However, considerable interdependencies exist among the phases of this project (particularly the amortised cost and impairment phase and macro hedging) and other projects that the IASB is concurrently working on (for example, insurance and financial statement presentation). Therefore, we believe that the IASB will need to consider the entire package of proposals before finalising the resulting standards. We would expect the IASB to review its conclusions regarding:

(a) the eligibility of embedded derivatives as hedging instruments; and

(b) the eligibility of equity instruments measured at fair value through other comprehensive income as hedged items.

If you wish to discuss our comments further, please do not hesitate to contact Katrien Schotte, Chiara Del Prete or me.

Yours sincerely,

Françoise Flores
EFRAG Chairman

Appendix A – Response to questions in the Exposure Draft

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of an entity's risk management activities.

The IASB should consider strengthening the objective by explicitly stating that, when an entity applies hedge accounting, the resulting financial reporting better reflects the economic effects of the risk management activities than would otherwise be the case.

We do not believe that hedge accounting should be restricted to risks that affect profit or loss only. We therefore urge the IASB to reconsider carefully why it is necessary to prohibit hedge accounting for items that affect other comprehensive income or equity as well.

1 EFRAG agrees with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of the entity's risk management activities. EFRAG believes that this objective helps to provide the basis for an approach to hedge accounting that allows a more transparent and consistent representation, in the primary financial statements and in the disclosures, of the extent and impact of the hedging activities on the economic performance of an entity.

2 As explained also in our response to Question 8 below, constituents have different views about the appropriate level of specificity of risk management objectives in hedging documentation. This has implications not only for the initial establishment of hedging relationships, but also for their continuance. For example, a subsequent transaction could give rise to a natural hedge and remove the requirement for the original hedging instrument. In these circumstances it is questionable (depending on how the risk management objectives were originally specified) whether or not the hedging relationship will cease to meet the risk management objectives and therefore be terminated. This is therefore another area where we believe the IASB should test the operationality of the proposed new model in practice.

3 The IASB should consider strengthening the objective of hedge accounting by explicitly stating that when an entity applies hedge accounting to its risk management activities, the resulting financial reporting better reflects the economic effects of the risk management activities than would otherwise be the case.

4 We agree with the proposed approach in the ED that hedge accounting should not be mandatory for all risk management activities of an entity and be based on voluntary designation of hedge relationships. We believe that it would not be meaningful or feasible to make hedge accounting mandatory, for the following reasons:

(a) an entity's risk management approach includes a large variety of strategies and actions, many of which are operational in nature and do not involve the use of financial instruments (for example, the insurance of risks, supply management and general terms of business);

(b) requiring an entity to identify all its risk management activities and to document at inception which of those qualify for hedge accounting would be challenging from an operational point of view.

5 The application of hedge accounting is an exception to the general recognition and measurement requirements. Therefore, it is necessary to have a disciplined designation process to avoid that it becomes an unrestricted accounting choice. EFRAG believes that for an entity to apply hedge accounting, it is necessary to have internal controls that enables it to explain how a designated hedge fits into it risk management strategy.

6 While we agree with the broad outline of the proposed objective, we do not believe that hedge accounting should be restricted to risks that affect profit or loss. We understand that the IASB decided not to permit the hedge accounting of risks that affect other comprehensive income, because it could result in reclassification of gains or losses from other comprehensive income to profit or loss. In our view, it is possible to engage in meaningful management of the risks that are reflected in other comprehensive income or equity. The following are examples of items that could be hedged in accordance with an entity's risk management: investments in equity instruments at fair value through other comprehensive income, pension obligations under defined benefit schemes, revaluation of emission rights under IAS 38 and foreign currency tax payments related to equity transactions. In particular, it is common to hedge equity investments measured at fair value through other comprehensive income. The gains or losses on the hedging instrument would be reflected in profit and loss, while the equity investments would be reflected in other comprehensive income. In our view, this does not accurately portray the effects of an entity's risk management activities. We believe the IASB should carefully reconsider why it is necessary to prohibit hedge accounting for such items.

7 In its Exposure Draft *Presentation of Items of Other Comprehensive Income – Proposed amendments to IAS 1*, the Board acknowledged that 'it has not set out a conceptual basis for how it determines whether an item should be presented in OCI'. In addition, the objective of the hedge accounting proposals is to align an entity's financial reporting closer to its risk management activities. Therefore, EFRAG believes that hedge accounting should not be limited only to items that affect profit or loss, until a proper debate is first had on the fundamental issues related to performance reporting, such as (a) the notion of performance, (b) the content of performance statement(s), including the principles that underpin comprehensive income, and (c) recycling.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible as hedging instruments. Furthermore, we also believe that non-derivative instruments other than those at fair value through profit or loss should be eligible as hedging instruments.

8 EFRAG welcomes the extension of the range of eligible hedging instruments to include non-derivative financial instruments, because it enables an entity to align its hedge accounting closer to its risk management objectives.

9 Considering the objective of hedge accounting, EFRAG thinks that the nature of the hedging instrument should be much less important than the achievement of the risk management objective. Therefore, EFRAG believes there is no conceptual basis for excluding as eligible hedging instruments any non-derivative financial instruments that

are not at fair value through profit or loss. The IASB understands that the practice of using non-derivative instruments that are not at fair value through profit or loss as hedging instruments may be limited. However, this should not be a reason for excluding these instruments in the absence of a strong conceptual argument.

10 We believe that the IASB should fully explore all avenues for improving hedge accounting. In particular, we believe that the Board should consider the possibility to further extend the range of eligible hedging instruments (for example, equity investments designated as at fair value through other comprehensive income, financial instruments at amortised cost, disaggregation of non-derivative hedging instruments into components other than foreign currency risk).

11 There appears to be an inconsistency between the objective of hedge accounting and the decision to extend the range of eligible hedging instruments to include non-derivative financial instruments measured at fair value through profit and loss. In particular, the designation at initial recognition of a financial instrument as at fair value through profit or loss is irrevocable. If such instruments would be designated as at fair value through profit or loss to serve as a hedging instrument, in accordance with an entity's risk management strategy, it would not be possible to revoke that election subsequently if that were to be in line with a change in that entity's risk management strategy. Conversely, it would not be possible to designate them as at fair value through profit or loss after initial recognition, even if that would be in line with an entity's risk management.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees that a synthetic exposure may be designated as a hedged item.

12 Entities may hedge risk exposures independently using different risk management strategies and different degrees of coverage for each type of risk. A hedged item may therefore consist of a combination of a derivative and a non-derivative instrument. EFRAG agrees with the decision to permit the designation of such a synthetic exposure as a hedged item.

13 We believe this change from IAS 39 will eliminate a significant unnecessary restriction, and should facilitate hedge accounting for entities that enter into transactions that give rise to a combination of different risks. We support this approach as it allows hedge accounting to be more closely aligned with actual risk management practices. However, we believe the proposals should clarify the accounting for derivative instruments that are designated as a hedged item because they are part of an aggregate exposure (i.e. would this affect measurement and/or presentation).

14 The ED retains the IAS 39 prohibition on designating net written options as hedging instruments. Under the proposals it is possible to designate an aggregate exposure that includes derivatives as a hedged item and this could include written options. In that case, it would be sensible to allow an entity to designate written options as hedged items, provided that the overall relationship does not result in a net written option. In this context, EFRAG encourages the IASB to clarify the guidance on determining whether a net written option exists and how they should be accounted for when they are part of an aggregate exposure.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG welcomes the proposal to allow the designation of a risk component as a hedged item if it is separately identifiable and measurable.

We question why non-contractually specified inflation cannot be designated as a component and urge the IASB to reconsider this issue.

We believe that the IASB should consider permitting hedging relationships to be designated when the effective interest rate of a financial instrument is below a benchmark interest rate (for example, sub-LIBOR)

15 EFRAG welcomes the decision to permit the designation of cash flows or fair values of an item attributable to a specific risk or risks as hedged items irrespective of the nature of the item being hedged. We believe that this will eliminate a significant issue for those companies that manage individual risk components separately and enables closer alignment of risk management practices to the accounting treatment.

16 However, we believe that the proposed guidance is not sufficient to ensure consistent application in practice. In particular, in situations where the risk components are implicit in the hedged item (for example, they are not contractually specified), it is not clear to what extent the risk components directly affect the total fair value or cash flows of the hedged item. For example, in the case of non-financial items, the physical presence of an ingredient (for example, rubber in rubber tyres) would not automatically mean that the prices of the ingredient and finished product are correlated. Therefore, EFRAG believes that the identification of individual risk components should reflect the underlying economics (i.e. individual risk components should not be arbitrary). In addition, it would be important to ensure that any ineffectiveness that is associated with the hedged component would not be included in the residual component (i.e. the portion of the entire non-financial item that is not being hedged) and hence would not be recognised. In conjunction with this, we believe that the IASB should consider whether additional guidance on the interpretation of 'separately identifiable' and 'reliably measurable' would be needed.

17 Paragraph B18 of the ED asserts that 'inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified'. We appreciate the difficulties that exist in identifying and measuring reliably non-contractual inflation components, and are aware of past IASB and IFRIC discussions on the topic. However, it is not clear to us why inflation components are unique to such an extent that the IASB should add a rule to a principles-based standard to prohibit specifically their designation as a hedged risk component (a similar remark is made in Question 15 regarding the eligibility of credit risk components as hedged items). In addition, it is not clear to us why paragraph B18 of the ED only applies to financial instruments, but not to non-financial instruments.

18 EFRAG believes that financial instruments with a rate of return that is below a benchmark interest rate (for example, LIBOR) are quite common (for example, sovereign debt) and will be even more common once the Basel III liquidity regulations come into force. From a risk management point of view, many entities hedge the

interest rate exposures related to these financial instruments using both individual hedges and macro hedges. Given the importance of these types of hedging transactions and in the light of the objective of the hedge accounting proposals, we believe that the IASB should consider permitting the designation of the benchmark interest rate component as a hedged item for financial instruments that have an effective interest rate which is below a benchmark interest rate (for example, LIBOR).

19 Furthermore, we understand that a similar issue exists regarding non-financial items that are priced by reference to a standard benchmark quality or location for the item plus or minus a difference due to the actual quality or location of the item.

Question 5

(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item.

20 EFRAG welcomes the decision to permit the designation of a layer component as hedged item. We believe that this will eliminate issues for those companies that manage layer components in their risk management strategies.

21 We note that it may be difficult to separate the effects of the fair value of a prepayment option that is affected by the changes in the hedged risk. However, we believe that the general hedge criteria in this phase of the project should apply – without exception – to any separately identifiable and reliably measurable risk component. Appendix C provides some further comments on macro-hedging of layer components.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

EFRAG's response

EFRAG welcomes the removal of the 80 to 125 per cent bright line test for assessing and measuring hedge effectiveness and the introduction of an objectives-based assessment.

We are concerned that the proposed guidance may create inconsistencies between risk management and accounting as explained in paragraph 26 below.

22 EFRAG welcomes the removal of the 80 to 125 per cent bright line test for assessing and measuring hedge effectiveness. It is a significant step towards introducing flexibility and abolishing unnecessarily restrictive requirements that currently discourage entities

from applying hedge accounting. The elimination of this requirement would simplify implementation of hedge accounting and align it more closely to an entity's risk management strategy.

23 During EFRAG's due process, our constituents expressed concerns about the way the new hedge effectiveness requirements are articulated:

(a) 'unbiased result' – constituents have expressed the concern that it is not uncommon for entities to enter into or continue with hedging relationships that are somewhat 'biased' because (1) they are a practical means to cost-effectively hedge the exposure; or (2) they remain within predefined sensitivity thresholds;

(b) 'minimise expected hedge ineffectiveness' – constituents are concerned that this might be interpreted in an overly rigid way as a rule that requires all hedge relationships to be highly effective (i.e. as strict as the 80-125 per cent effectiveness range).

We believe that the IASB should consider clarifying these definitions and making the redrafted definition publicly available to constituents for comments.

24 We also agree with the elimination of retrospective hedge effective testing. This should facilitate the application of hedge accounting, as it prevents de-designation in situations in which minor changes in price cause a hedge to be retrospectively ineffective.

25 In line with the purpose of defining designation criteria that are closely aligned to an entity's internal risk management strategy, we agree with the proposed method to assess effectiveness based on an entity's internal risk management strategy.

26 However, we are concerned about potential inconsistencies that the proposed guidance on the method of assessing effectiveness and measuring ineffectiveness may create. For example, it may be possible to demonstrate that a hedge will be 100 per cent effective at maturity. Nevertheless, if the hedged item and the hedging instrument are traded in markets with different degrees of liquidity then there may still be hedge ineffectiveness for accounting purposes during the life of the hedge. We believe that, in line with the objective for hedge accounting, the hedge ineffectiveness that is recognised in profit or loss should be determined in accordance with risk management practices.

27 We believe that the lack of a component approach for the hedging instrument contributes to the divergent views on hedge effectiveness. Therefore, EFRAG believes this requirement may cause a disconnection between the risk management view of hedge effectiveness and the accounting view. We believe that this introduces unnecessary complexity in hedge accounting and represents a departure from the objective to reflect an entity's internal risk management in its financial statements.

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees with the notion of 'rebalancing' hedging relationships, because this enables an entity to reflect in hedge accounting the changes in hedge ratio that it makes for risk management purposes.

The notion of rebalancing is not yet well understood and we therefore suggest that the IASB undertake the necessary field-testing to ensure that the proposals can be operationalised.

28 Hedge accounting requires the designation of a specific relationship between a hedged item and a hedging instrument – in line with its risk management activity. This in turn gives rise to the notion of a 'hedge ratio' (when there is not a simple one to one relationship between the hedging instrument and the hedged risk) because of the need to measure and report hedge ineffectiveness. EFRAG therefore agrees with the notion of 'rebalancing' hedge relationships, because this simply enables an entity to reflect changes that occur in that hedge ratio without discontinuing and restarting the hedge relationship. For that reason, we agree that rebalancing should be a requirement.

29 During our due process, however, we noted that the notion of rebalancing and its interaction with the notion of hedge discontinuation are not well understood by constituents. In particular, the relationship between risk management activities and the requirement to rebalance for hedge accounting purposes is unclear. For example, some constituents interpret the guidance on rebalancing as requiring them to adjust their hedge documentation or purchase additional derivatives, even if there are no changes in the underlying risk management strategy. It is for these reasons we believe that a number of constituents have called for rebalancing to be voluntary.

30 This is another area which illustrates that the proposals bring in important new concepts and definitions that are not well understood by constituents in the way they are currently drafted. This creates considerable uncertainty around the operationality of the proposed new model. To address these concerns and make the future standard more robust, we believe the IASB should consider:

(a) clarifying the drafting of the key concepts and definitions;

(b) making the redrafted proposals publicly available to constituents for comments; and

(c) testing the operationality of the proposals in practice.

31 In particular, we also believe that the rebalancing and discontinuation model as proposed requires a significant degree of judgement.:

(a) Economic strategies are adjusted frequently; it is not always straightforward to identify when the risk management objective has changed from hedging to trading.

(b) Understanding whether a new trend is emerging, or whether there are fluctuations around a long-term trend, requires judgement. This is particularly difficult when the time horizon under consideration is well into the future.

32 We acknowledge that this judgement is a necessary consequence of a more principles-based approach. Given the degree of judgement required in applying the guidance on rebalancing of hedge relationships, the IASB should consider whether users require additional disclosures to understand the circumstances leading to the rebalancing and the frequency, method and consequences of the rebalancing.

33 Finally, we would recommend that the requirement to recognise ineffectiveness before any rebalancing be moved from paragraph B47 of the ED to the body of the standard.

Question 8

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria.

EFRAG agrees that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy, and that continues to meet the qualifying criteria.

34 EFRAG agrees that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria. Consequently, we agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy, and that continues to meet the qualifying criteria.

35 EFRAG agrees with the introduction of rebalancing and partial discontinuation. We believe that rebalancing would help to achieve more flexible accounting requirements and would help to reflect better the developments of the entity's risk management activities in the financial statements. We understand, in particular, that the proposals permit avoiding discontinuation of hedge accounting when the entity intends to continue to use the same hedging instrument for managing the same underlying risk. However, in that case an entity needs to change the weightings of hedged item and hedging instrument to reflect the unexpected changes in the economic hedging relationship.

36 During our due process, we noted that constituents have different views about the appropriate level of specificity for risk management objectives in hedging documentation which has implications for how the model will be used:

(a) Constituents who believe that risk management objectives should be set at a more detailed level do not generally consider that voluntary de-designation of hedge relationships is necessary because changes in circumstances are likely to give rise to changes in the risk management objectives which would in any event result in discontinuation of hedge relationships.

(b) Other constituents who believe that risk management objectives are set at a relatively high level (i.e. in the context of overall asset liability management) are concerned that hedge relationships could only ever be discontinued following a change in an entity's overall risk management approach. Therefore, these constituents believe that without an option to discontinue hedge accounting the proposals in the ED are not operational.

37 As noted in our response to Question 1 above, we believe that the IASB should consider strengthening the objective of hedge accounting by explicitly stating that –

when an entity applies hedge accounting to its risk management activities – the resulting financial reporting better reflects the economic effects of the risk management activities than would otherwise be the case. For example, currently many entities designate cash flow hedges of the foreign exchange risk on forecasted transactions, but discontinue hedge accounting once the forecasted transaction results in a recognised receivable or payable. We believe that the Board should confirm that this will continue to be possible provided that this reflects the entity's underlying risk management objective.

38 In the response to Question 7 above, we have raised a number of concerns regarding the complexity, operationality, administrative burden and need for field-testing of the rebalancing/discontinuation proposals. In addition, we are concerned that the proposals may not be flexible enough to allow for the discontinuation in instances where external derivative instruments – acquired in accordance with a risk management strategy based on matching internal derivatives – continue to be held while the relationship between the hedged item and the internal hedging instrument ceases to exist. We believe that it is not clear whether this would constitute a change in risk management objective and therefore lead to discontinuation of the hedging relationship. It is important that the IASB clarify this in finalising the proposals.

Question 9

(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

EFRAG's response

EFRAG acknowledges that the proposed presentation of fair value hedges would show the effect of hedging transactions in a single place of the financial statements. However, we fail to see what additional information that this would provide to users of financial statements.

We believe that instead of requiring presentation on a gross and disaggregated basis in the statement of financial position, we would recommend that all fair value changes be aggregated into a single line item in the statement of financial position and to provide details in the notes.

EFRAG does not support linked presentation where gross assets and gross liabilities that are related by way of a fair value hedge are presented together on the same side of the statement of financial position.

39 EFRAG believes the IASB was right in abandoning its original proposal to replace the fair value hedge accounting mechanics with the cash flow hedge mechanics for the same reasons as those stated in paragraph BC120 of the ED.

40 EFRAG acknowledges that the transfer via other comprehensive income would show all information on hedge (in)effectiveness in a single place on the face of the financial statements. However, EFRAG believes that the introduction of the two-step approach would not have additional information value:

(a) We believe there is no principle for supporting the first step (i.e. recognising the gains or losses on the hedged item and the hedging instrument in other comprehensive income).

(b) The second step would immediately transfer any ineffectiveness from other comprehensive income to profit or loss thus ultimately reporting all ineffectiveness in profit or loss. This is not a change from IAS 39, which already requires ineffectiveness to be reported in profit or loss.

41 We believe that retaining the IAS 39 presentation, (i.e., reporting all effects in profit or loss) is preferable to the proposal in the ED because:

(a) The additional step would only create operational complexity for preparers without adding value to the information for the users;

(b) The three proposed line items in other comprehensive income (change in fair value of the hedged item, change in fair value of the hedging instrument and ineffectiveness transferred to profit or loss) would reflect an aggregation of different types of hedging strategies and hedging transactions that would inevitably have different degrees of effectiveness;

(c) The net amounts are at a level of aggregation that prevents users from assessing the effectiveness of an entity's risk management strategy; and

(d) The face of the primary financial statements is not the best place to explain complex hedging strategies involving a large number of underlying items.

42 EFRAG agrees with the proposal not to adjust the hedged item for the gain or loss associated with the risk being hedged. We believe this change to the fair value hedge accounting mechanics would avoid using a measurement attribute that is neither amortised cost nor fair value (i.e. an amortised cost adjusted with a fair value adjustment for the risk that is being hedged). The proposed change will lead to a more transparent presentation of the hedged item on the face of the statement of financial position that is easier to understand for users of the financial statements.

43 We acknowledge that the presentation of that valuation adjustment as a separate line item in the statement of financial position, adjacent to the line item that includes the hedged asset or liability, would increase the information provided on the face of the statement of financial position. However, the clarity and usefulness of this information would decrease the more hedge accounting an entity uses. We consider that when an entity applies hedge accounting to a wide range of different assets and liabilities, the new presentation requirements may substantially increase the number of line items presented on the face of the statement of financial position. In addition, the effect of presenting the hedging gain or loss on a separate line item adjacent to the hedged statement of financial position item will to a certain extent be negated by the effect of aggregating individual hedges, even when those hedges are straightforward. Finally, where an entity is hedging a net position of assets and liabilities the split presentation of the adjustment on both sides of the statement of financial position will be rather artificial and will not be representative of the risk management approach to hedging. Users will not be able to distinguish between hedging gains and losses resulting from single hedges and hedges of closed groups of assets and liabilities unless these would be shown in further line items, which could further increase the number of line items on the statement of financial position.

44 Therefore, we would suggest to aggregate all fair value hedge adjustments of the hedged items into a single net amount that would be reported on the face of the statement of financial position (on the asset side in case of a debit balance and on the liabilities side in case of a credit balance). The net amount should be disaggregated in the disclosures at a level that would allow users to identify the hedged items and the associated gains or losses related to those items.

45 EFRAG agrees that linked presentation is not an appropriate tool to report on the link that the entity's risk management strategy establishes through hedge accounting between different assets and liabilities. We believe that the risk management strategy of an entity should be explained in the notes to the financial statements. Showing linkage on the face of the statement of financial position would create confusion and impair comparability between entities. Considering the risk management practices in some industries, to manage risks on a portfolio basis using dynamic hedging strategies, EFRAG thinks it would be difficult to achieve linked presentation in practice without affecting the comparability of financial information for the entity across different reporting periods.

Question 10

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG welcomes the proposals, which address the issue of ineffectiveness due to the time value component in options and provide a solution to an important practical issue.

The Board should consider a single approach for the reclassification from other comprehensive income to profit or loss of the time value component accumulated in other comprehensive income. EFRAG believes that an allocation over the relevant period on a rational basis would be the most appropriate method.

46 We welcome these proposals, which address the issue of ineffectiveness due to the time value component in options and provide a solution to an important practical issue.

47 We acknowledge that these proposals have the potential to introduce additional complexity. Nevertheless, we consider that the proposals achieve a reasonable trade off between the added complexity and the benefits of solving this issue, from a practical perspective.

48 In order to limit the complexity, we believe that the Board should select a single approach for the reclassification to profit or loss of the time value component accumulated in equity (see paragraph 33 of the ED). EFRAG believes that an allocation over the relevant period on a rational basis would be the most appropriate method. Moreover, the option to reclassify the amount directly out of equity without affecting other comprehensive income creates a new category of transactions in the statement of equity that does not represent a transaction with the owners (see also paragraph 73 of Appendix B). In addition, this approach could result in double counting of the same gain (or loss) in other comprehensive income and profit or loss, because the reclassification directly out of equity would not result in a reversal of other comprehensive income.

49 It is not clear to EFRAG how the notion of 'aligned time value' differs from that of the 'time value of a hypothetical derivative'. If the two concepts are the same then we would recommend that the Board use the latter, as it is already accepted in practice.

50 Finally, we believe that the IASB should clarify the accounting treatment to be applied to the interest element of a forward contract, if the entity designates as the hedging instrument only the change in the spot element of a forward contract and not the interest element.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG will not be able to comment on these proposals in full until we gain a better understanding of the Board's direction in respect of macro hedging.

It is not immediately evident from the ED, what the underlying principle is for the treatment of groups of items. We believe that further outreach and field-testing should be undertaken to avoid replacing one set of complex, rules-based, requirements with another.

51 We understand that these proposals represent an intermediate step towards the development of an accounting model for hedges of open portfolios (i.e. macro hedges). However, until we gain a better understanding of the Board's direction in respect of macro hedging, we will not be able to comment on these proposals in full.

52 We observe that some restrictions will be maintained in the general hedging model for closed groups of hedged items and the rationale for these restrictions it is not always clear.

(a) We note that all individual items in a group need to meet the eligibility criteria in order to be collectively designated as hedged items. For a group that represents a net position, the corresponding gross amounts need to be identified as well. We have concerns about the possible internal inconsistencies in this approach as it tries to give prominence to the risk management approach but continues to pursue an accounting approach based on individual items.

(b) The Board concluded that permitting designation of cash flows that occur in different periods would be inconsistent with the general hedge accounting requirements; therefore, cash flow hedge accounting of net positions is only permitted if the corresponding cash flows offset in the same reporting period. We believe that this issue has not been explored sufficiently and this may preclude hedge accounting for perfectly valid risk management strategies and seems to penalise entities that report on a quarterly basis. If the Board were to retain this requirement, we believe that the underlying reasoning should be better explained.

53 We understand that in its deliberations the Board considered a series of practical examples from a number of industries. However, it is not always immediately evident what the principle underlying the resulting changes in the hedge accounting model is. We believe that further outreach and field-testing should be undertaken. Otherwise, the Board risks replacing one set of complex, rules-based, requirements with another.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees with the proposals regarding the presentation in profit or loss of the effects of hedge accounting for groups of items.

EFRAG disagrees with the way gains or losses from fair value hedges of net positions are proposed to be presented.

54 We agree with the proposals regarding the presentation in profit or loss of the effects of hedge accounting for group of items. In particular, we agree with the proposal to present on a net basis in a separate line item in profit or loss, the gains or losses from the hedging instrument, when it is designated in a hedging relationship of a net position of offsetting items that affect different lines of that statement. This would avoid artificial grossing up of gains or losses.

55 However, we are concerned about the proposals in the ED in relation to the presentation in the statement of financial position of the effects of fair value hedge accounting for group of items. In particular, when an entity designates as a hedged item a group of items (including a net position) in a fair value hedge, the cumulative change in fair value of the hedged risk from each of the items is required to be presented on a gross basis adjacent to the related assets and liabilities in a separate line item. We believe that this would result in artificial grossing up of assets and liabilities.

56 Finally, as explained above in our response to Question 9, we recommend that all fair value changes be aggregated into a single line item in the statement of financial position and to provide details in the notes. We consider that where an entity is hedging a net position, the split presentation of the adjustment of the assets and liabilities would be rather artificial and not represent the risk management approach to hedging.

Question 13

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

EFRAG's response

EFRAG supports the categories of disclosures proposed in the ED. We believe that disclosures play a fundamental role in providing users with an understanding of an entity's risk management strategy and hedging activities.

We are concerned about the prescriptive nature of the disclosure requirements and the interaction with the disclosure requirements of IFRS 7.

57 EFRAG believes that disclosures play a fundamental role in complementing financial information derived from the principles-based proposals in the ED. The proposals require application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the overall risk management strategies. Disclosures should also allow users to understand the overall risk management approach of the entity, the results of both the hedged and un-hedged positions and in particular to gain a better insight into the exposures to which an entity could have applied hedge accounting but elected not to do so and why it elected not to do so.

58 We believe that the proposed disclosure objectives aim to achieve this. EFRAG supports the categories of disclosures proposed in the ED. We agree that these categories provide an insight into an entity's hedging activities and the effect of those activities on the performance of the entity.

59 Having said that, we are concerned about the prescriptive nature of the wording and in particular the use of words such as 'shall' as opposed to 'may or may not' in paragraph 44 and others. In our view, this may result in a checklist approach and entities providing boilerplate disclosures rather than meeting the disclosure objectives in the most information-rich way. We believe that a more judgemental approach to the disclosures may allay some of the concerns regarding commercial sensitivity of information that have been raised by constituents. Furthermore, we find it difficult to understand how the proposals would interact with the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*. We urge the IASB to consider these issues in finalising disclosures that would meet the objectives set out in the ED.

60 In addition, we would urge the IASB to review carefully the existing disclosure requirements regarding financial instruments to ensure that there is an appropriate cost-benefit trade-off. In this context, we note that, where possible, the IASB should consider disclosures already required by prudential regulators.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG agrees that the proposals are a step in the right direction, but urge the IASB to investigate this issue further in finalising the proposals.

61 EFRAG supports the proposals in the ED regarding the 'own use' scope exception subject to disclosures that would clarify the accounting treatment applied by an entity. We believe that the proposals will solve a practical issue for those IFRS appliers that adopt a risk management strategy that is based on fair value. Furthermore, we find that the proposals will result in useful information by allowing entities to better reflect their activities. In our view, this will better serve users of financial statements.

62 However, we note that these proposals do not address all concerns of our constituents. In particular, entities that process or refine commodities often manage the price risk on their entire flow of goods on a fair value basis (for example, oil refineries that manage their purchase and sale contracts as well as their physical inventory at fair value). However, even under these proposals they will not be able to apply fair value accounting to their physical inventory, as they are neither producers of commodities nor broker-dealers as required by IAS 2. Rather than addressing these concerns on a standard-by-standard basis, we believe that the IASB should take a more holistic approach to the underlying concerns and address these as part of a separate project.

Question 15

(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?

(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

EFRAG's response

EFRAG believes that, where the hedged item is credit risk, there is not any inherent reason to prevent hedge accounting per se and hedge accounting should be permitted provided that the hedging relationship meets the general requirements for qualification and is consistent with the risk management activities.

We acknowledge this may be difficult to achieve in practice. Therefore, we support the IASB in its efforts to investigate further the development of the proposed accounting alternatives.

63 EFRAG believes that, considering the objective of the hedge accounting (i.e. to represent the effect of an entity's risk management activities), the requirements should provide entities with the tools to capture their risk management practices in the financial statements. However, we understand that under these proposals it would be difficult for credit derivatives to qualify as hedging instruments.

64 The IASB argues that the spread between the risk-free and market interest rate incorporates components other than credit risk (i.e. liquidity, funding and any other unidentified risk component). In the IASB's view, this makes it operationally difficult (if not impossible) to isolate and measure the change in fair value attributable to the credit risk and therefore to meet the criteria for designation.

65 Financial institutions normally measure at fair value through profit or loss those credit derivatives for which it is difficult to achieve hedge accounting, due to the ineffectiveness arising from the different terms between the hedging instrument and the hedged item (for example, when the derivatives only provides protection for changes in credit rating of the entity and not on default events specific to the hedged debt instrument). However, where the hedging derivative provides protection specifically from default events of the hedged debt instrument, it is in theory possible to achieve hedge accounting under existing IAS 39 and under the proposals in the ED. In this context we would like to draw attention to the fact that the guidance in IFRS 7 and IFRS 9 already requires that the credit risk component of own debt to be separately accounted for and disclosed. We believe it is inconsistent to require separation of credit risk under these standards, but preclude its use for hedge accounting purposes.

66 As EFRAG has stated in its response to Question 4, we believe the IASB should develop a principles-based standard without adding rules to outlaw specific components. Therefore, EFRAG believes that, where the hedged item is credit risk, there is not any inherent obstacle to achieving hedge accounting per-se and hedge accounting should be permitted provided that the hedging relationship meets the general requirements for qualification and is consistent with the risk management activities. We acknowledge this may be difficult to achieve in practice. Hence, where entities fail to meet the qualifying criteria for hedge accounting, they should have access to an alternative for hedge accounting. We support the IASB in its efforts to investigate further the development of the proposed accounting alternatives.

67 Some constituents pointed out that the three alternative models suggested in the Basis for Conclusions are different formulations of the fair value option and would result in added volatility in profit or loss that is not always representative of the risk management strategy applied. We note that during the EFRAG-IASB *Discussion Forum on Financial Instruments* on 28 February 2011, constituents suggested several other alternatives that the Board may want to consider. These alternatives have been communicated to the IASB staff and are included in our feedback report that is available on our website.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

EFRAG's response

EFRAG supports an effective date of 1 January 2015 for all phases of IFRS 9 and the other major projects currently under the consideration of the IASB.

EFRAG supports prospective application of the proposals.

68 EFRAG supported the proposals regarding effective dates and transition in earlier phases of the consultation on the replacement of IAS 39, with the exception of the proposals relating to the fair value option for financial liabilities. In that instance, EFRAG supported the amendment of IAS 39 because the proposals represented a solution to an existing problem that could easily be implemented as a short-term improvement.

69 However, in its draft comment letter on the IASB's Request for Views on *Effective Dates and Transition Methods*, EFRAG suggested that the standards resulting from the

projects on Revenue from Contracts with Customers, Leases, Insurance Contracts, Financial Instruments (IFRS 9) and Fair Value Measurement should have a single effective date of 1 January 2015 at the earliest.

70 Providing different effective dates and early adoption requirements for first-time adopters might be considered for purely pragmatic reasons (i.e. first-time adopters would not have to adopt standards that are about to be abolished). However, this should not result in a mandatory acceleration of effective dates for existing IFRS reporters.

71 EFRAG generally supports retrospective application, as retrospective application facilitates comparability between periods. However, in this case EFRAG agrees with the IASB that prospective application is appropriate because:

(a) it would be very difficult to apply the provisions retrospectively without the application of hindsight; and

(b) entities would in many instances find it difficult to provide the necessary documentation to support the hedging relationships (for example, they would be required to compile and assess historic market data to determine effectiveness).

72 EFRAG agrees that the alternative approach that grandfathers the accounting under IAS 39 is inappropriate. We also agree that no changes to IFRS 1 are necessary.

Appendix B – Other issues

Mandatory basis adjustment and reclassification directly out of equity

73 The Board is proposing to require a basis adjustment in accounting for cash flow hedges and to eliminate the alternative treatment that leaves the gain or loss on the hedging transaction in other comprehensive income. While we generally agree with the elimination of accounting policy choices, we disagree with the Board's proposal in respect of the basis adjustment. In particular, we disagree with the proposal to reclassify directly from equity instead of recycling through other comprehensive income as this introduces a new class of transactions in the statement of equity that is not a transaction with the owners.

Risk management transactions that lock in a net margin

74 EFRAG observes that risk management strategies, which use a combination of financial assets, financial liabilities and derivatives, that result in a locked-in net margin are frequently used in the banking industry. However, it is not possible to apply hedge accounting to the natural offsetting of the cash flows of the combined financial asset, financial liability and the swap, because strictly this would be neither a fair value hedge nor a cash flow hedge. The IASB should further consider how these risk management strategies could be represented in the financial reporting.

Internal derivatives

75 We agree that internal derivatives are not eligible hedging instruments in the consolidated financial statements of a group because they are not transactions with external parties.

76 In paragraph BC42 of the ED, the Board noted 'that the eligibility of internal derivatives as hedging instruments is not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge is how to make hedge accounting operational for groups of items and net positions'. Many institutions use internal derivatives in the practical implementation of their risk management strategies. We therefore believe that the Board should give further consideration as to how internal derivatives might be incorporated more effectively into the hedging model, perhaps through appropriate designation of portfolios of external derivatives as hedged items.

Appendix C – Macro hedging

77 In this letter we mainly comment on the proposals for the general hedging model of single items and closed portfolios. However, EFRAG believes that some issues that have been addressed by the ED should be considered further by the IASB in its deliberations on the forthcoming hedging model for open portfolios. Furthermore, we believe that it is important that the basic principles should be consistent and hence the general hedge accounting requirements should be not finalised before hedge accounting of open portfolios has been properly developed.

Layer components as hedged items and core deposits

78 In relation to the designation of a layer component as a hedged item, we noted in our response to Question 5 that it may be difficult to separate the effects of the fair value of a prepayment option that is affected by changes in the hedged risk. However, we further note that banking entities often have modelling techniques for prepayment risk that have proven sufficiently reliable to be incorporated into fair value estimates.

79 Similarly, in the case of core deposits modelling techniques are used to take into account the expected behaviour of certain hedged items without a predefined maturity.

80 While this is ultimately an issue that needs to be resolved in the context of the macro-hedging phase of the hedging project, we believe that the general hedge criteria in this phase of the project should apply – without exception – to any separately identifiable and reliably measurable risk component.

Sub-LIBOR

81 As noted in paragraph 18, many entities hedge the interest rate exposures related to these financial instruments using both individual hedges and macro hedges. Given the importance of these types of hedging transactions and in the light of the objective of the hedge accounting proposals, we believe that the IASB should consider this issue in the project on macro hedging.