European Financial Reporting Advisory Group

**Review Draft IFRS 9 General hedge accounting**

**Request to allow hedge accounting to comply with either IAS 39 or IFRS 9 while the macro hedging project is developed**

# Feedback to constituents

**July 2013**

## Summary of contents

# Introduction

## Objective of this feedback statement

On 18 January 2013, EFRAG issued its letter to the IASB commenting on the IFRS 9 Hedge Accounting Review Draft. EFRAG's comments reflected the results of the field test carried out by EFRAG in partnership with the ANC, ASCG, FRC and OIC. The letter provided an overview of the implementation difficulties, including fatal flaws and requests for additional guidance. In addition, it provided input to the IASB's effect analysis.

As part of the findings of the field test, many constituents reported that it was unclear to them whether the requirements in the Review Draft would change the way they dealt with macro hedge relationships. In order to address these concerns, EFRAG organised further outreach. The results of these outreach activities were assessed together with the text of the Review Draft.

On 22 March 2013, EFRAG published its request to the IASB regarding macro hedging practices, which analysed the impact on current macro hedging practices of the transition between IAS 39 and the Review Draft and the consequences of the IASB's separation of its project on macro hedging for open portfolios from the general hedge accounting requirements.

This feedback statement summarises the work performed by EFRAG regarding:

- The field test of the Review Draft; and
- The consultation on macro hedging practices.

Furthermore, it explains how the input received in the field test and the comment letters received were considered by the EFRAG Technical Expert Group (EFRAG TEG) during its technical discussions, and, where applicable, the justification for EFRAG's final position.

## Background to the field test of the Review Draft

In September 2012, the IASB published the Review Draft Hedge accounting, the requirements of which will be added to IFRS 9 *Financial Instruments*.

An Exposure Draft is the IASB's main vehicle for consulting the public and therefore includes an invitation to comment. A Review Draft has a limited purpose. It is an editorial 'fatal flaw' review in which reviewers are asked for feedback on whether the draft document is clear and reflects the technical decisions made by the IASB. A draft for editorial review does not include an invitation to comment because the purpose of such a review is not to debate again the technical merits of the IASB's decisions.

EFRAG organised a field test of the Review Draft with four national standard setters to uncover any fatal flaws and to test the proposals with actual transactions, which was carried out from September to November 2012.

Based on the responses to the field test, EFRAG staff prepared an analysis of the issues identified, which served as the basis for EFRAG's letter to the IASB on 18 January 2013. EFRAG discussed the findings from the field test in its meetings on 13 December 2012, 20 December 2012 and 17 January 2013.

## Background to the comment letter on macro hedging

One of the findings from the field test was that there existed significant uncertainty about the degree to which it would be possible to maintain the 'status quo' with respect to the application of the IAS 39 requirements on macro hedging – including macro cash-flow hedging – until the IASB completes its now separate project on macro hedging.

Based on its technical discussions in December 2012 and January 2013, EFRAG concluded initially that in order for the IASB to achieve its goal of maintaining a status quo for macro-hedging, it would need to modify the wording of paragraph 71 of IAS 39 to allow a broader range of hedges to be accounted for under what remained of IAS 39. Related implementation guidance should be maintained accordingly.

On 22 January 2013, EFRAG published its Draft Comment Letter and asked constituents for comments by 21 February, to complete its recommendations to the IASB in March.

EFRAG discussed the comments received to this draft letter in its meeting on 27 February 2013. Based on this discussion the draft comment letter was amended to propose an accounting policy option for hedge accounting. In its conference call on 12 March 2013, EFRAG was made aware that whilst is preliminary views had been widely supported, the decision it had reached was considered by some national standard setters and constituents as unduly restrictive. It therefore decided to allow for another round of consultation.

The respondents to the February consultation were asked the following targeted questions:

a) Are there some of your hedging activities that can be clearly defined to which you believe IFRS 9 should apply (so as to benefit from an improved hedge accounting model)? If so which are these?

b) If you believe they can be easily defined, please provide the accounting policy description you would provide in your annual report, to indicate to what hedging activities you apply IFRS 9 and those to which you apply IAS 39.

Based on the input received in those additional due process steps, EFRAG approved its letter to the IASB in its conference call on 21 March 2013. On 22 March 2013, EFRAG published its request to the IASB regarding macro hedging.

To view information related to this project, please access EFRAG's project webpage on the Review Draft Hedge accounting by clicking here.

# Feedback Statement

## Participation in the field test of the Review Draft

Forty-four (44) companies participated in the field test. The following table provides an overview of the respondents by type and country.

| *Respondent by type* | | *Respondent by country* | |
|---|---|---|---|
| Banks | 16 | Austria | 1 |
| Basic materials | 1 | Denmark | 1 |
| Consumer goods | 4 | France | 13 |
| Consumer services | 1 | Germany | 15 |
| Healthcare | 2 | Italy | 5 |
| Industrials | 8 | Luxembourg | 1 |
| Insurance companies | 2 | Norway | 1 |
| Oil and gas | 1 | Spain | 2 |
| Technology | 3 | Sweden | 1 |
| Utilities | 6 | United Kingdom | 4 |
| | 44 | | 44 |

The names of all contributors contacted are listed at the end of this document, unless constituents explicitly asked that their names not be disclosed.

## Participation in the consultation on macro hedging

Twenty eight (28) respondents participated. The following table provides an overview of the respondents by type and country.

| *Respondent by type* | | *Respondent by country* | |
|---|---|---|---|
| Accounting firms | 4 | Austria | 1 |
| Associations-Organisations | 5 | Belgium | 6 |
| Banks | 12 | France | 8 |
| Energy | 1 | Germany | 4 |
| Regulators | 1 | International | 5 |
| Service providers | 1 | Italy | 2 |
| Standard-setters | 4 | Sweden | 1 |
| | | Switzerland | 1 |
| | 28 | | 28 |

This feedback statement reflects the comments received coming from 28 separate organisations:

(a) ten comments letters received on a timely basis;
(b) seventeen telephone calls with constituents (including some constituents who provided a comment letter as well); and
(c) input received from four members of EFRAG's Insurance Accounting and Financial Instruments Accounting working groups.

The names of all contributors contacted are listed at the end of this document, unless constituents explicitly asked that their names not be disclosed.

**Input from EFRAG working groups and regulators**

In dealing with the project, EFRAG received the invaluable advice of the EFRAG Financial Instruments Working Group, the EFRAG Insurance Accounting Working Group and the EFRAG User Panel.

Finally EFRAG reached out to a number of regulators from the banking and insurance industries to take into account their perspective in the finalisation of its position.

# A. Field test on the Review Draft

## Constituents' comments from the field test

*Constituents' comments*

The constituents in the field-test confirmed that the Review Draft introduces important improvements in the hedge accounting requirements such as: (a) improvements in the hedge effectiveness testing requirements; (b) the treatment of the time value of options and the treatment of forward points; (c) the possibility to designate aggregated exposures as eligible hedged item; (d) the ability to designate risk components as eligible hedged item; and (e) the ability to rebalance hedge relationships.

Constituents identified the following fatal flaws:

a) Aggregated exposures and net positions: Paragraph 6.6.6 of the Review Draft relating to net position used 'risk' in the singular while paragraph B6.3.3 of the Review Draft relating to aggregating exposures referred to 'risks' in plural. Constituents believed that the IASB should clarify in the final standard that a net position could consist of several risks that on a net basis add up to a nil position.

b) Hedge ratio and effectiveness: Paragraph 6.4.1 (c) (iii) of the Review Draft defining the hedge ratio assumed that there was always a clearly identified direct relationship between hedged items and hedging instruments. However for banks and energy companies that manage high volumes of financial instruments this was deemed very difficult to achieve. Additionally, the interaction between the hedge ratio and its potential rebalancing was not clear to constituents (paragraphs 6.4.1 (c) (iii) and 6.5.5 of the Review Draft).

c) Open and closed portfolios: Some constituents questioned whether reference in the Review Draft to a group of items (as a hedged item) was meant as a reference to a closed portfolio or not. They noted that paragraph 6.6.6. of the Review Draft which stated that 'the hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity', was more akin to an open portfolio.

## EFRAG's response to constituents' comments

EFRAG agreed that the Review Draft introduced significant improvements in the hedge accounting requirements compared to IAS 39. The objective of reflecting the effect of an entity's risk management activities in the financial statements was generally supported.

*Fatal flaws*

EFRAG acknowledged that paragraph 6.6.6 of the Review Draft relating to net position used 'risk in the singular while paragraph B6.3.3. of the Review Draft relating to aggregating exposures referred to 'risks' in plural and agreed this was a fatal flaw. Consequently EFRAG asked the IASB to address this point when finalising the standard. EFRAG also acknowledged the issue related to the hedge ratio as a fatal flaw but noted additionally that some of the practices used in high volume hedge accounting were close to macro hedge accounting. Consequently, EFRAG asked the IASB to consider the feedback received from constituents in its work on the macro hedging project and take into account potential inconsistencies between the two projects.

*Other issues*

EFRAG disagreed that the issue relating to open and closed portfolios was a fatal flaw as paragraph IN8(c) of the Review Draft clearly stated that 'The Board did not address specific accounting for open portfolios or macro hedging as part of the general hedge accounting requirements in IFRS 9.' Even when the issue could not be qualified as a fatal flaw, EFRAG acknowledged it as a point needing further clarification. The confusion which hedging requirements were

### Constituents' comments from the field test

One constituent raised several application issues with regard to the use of open portfolios under the Review Draft. Additional guidance was requested to the IASB by constituents.

d) Macro-hedging: constituents were concerned whether the exception in paragraphs 81A, 89A and AG114-AG132 of IAS 39 would continue to apply under the requirements of the Review Draft. Also, it was not clear to them whether all other hedge requirements of IAS 39 would also continue to apply to these hedges. Additionally, it was unclear whether the Review Draft permitted hedge accounting strategies described in Section F of the Implementation Guidance of IAS 39. Finally, it was questioned whether macro cash flow hedges were to be addressed in the macro hedging project of the IASB.

Other inputs received during the field-test included various detailed implementation issues. Some constituents reported implementation difficulties on the treatment of basis risk in cross currency interest rate swaps; the accounting treatment for time value of options and forward elements for forward contracts and the own use exception. Constituents pointed out areas where the Review Draft did not allow accounting for some hedging strategies such as hedging credit risk or using sub-LIBOR hedges. Constituents also noted that hedges of foreign currency risk were to be accounted differently from hedges of commodities. Additionally, constituents were concerned about the commercial sensitivity of some of the information that would need to be disclosed.

### EFRAG's response to constituents' comments

applicable to open portfolios of hedged items on the one hand and closed portfolios of hedged items on the other hand might lead to inconsistent accounting for portfolios of hedged items. Therefore EFRAG urged the IASB to clarify in a more detailed way the appropriate treatment for open and closed portfolios of hedged items.

Additionally, EFRAG asked the IASB to clarify in the effects analysis to the final standard why the application issues with regard to the use of open portfolios could not be addressed in the Review Draft.

EFRAG disagreed that the treatment of macro-hedging was a fatal flaw as paragraph IN8(c) of the Review Draft clearly stated that 'The Board did not address specific accounting for open portfolios or macro hedging as part of the general hedge accounting requirements in IFRS 9.' Nevertheless, before taking a final position on the issue, EFRAG decided to do a more detailed analysis and to report on the outcome to the IASB. EFRAG announced this work stream in its letter to the IASB of 17 January 2013. The outcome of this analysis is discussed in part B of this feedback statement.

To address constituent's concerns, EFRAG asked the IASB for further clarification on the treatment of basis risk in cross currency interest rate swaps, the accounting treatment for time value of options, forward elements for forward contracts and the own use exception.

In those cases where the Review Draft did not allow the accounting for some hedging strategies, EFRAG requested the IASB to clarify in the effects analysis the reasons why.

On the hedging of credit risk, EFRAG noted that the pricing in credit derivative markets and cash markets were not always strongly correlated, consequently it could be questioned whether the elective fair value option was the appropriate accounting method to address credit risk.

EFRAG also observed that negative yields had become more common and thus questioned the continuing restriction on sub-LIBOR hedging. EFRAG requested the IASB to explain more fully the

| Constituents' comments from the field test | EFRAG's response to constituents' comments |
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| | underlying reasoning for not allowing hedging of other types of risks in the same way as foreign currency risk as EFRAG agreed with constituents that the justification of the application of a different accounting treatment compared to commodities was not sufficiently well explained.<br><br>On the disclosure requirements EFRAG noted that these add to the operational complexity of the requirements and, as the information required is not for all companies already internally available in the accounting systems, it was necessary to allow a sufficient implementation period for companies. |
| Constituents also had concerns about the drafting of the Review Draft, the balance between standard and application guidance, and the intelligibility of the hedge accounting standard as a standalone document. | EFRAG has requested the IASB to clarify the wording of the standard, so it can be understood by accountants who are not necessarily financial instruments specialists. EFRAG asked the IASB to investigate any fatal flaws between the different parts of IFRS 9 as well as consequential amendments to other IFRSs. Finally, EFRAG requested that the standard be made more accessible for non-financial companies. |

# B. Consultation on macro hedging

### EFRAG's tentative views expressed in the draft comment letter and constituents' comments

*EFRAG's tentative position*

EFRAG noted that paragraph BC6.12 of the Review Draft stated that the IASB decided '…not to address open portfolios or 'macro' hedging (i.e. hedging at the level that aggregates portfolios) as part of the exposure draft'. Also, paragraph BC6.15 of the Review Draft stated '…that during the project on accounting for macro hedging the status quo of 'macro' hedge accounting under previous IFRSs would broadly be maintained so that entities would not be worse off in the meantime'.

EFRAG noted that the revised wording of paragraph 71 of IAS 39 did not allow the IASB to achieve the goal of maintaining the status quo for macro hedge accounting. EFRAG supported that goal but was concerned that the IASB decision to make the general hedge accounting requirements effective before it completed its work on macro hedging of open portfolios could result in piecemeal changes to current macro hedge accounting practices (cash flow and fair value hedge accounting).

To avoid such piecemeal changes, EFRAG noted that the IASB would need to modify the wording of paragraph 71 of IAS 39 to allow current hedge accounting requirements for open portfolios to be maintained under what remained of IAS 39. Accordingly, the related Implementation Guidance in section F Hedging directly relevant to macro hedging was to be maintained.

*Constituents' comments*

One National Standard Setter asked that EFRAG's draft recommendation was to be reconsidered as IAS 39 never contained any macro hedging concept and the issue could thus not be resolved by EFRAG's tentative recommendation. Instead IAS 39 used a transaction-based approach. As such, the IASB could not take anything away from its constituents. The authority of the IAS 39 Implementation Guidance had been exaggerated since it is non-authoritative and non-mandatory

### EFRAG's response to constituents' comments

EFRAG agreed to the comment that IAS 39 never contained any 'macro' hedge accounting references and consequently agreed that it could not maintain its tentative position.

The comments received strengthened EFRAG in its position to request a status quo for hedging practices described as macro hedging practices. Yet EFRAG agreed that carrying over the requirements of IAS 39 would not bring relief insofar these were consistent with IFRS 9 and where the requirements of IAS 39 were inconsistent with IFRS 9, it would not be possible to incorporate them. EFRAG also noted constituent's support for the IFRS 9 objective of reflecting the effect of an entity's risk management activities in the financial statements of an entity.

EFRAG thus abandoned its tentative position to maintain the current Implementation Guidance of IAS 39. EFRAG remained at this stage of the analysis with the position to broaden the scope exemption for the portfolio fair value hedge of interest rate risk to other hedges of open portfolios of hedged items. In doing so, it was not possible to refer to 'macro' hedging as this terminology did not exist in IAS 39. Instead, reference was made to hedging of open portfolios of hedged items.

However, EFRAG noted that macro hedge practices were not limited to the use of open portfolios of hedged items or continually rolled over closed portfolios but also included practices based upon large volumes of individual hedge relationships. This made it impossible to understand and define any criteria that differentiated between hedge relationships following the IAS 39 requirements and those following the IFRS 9 requirements. EFRAG subsequently abandoned its tentative position to modify the wording of paragraph 71 of IAS 39 to allow for current hedging requirements applicable to open portfolios to

| **EFRAG's tentative views expressed in the draft comment letter and constituents' comments** | **EFRAG's response to constituents' comments** |
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| literature.<br><br>Constituents confirmed that it was uncertain whether existing IAS 39 compliant portfolio hedge accounting practices (such as portfolio cash flow hedges, hedges based on Section F of the Implementation Guidance, e.g. F.6.2 and F.6.3, and proxy hedging) could continue under the Review Draft. Respondents identified areas in the Review Draft that could be interpreted in a way that would change current practices. Many constituents doubted that the uncertainty about the practical implications and the true scope of the tentative decisions made by the IASB in January 2013 could be removed by the final drafting of the general hedge accounting standard.<br><br>Constituents agreed that it would be disruptive and costly to require entities to change their macro hedging accounting practices twice.<br><br>Some constituents however noted that carrying over the IAS 39 requirements might not fully address the concerns raised because: (i) to the extent the requirements of the Implementation Guidance of IAS 39 are consistent with IFRS 9, there would be no relief; (ii) to the extent where the Implementation Guidance of IAS 39 is inconsistent with IFRS 9, it would not be possible to incorporate them. | be available under what remains of IAS 39.<br><br>Finally, EFRAG noted that macro hedging was important for European financial institutions and therefore needed to be put on a solid conceptual footing. Consequently, EFRAG believed that the IASB should fully consider all aspects of macro hedge accounting – and its definition – without further delaying finalisation of IFRS 9. |

| EFRAG's tentative views expressed in the draft comment letter and constituents' comments | EFRAG's response to constituents' comments |
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| Hereafter we describe the different approaches EFRAG considered in identifying the most appropriate solution to preserve the status quo for current macro hedging practices.<br><br>Approach A – to modify the wording of paragraph 6.1.3 of IFRS 9 to allow for current hedging requirements applicable to open portfolios to be available under what remains of IAS 39;<br><br>Approach B – to carry over to IFRS 9 the implementation guidance in Section F related to portfolio hedging;<br><br>Approach C – to grant a temporary exemption from IFRS 9 - under this approach, entities would not need to demonstrate the link to risk management in the way currently envisaged by IFRS 9 (but would nonetheless provide some sort of documentation and disclosure); and<br><br>Approach D – to grant an option that allowed entities to choose either to comply with IAS 39 or IFRS 9 (as per the Review Draft) for hedge accounting in its entirety.<br><br>Some constituents noted that Approach A could imply a very large scope-out from IFRS 9, since the notion of open portfolios was not well-defined.<br><br>As the portfolio fair value hedge of interest rate risk was scoped out already from IFRS 9 hedge accounting, the approach would focus on macro cash flow hedges which were dealt with both under IAS 39 and IFRS 9. A clear definition would be necessary to ring-fence 'macro' cash flow hedges (subject to the IAS 39 requirements), from the other cash flow hedges (subject to the IFRS 9 requirements). However, as IAS 39 did not explicitly deal with macro hedges (as described above), this approach could not be followed.<br><br>The same criticism applied to Approach B; carrying over the Implementation Guidance of IAS 39 required first a clear definition of what was meant by 'macro hedging' to avoid expanding the scope to other hedging relationships. | In reaching its final conclusion and recommendation, EFRAG took the following into account: IFRS 9 has been developed to reflect in the financial statements the effect of an entity's risk management activities. As this principle has been widely supported in constituents' responses to the field-test, reverting back to hedge accounting practices under IAS 39 was not regarded as an improvement.<br><br>Current hedge accounting practices, described by constituents as being macro hedging even when IAS 39 did not explicitly deal with macro hedges, varied. Defining a scope exemption from IFRS 9 became difficult as it was impossible to define the boundaries appropriately and might lead to accounting arbitrage between the two standards. In addition, a 'macro hedge' has been defined by the IASB as a hedge of an open portfolio. EFRAG considered this definition as ineffectual for the purpose of standard setting as most closed portfolios could easily be made 'open'. The term 'macro hedging' should be reconsidered as part of the future IASB project.<br><br>Some banks used the IAS 39 Implementation Guidance for 'macro' interest rate cash flow hedges and foreign currency cash flow hedges including Implementation Guidance F6.2 and F6.3, while others did not.<br><br>EFRAG understood from a few banks' comments that without carrying forward the Implementation Guidance in IAS 39 (Section F.6) they would not be able to continue their existing practice while other banks believed the Implementation Guidance was not necessary.<br><br>EFRAG considered the significant operational challenges resulting from the fact that entities might be required to change their hedge accounting practices twice, once to adopt IFRS 9 and a second time to adopt the final macro hedging standard.<br><br>As a result, Approaches A and B were rejected for the reasons as described above.<br><br>Approach C proved impossible to define as current macro hedging |

| EFRAG's tentative views expressed in the draft comment letter and constituents' comments | EFRAG's response to constituents' comments |
|---|---|
| In relation to Approach C constituents noted that the drafting of the exemption would require significant time to identify the right scope of application and therefore delay the finalisation of the general hedge, accounting standard. Also, this alternative had the shortcoming of sacrificing a newly developed and widely praised principle to accommodate a subset of entities relying heavily on their current macro hedge accounting solutions.<br><br>Some respondents criticised Approach D as too radical because they considered that the Review Draft significantly improved hedge accounting requirements and entities that choose to comply with IAS 39 would be prevented from benefiting from those improvements. Also, they believed that granting an accounting option would impair comparability. | practices included not only open portfolios of hedged items, continually rolled over closed portfolios of hedged items but also practices based upon large volumes of individual hedge relationships. While the hedge accounting requirements of IFRS 9 were praised for their link with risk management, the scope exemption would sacrifice this principle to accommodate a subset of entities relying heavily on their current macro hedge accounting solutions.<br><br>EFRAG concluded that the only available viable technical solution at this stage was to recommend an accounting option (Approach D). This approach had the benefit that it provided a solution without the risk of undoing the improvements that the new IFRS 9 hedge accounting brought.<br><br>EFRAG also considered that a drawback of Approach D would be that it reduces comparability between those who would apply IFRS 9 and others that continue to apply IAS 39 for their hedge accounting. However, EFRAG noted that under both IAS 39 and IFRS 9: (1) establishing hedge relationships between derivatives and underlying positions was not mandatory and (2) hedge relationships between the same derivatives and underlying positions could be articulated in many different ways. Therefore, EFRAG believed that the cost of changing portfolio hedge accounting twice would outweigh the potential reduction in comparability.<br><br>As a result, EFRAG has concluded that the most straightforward and practical way of ensuring that existing IAS 39 compliant portfolio hedging practices would not be affected by the Review Draft would be to provide entities a simple choice to either (i) retain IAS 39 hedge accounting for all of their hedges until either they decide to apply the IFRS 9 Review Draft on current macro hedges irreversibly or the project on macro hedging is completed or (ii) to adopt irreversibly the requirements of the Review Draft as drafted (including the exception in paragraph 6.1.3 on portfolio fair value hedges of interest rate risk). |

# Lists of respondents

**Field test participants**

EFRAG would like to thank the following companies for participating in the field-test as well as the four Standard Setters (ANC, ASCG, OIC, FRC):

Alcatel-Lucent, Allianz, Areva, AXA, Banesto, Barclays, BPCE, Commerzbank, Crédit Agricole, Daimler, Danfoss, Deutsche Bank, DZ Bank, EADS, EDF, EnBW, Enel, ENI, Erste Group, France-Telecom, GDF Suez, Handelsbanken, Helaba, Intesa San Paolo, KfW, L'Oréal, Mediobanca, Merck, RTL, RWE, Safran, Sanofi, Siemens, Telefonica, ThyssenKrupp, Unicredit Group, Vinci, Volkswagen, Wüstenrot, Yara, and four undisclosed companies.

**Comment letters received in response to Draft Comment Letter on macro hedging**

Autorité des Normes Comptables (ANC), Accounting Standards Committee of Germany (ASCG), French Banking Federation (FBF), Federation of European Accountants (FEA), Financial Reporting Council (FRC), HSBC, DZ Bank, Barclays, Crédit Agricole, Deutsche Bank.

**EFRAG would like to thank the following companies and organisations for their participation in the telephone calls**

ABI, Barclays, BPCE, Commerzbank, Crédit Agricole, Deutsche Bank, EBF, Erste Group, Ernst&Young, GDF Suez, Handelsbanken, HSBC, Mazars, UBS, WoltersKluwer and two undisclosed respondents.

**Input received from members of the EFRAG Insurance Accounting Working Group and the Financial Instruments Working Group**

KPMG, Mazars, PriceWaterhouseCoopers, Unicredit.