EFRAG
European Financial Reporting Advisory Group

22 March 2013

International Accounting Standards Board
Attn. Hans Hoogervorst
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir,

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

In September 2012, EFRAG initiated a field-test together with the ANC, ASCG, FRC and OIC on the Review Draft general hedge accounting. The results of the field-test were communicated to you in our letter of 17 January 2013. In that letter, we wrote that we would be undertaking a detailed analysis of the impact on macro hedge relationships of the consequential amendments proposed by the Review Draft that would be subject to full due process with our constituents. This letter reports on the findings from that analysis and the conclusions that we have drawn from it.

This letter is intended to contribute 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 endorsement of definitive IFRS in the European Union and European Economic Area.

While the IASB is considering portfolio hedging strategies and developing appropriate hedge accounting to best reflect those hedging strategies, EFRAG believes no change should be mandated, so as to avoid the cost and the disruption caused by successive changes in financial reporting requirements. EFRAG therefore believes it is necessary that entities be granted the ability to maintain in all circumstances the status quo regarding existing IAS 39 compliant portfolio hedge accounting practices until the project on macro hedging is completed.

The input received from constituents in this supplementary consultation has led EFRAG to note the following:

(a) Significant uncertainty exists as to 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) will continue to be possible under the Review Draft.

(b) There is a significant risk that entities will be required to change their IAS 39 compliant portfolio hedge accounting practices twice (i.e. once upon finalisation and adoption of the general hedge accounting requirements and once again when the macro hedging project is completed) and that entities might be required to make significant systems investments in order to meet the disclosure requirements regarding proxy hedging.

(c) The term 'macro hedging', for which there is not a single universally applied definition in practice, would need to be defined as part of the development of the discussion paper on macro hedging. The term alternatively refers to either what is being hedged – open portfolios and/or net positions that arise from them – or the hedge accounting technique that is used – transaction-by-transaction or otherwise. Furthermore, we note that defining a 'macro hedge' as a hedge of an open portfolio may not be the most appropriate approach as most closed portfolios can easily be made 'open'; thereby rendering the definition ineffectual for the purpose of setting the scope of standards.

(d) The respondents 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 an eligible hedged item; and (e) the ability to rebalance hedge relationships.

EFRAG has considered several approaches including those suggested by constituents on how the above issues might be best addressed:

(1) *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* – This could lead to a very open-ended scope out from the IFRS 9 hedge accounting requirements, as the notion of open portfolio hedging is not well-defined and potentially very broad (as noted under (c) above); in contrast with portfolio fair value hedge of interest risk, cash flow hedge accounting is dealt with in both IFRS 9 and IAS 39; if this approach were to be adopted, the IASB would have to define how to robustly ring-fence the option;

(2) *To carry over to IFRS 9 the implementation guidance in Section F related to portfolio hedging* – This approach would not fully address concerns, because to the extent that parts of Section F are consistent with IFRS 9, it would not provide any relief. And where Section F is inconsistent with IFRS 9, it would not be possible to incorporate it.

(3) *To grant a temporary exemption from IFRS 9* – The hedge accounting requirements in IFRS 9 align hedge accounting more closely with risk management, resulting in more useful information to users. However, under this alternative, 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). Therefore, this alternative has the shortcoming of sacrificing a newly developed and widely praised principle for a subset of entities; and

(4) *To grant an option, each entity having the choice to comply with IAS 39 or IFRS 9 (as per the Review Draft) for hedge accounting in its entirety.* This option ensures that the status quo can be maintained. It has the drawback from the point of view of many European banks – particularly those that favour option 1 – that it is considered to be radical and to deprive them from the benefits that IFRS 9 could bring outside the remit of portfolio hedging.

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 (1) retain IAS 39 hedge accounting for all of their hedges until either they decide to apply IFRS 9 irreversibly or the project on macro hedging is completed or (2) 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).

This approach provides certainty that entities can continue to apply IAS 39 compliant portfolio hedging practices until the project on macro hedging is completed, without incurring the cost of considering whether their current IAS 39 compliant practices are compliant with IFRS 9 and without running the risk of having to incur the costs of changing their portfolio hedge accounting twice. In addition, it avoids:

(a) the complexity that would arise from the interaction between the scope and the requirements of IAS 39 and IFRS 9;

(b) the potential drawbacks of grandfathering IAS 39 practices into IFRS 9 without due consideration;

(c) the risk of giving rise to an accounting approach that mixes-and-matches elements of IAS 39 and IFRS 9 on a transaction-by-transaction basis; and

(d) any tainting of the fundamental objective of IFRS 9 that hedge accounting should reflect risk management practices.

It has been argued that a drawback of this approach 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, we note that under both IAS 39 and IFRS 9: (1) establishing hedge relationships between derivatives and underlying positions is not mandatory and (2) hedge relationships between the same derivatives and underlying positions can be articulated in many different ways. Therefore, EFRAG believes that the cost of changing portfolio hedge accounting twice would outweigh the potential reduction in comparability.

In the course of this supplementary consultation with stakeholders, EFRAG constituents have highlighted the significant improvements that hedge accounting under IFRS 9 brings compared to IAS 39. EFRAG does not want to discourage the IASB from developing a solution along the lines of approach (1) above (i.e. ring-fencing macro hedge accounting), as this would make the benefits of IFRS 9 available to the greatest number of constituents possible. However, so far we have not been able to identify a workable approach that we could recommend to you. In the absence of such a possibility, we consider that the option to apply IAS 39 must remain available.

Also, the majority of entities – that benefit from the improvements that the IFRS 9 hedge accounting requirements bring – would not be required to wait for the completion of the macro hedging project before being able to apply the new requirements.

Finally, EFRAG believes that macro hedging is important for European financial institutions and needs to be put on a solid conceptual footing. Therefore, we need the IASB to continue with its macro hedging project and to consider without prejudice both fair value hedge accounting and cash flow hedge accounting. While we note that IASB's discussions to date on the macro hedging project have focused on macro fair value hedging for interest rate risk, we believe that IASB should fully consider all aspects of macro hedge accounting – and its definition – without further delaying finalisation of IFRS 9.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Marc Labat or me.

Yours sincerely,

Françoise Flores
EFRAG Chairman