

Email

International Accounting Standards Board  
Mr Martin Edelmann, Mr Stephen Cooper  
and Mr Takatsugu Ochi  
30 Canon Street  
London EC4M 6XH  
United Kingdom

Brussels, 6 November 2012

**Subject: EBF Comments on the Review Draft Standard on General Hedges**

Dear Sir/Madam,

As a follow-up on the meeting which was held in London on 11 October 2012 between IASB Staff members (Mr Martin Friedhoff and Ms Jane Hurworth) and the EBF Hedge Accounting Working Group, we would like to provide you with written comments on the Revised Draft Standard on General Hedges.

In addition to the comments the EBF made on the Exposure Draft, we have identified the two further critical issues in the Revised Draft.

First, we see the changes to the treatment of hypothetical derivatives and the impact of paragraph B 6.5.5 on currency basis as being a change to current accepted practice (and US GAAP). We think inappropriate to use in IFRS the same wording as in US Guidance, but with a different meaning. Furthermore, this issue has never been exposed, nor discussed during the elaboration of the standard. Given the implications of this paragraph, we consider this first issue as being a fatal flaw.

The second issue relates to the treatment of open portfolios which, under a number of perspectives, lacks clarity. We call for the Board to amend the text in B 6.5.5 adequately and to allow institutions which macro hedge economically to continue to apply macro-hedge accounting until the open portfolio hedge accounting standard becomes available.

Please note there are other elements in the Revised Draft Standard which we are still considering and on which we may want to come back to you later.

Yours sincerely,



Guido Ravoet

Enclosure: 1

c.c. Ms Sue Lloyd, Mr Martin Friedhoff and Ms Jane Hurworth

*Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.*

## **EBF COMMENTS ON THE REVIEW DRAFT STANDARD ON GENERAL HEDGES**

### **Key Points**

The EBF has identified two critical issues in the Revised Draft Standard.

First, we identified the changes to the treatment of hypothetical derivatives and the impact of paragraph B 6.5.5 on currency basis as being changes to current accepted practice (and US GAAP) which had not been exposed to or debated by the Board. Given the implications of this paragraph, we consider this first issue we have with the Revised Draft Standard as a fatal flaw.

The second issue relates to the treatment of open portfolios which, under a number of perspectives, lacks of clarity. We call for the Board to examine these issues further and to provide clarity as appropriate.

## Issue no 1: exclusion of Currency Basis – Paragraph B6.5.5

We would like to point your attention to the fatal flaw related to paragraph B6.5.5 in the Review Draft. The paragraph states that

“... a ‘hypothetical derivative’ cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item). An example is debt denominated in a foreign currency (irrespective of whether it is fixed rate or variable rate debt). When using a hypothetical derivative to calculate the change in the value of such debt or the present value of the cumulative change in its cash flows, the hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a charge (e.g. cross-currency interest rate swaps).” (Our emphasis added)

The above paragraph will have relevance on the accounting in the following instance:

Entity X has a significant presence in Europe; consequently the majority of its funds raising activities are sourced from European markets. Therefore, the model that the Entity operates to fund its business operation in other geographical locations e.g. in the US, is to raise funding from Europe (typically fixed rate and denominated in EUR), swap that into the currency of the subsidiary where funding is required e.g. USD, using a cross currency swap and transfer the funds to its foreign subsidiaries in form of an intercompany loan denominated in the subsidiary’s local currency e.g. USD.

For risk management purposes, it is a commonly held view that the economic risk related to the external fixed rate EUR borrowing and the risk related to the intercompany USD loan are viewed and managed in aggregation, typically using a cross currency interest rate swap which converts the fixed EUR borrowing into floating USD borrowing. The hedging strategy is put in place to address both the interest rate risk created by the fixed rate borrowing and the foreign currency risk created by the intercompany lending. Therefore, although the individual loan instruments themselves (e.g. the intercompany loan and the external fixed rate EUR borrowing) do not involve exchanging different currencies, the hedge strategy clearly involves exchanging different currencies and accordingly it would be inappropriate and inconsistent with both the risk management objective and strategy to disregard the exchange of currencies while measuring the performance of the management’s hedging strategies.

We note that currently under IAS 39, entities frequently apply hedge accounting for such strategies in accordance with paragraphs 76, F.1.12 and F2.18 of IAS 39 and the results of application of hedge accounting is also closely aligned with the actual risk management strategy. More specifically, the cross currency swap is designated separately as a fair value hedge of the interest rate risk associated with the external fixed EUR borrowing and a cash flow hedge of the currency risk associated with the intercompany loan. The hedge effectiveness for the fair value hedge and the cash flow hedge is measured separately by splitting the cross currency swap into two notional derivatives by imputing equal and opposite functional currency legs as following:

1. A Receive fixed Euribor, Pay floating Euribor; and
2. A Receive floating Euribor, Pay floating US\$ LIBOR

Operationally, the cross currency swap is split in such a way that it results in creation of two swaps which have terms similar to those commonly found in the marketplace in order to ensure that the sum of their fair values is equal to the fair value of the cross currency swap at inception and subsequently.

Where the critical terms of each of the above swaps perfectly matches the respective underlying hedged risk, the hypothetical derivatives used to measure ineffectiveness are arguably the same as the two swaps above; therefore, the results of hedge accounting remain closely aligned with the management risk strategy.

The example provided in the last sentence of paragraph B6.5.5, on the other hand, will force entities to impute non-commercial and non-observable hypothetical derivatives and therefore, will force the hedge relationships to represent only a limited view of the risk management strategy. This is likely to give misleading results to the user of the financial statement by creating artificial ineffectiveness that economically does not exist. We note that this would also be inconsistent with the Board's objective of aligning hedge accounting with risk management strategies and change the current practice applied today.

We therefore, kindly request the Board to consider the following drafting changes to paragraph B6.5.5: (added text is underlined and deleted text is struck)

B6.5.5 To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item (this is commonly referred to as a 'hypothetical derivative'), and, for example for a hedge of a forecast transaction, would be at the money at the time of designation of the hedging relationship. This is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach. Hence, using a 'hypothetical derivative' is not a method in its own right but a mathematical expedient that can only be used to calculate the value of the hedged item. Consequently a 'hypothetical derivative' would be expected to perfectly represent the hedged cash flows or perfectly offset the hedging instrument cash flows if the critical terms of the hedged item and hedging instrument are matched.  ~~cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item). An example is debt denominated in a foreign currency (irrespective of whether it is fixed rate or variable rate debt). When using a hypothetical derivative to calculate the change in the value of such debt or the present value of the cumulative change in its cash flows, the hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a charge (eg cross currency interest rate swaps).~~

## Issue no 2: Hedge accounting for open portfolios

We believe that further clarification is appropriate in the area of the treatment in the Review Draft for 'open portfolios'.

An entity's risk management strategy often assesses risk exposures at a portfolio level. For this purpose entities tend to define portfolios as either:

- 'Open Portfolios' i.e. where the net portfolio exposure is monitored on a continuous basis and over time new exposures may be added and existing exposures may be removed from it; or
- 'Closed Portfolios' i.e. a portfolio to or from which items cannot be added, removed or substituted without treating each change as the transition to a new portfolio or a new layer.

For closed portfolios, hedge accounting is generally applied under paragraph 83 of IAS 39. However, for open portfolios, depending upon the risk management strategy, hedge accounting may be achieved in number of ways. That is open Portfolios may be:

1. Hedged using the exception in IAS 39 for a fair value hedge of an interest rate exposure of a portfolio of financial assets or financial liabilities (i.e. under paragraph 81A, 89A and AG114-AG132 of IAS 39)
2. Hedged under a Macro Cash Flow hedge accounting model as per the guidance provided in Implementation Examples F6.2 and F6.3 of IAS 39.
3. Hedged as a group of items under paragraph 83 of IAS 39, however, unlike the hedge of closed portfolio, the hedge relationships are continuously de-designated and re-designated to reflect the changes in the underlying portfolio.

Whilst it is clear in the Review Draft that for those hedges of open portfolio where the exception provided in paragraphs 81A, 89A and AG114-AG132 of IAS 39 is applied (i.e. the first instance referred to above), the relevant exception will continue to apply under the Review Draft, however it is not clear whether all other requirements of IAS 39 (e.g. specifically those relating to retrospective effectiveness, use of 80%-125% threshold etc in paragraph 88 of IAS 39 which are not being carried forward in the Review Draft) would also continue to apply to these hedges.

Further, the review Draft is not clear in relation to the hedges of open portfolios that are not created under the exception provided in paragraphs 81A, 89A and AG114-AG132 of IAS 39 (i.e. the second and the third cases described above).

We understand that the intention of the Board was to retain "the status quo of 'macro' hedge accounting under previous IFRSs" (paragraph BC6.15). We support this intention and strongly agree that entities that apply macro hedge accounting under IAS 39 should not be worse off until the new guidance on open portfolio hedging becomes available. To achieve this the wording of IFRS 9 under the transition requirements should clearly state that entities that have macro hedge accounting models, including the Macro Cash Flow hedge accounting

model supported by IG F6.2 and F6.3, in place may choose to continue to apply IAS 39 in its current form to their existing macro hedges until the open portfolio hedge accounting standard becomes available.

We therefore, request the Board to provide additional clarification in these matters.

We would be pleased to discuss these matters with you at your convenience.

