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Reference: IFRS 9 on general hedge accounting – Review Draft

Dear Board members,

ISDA's¹ European Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and, specifically, derivative financial instruments.

We consider the new general hedge accounting chapter of IFRS 9 to be, in most respects, an improvement on the model set out in IAS 39, permitting hedge accounting to be better aligned with risk management activity. However, we are writing to express our concerns about four aspects of the review draft: (i) the approach to constructing hypothetical derivatives and the treatment of 'currency basis', as set out in paragraph B6.5.5, (ii) the implications of paragraph BC6.300 for the use of the forward rate method for cash flow hedges of foreign currency risk under IAS 39, (iii) the ambiguity of what is meant in paragraph 6.4.1 9c) (ii) that "the effect of credit risk does not dominate the value changes...", and (iv) the removal of IGC F6.3 of IAS 39 on macro cash flow hedge accounting.

¹ Since its founding in 1985, ISDA has worked to make over-the-counter (OTC) derivatives markets safe and efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. ISDA has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has more than 800 members from 55 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on OTC derivatives to efficiently manage the financial market risks inherent in their core economic activities. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of ISDA toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

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(i) Hypothetical derivatives and currency basis*a) Currency basis risk*

Paragraph B6.5.5 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)” and goes on to give, as an example, that “the hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which currencies are exchanged might include such a charge (eg cross-currency interest rate swaps)”. We assume that this refers to the difference between the rates at which currency derivatives are traded in the market and the rates that would be derived from economic theory, known as ‘foreign currency basis’.

In making this statement, the new Standard would appear to change fundamentally the way that cash flow hedges of foreign currency are accounted for. We are not aware whether this issue has been discussed by the Board, and therefore it is possible that the Board has never considered the consequences of this proposal. Therefore we believe this drafting represents a fatal flaw that should be remedied before the Standard can be issued.

The issue has taken on considerable significance over the last four years since the financial crisis as market prices for foreign currency derivative instruments have differed from what would be predicted by economic theory, based on spot rates of exchange and interest rates in the two currencies involved.

The paragraph specifically refers to cross currency interest rate swaps, but the issue is more easily illustrated by reference to foreign currency forward contracts. When a forward currency risk is designated as the hedged item, as permitted by the Standard, it would appear that a hypothetical forward exchange rate needs to be mathematically derived to value the hedged item, presumably based on the interest rates in the two currencies together with the spot exchange rate. Paragraph B.6.5.5 would appear to not permit the use of market forward foreign currency rates, as reflected in actual forward contracts.

Our concerns are that the method required by the draft standard would be i) operationally difficult to apply, ii) inconsistent with the ‘market structure’, iii) does not give more meaningful information for users; and iv) is inconsistent with how organizations actually hedge their risks. Hence it does not achieve the Board’s aim as set out in paragraph IN8 (b) of the draft standard, that the new requirements should “align hedge accounting more closely with risk management”. Also, v) it would have a wider impact for other types of basis risk and vi) it would create an unnecessary divergence from U.S. GAAP.

Operational difficulty

Although it is not clear, the method seems to suggest that forward rates used to measure hedged items need to be hypothetically derived from theory rather than the market. This would present an enormous challenge for preparers, who would need not only to calculate the fair values of hedging instruments based on market prices but, at the same time,

construct hypothetical forward prices based on economic theory. To do so would considerably increase the amount of work that entities need to undertake and this operational burden would more than offset any reductions in workload due to other simplifications introduced by the standard.

Inconsistent with market structure

Hedge accounting should focus on the hedging of market risks rather than ones that are only theoretical. This is implicit in the guidance in the draft standard that risk components must be “separately identifiable and reliably measureable” and should be assessed “within the context of the particular market structure” (paragraphs B6.3.8 and 9).

It would not make sense to construct a hypothetical derivative based on a hedging instrument that does not reflect the market structure of the price of the hedged item. Paragraph B6.5.5 does not permit the actual market structure to be used to construct the hypothetical derivative, i.e. it does not allow the construction of a hypothetical derivative taking into account hedging instruments that are actually available in the market.

Whenever market participants think about forward foreign currency rates, it is the rates used by the market, reflected in the pricing of actual derivative contracts, not the rates that would be forecast by theory.

Not meaningful information

The effect of constructing a hypothetical derivative based on actual market prices to measure the hedged item in a cash flow hedge is that any currency basis reflected in market prices would be recognised in profit or loss at the same time as the hedged item. This is consistent with the objective of cash flow hedging, to lock in the rate or price of a forecast or variable cash flow.

Applying the method set out in B6.5.5 would, in contrast, result in the currency basis being reflected in profit or loss over the life of the transaction. This would lead to significant volatility in recorded profit or loss as the fair value of the basis fluctuates, that would not have occurred had there been no hedging activity at all. The recognition of ineffectiveness in profit or loss would be counter-intuitive, since the entity has transacted the best possible hedge available to it and has eliminated all variability in cash flows.

Not aligned with risk management

We are also concerned that the proposals are inconsistent with the way that foreign exchange risks are actually managed. In practice, foreign currency forward contracts and cross currency swaps are considered to reflect the market pricing of such risks and so are regarded as representative of the items hedged. Hence they would form the basis of an appropriate hypothetical derivative.

Wider impact

The restrictive principle introduced by paragraph B6.5.5 has wider consequences than just currency basis risk, such as for cash-collateralised derivatives. If a cash-collateralised

LIBOR swap is designated as a hedge of a variable rate bond referenced to LIBOR, there is a feature in the derivative not present in the hedged item, the fact that it is not exposed to the same credit risk. The discount rate in respect of the hedging instrument should not influence the effectiveness of the hedge accounting relationship, which is what the proposals would lead to.

When only the spot element of a forward contract is designated, paragraph 6.5.16 permits changes in the value of forward points to be accumulated in OCI and amortised over the period to which the forward points relate on a systematic and rational basis. Paragraph B6.5.34 then requires the forward element of the forward contract to be aligned with that of the hedged item. It would seem that the effect of the application of B6.5.5 is that the forward element of a forward contract will rarely be aligned with that of the hedged item, meaning that it would always be necessary to calculate an aligned hypothetical derivative based on economic theory. This will significantly reduce the value of the changes introduced by paragraph 6.5.16.

U.S. GAAP

Under U.S. GAAP there is no such restriction as to how the hypothetical derivative can be constructed. While it is accepted that hedge accounting under IFRS 9 may differ in the future from that under U.S. GAAP, there is no value in assigning different definitions to shared concepts.

Recommendation

We recommend that the last part of the paragraph, from 'An example is ...' is removed, enabling entities to designate cash flow hedges using the forward rate method, and that the Board considers introducing a spot based solution consistent with that for forward points and the time value of options, for entities that are able to manage the operational difficulties mentioned above.

b) At the money

A second concern with the wording of paragraph B6.5.5 is the reference to 'at the money'. This term is most usually associated with options, yet it will be rare that an at the money option is ever entered into or designated as a hedging instrument. Options are usually used as 'insurance' products, to buy protection in case prices or rates move too far. An example is a cap or floor, which will normally have a strike price that is above or below current market rates, respectively. It would make no sense to designate as the hypothetical derivative an at the money cap, when that is not the risk the entity set out to hedge. We presume that the Board had intended the test to be that the hypothetical derivative would be 'at market', which would mean being 'at the money' only for non-option products. This flaw in the wording should be corrected.

(ii) Forward rate method

Our members believe the treatment of the forward element of forward contracts as set out in paragraph 6.5.16 is a useful improvement to the hedge accounting requirements for fair value hedges. However, Paragraph BC6.300 states that "like IAS 39, IFRS 9 (see

paragraph B5.7.2) requires an entity to apply IAS 21 to those instruments, which means that they are translated into the entity's functional currency by using the spot exchange rate", implying that this approach would not currently be possible under IAS 39 for cash flow hedges of monetary assets and liabilities, which we believe is conceptually incorrect and is inconsistent with market practice and U.S. GAAP. Consequently, the wording of this paragraph is flawed as it would suggest that current practice under IAS 39 is not permitted.

It is clear that it is possible to designate future cash flows of a monetary asset or liability in a cash flow hedge under IAS 39 IGC F.1.13 which illustrates how changes in the fair value of a principal payment can be designated as the hedged item, measured at the forward exchange rate. It must follow that changes in the forward rate would have to be recorded in OCI and paragraph 100 of IAS 39 would require such amounts to be reclassified to profit or loss "in the same periods during which the hedged forecast cash flows affect profit or loss". To the extent that the change in the forward rate is reflected also in changes in the spot rate, this component of OCI would be reclassified to profit or loss as the monetary asset or liability is retranslated in accordance with IAS 21, with the premium or discount in the forward foreign exchange rate reclassified to profit or loss over the period over which the hedged cash flows impact profit or loss, in accordance with IAS 39.

IAS 39 IGC F6.4 is perhaps confusing on this point. The first sentence says that the discount or premium can never be amortised to profit or loss, but the second sentence goes on to say that "derivatives are always measured at fair value" implying that the first sentence deals only with situations where the spot rate has been designated in the hedge relationship. This is also implied by the next sentence, which says "The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognised in profit or loss **unless** the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a foreign operation, in which case the effective portion of the gain or loss is recognised in other comprehensive income" (emphasis added). The next sentence then, not completely accurately, states that "In that case, the amounts recognised in other comprehensive income are reclassified from equity to profit or loss when the hedged future cash flows occur or on the disposals of the net investment". This would be true for hedges of forecast transactions in non-monetary items and net investment hedges – since profit or loss would be affected at the same time as the occurrence of the cash flow or sale of the net investment. But for cash flow hedges of monetary assets or liabilities, it would be inappropriate to retain the forward points in OCI until the cash flows occur, since that would result in recognising the premium or discount in profit or loss at the date of repayment.

The only practical and sensible way to treat cash flow hedges of monetary assets and liabilities (when designating the forward rate) is to accumulate changes in the fair value of the hedging instrument, to the extent that they are effective, in OCI, to recycle the effect of changes in spot changes as the hedged item is translated in accordance with IAS 21 and to reclassify the premium or discount over the period in which the hedge cash flows impact profit/loss. BC6.300, should be deleted or amended to make it clear that

entities can apply either a spot rate (under IFRS 9 paragraph 6.5.16) or the forward rate method as is currently possible under IAS 39. This will ensure that IFRS 9 gives entities the choice provided in IAS 39 to designate either spot or forward rate risk.

(iii) Credit risk

B6.4.6 mentions that “hedge effectiveness is not solely determined by the economic relationship between those items (i.e. the changes in their underlying) but also by the effect of credit risk on the value of both the hedging instrument and the hedged item.” Our members are concerned that, as drafted, this requirement imposes a higher burden on preparers to monitor the effects of changes in the fair values attributable to credit risk than the Board intended.

In particular, it is unclear as to what extent changes in fair value attributable to changes in credit risk need to be monitored and considered, period by period. Paragraph B6.4.6 seems to require an entity to continuously monitor the effect of credit risk on the value of the hedged item. This is seen in the reference to “become erratic” and the advice that “if during a particular period there is little change in the underlyings...”. However, like under IAS 39, we believe the criterion should be whether the hedged cash flows are expected to be received or paid over the life of the hedging relationship.

Further, given that the Board views credit risk as not separable from liquidity, it is not actually possible to assess changes in fair value driven purely by credit risk, particularly during times of risk aversion.

IAS 39 IGC F4.3 makes a useful distinction between fair value hedges and cash flow hedges. For cash flow hedges, the criterion for whether credit risk precludes hedge effectiveness is whether “it becomes probable that a counterparty will default”. In contrast, for fair value hedges, it is currently necessary to assess changes in the fair value, presumably since these might affect the 80% to 125% effectiveness thresholds. Now that the 80% to 125% thresholds have been removed, it should no longer be necessary to assess the change in fair values in such a period by period, quantitative manner. In both cases, all changes in fair value will, of course, be reflected in the measurement of ineffectiveness.

Meanwhile, under IAS 39, if a hedged monetary asset is considered impaired then hedge accounting should be discontinued, as the hedge would not meet the qualification criteria under paragraph 88, but there is no explicit need to monitor changes in its fair value attributable to credit risk.

A too stringent interpretation of the new requirement would have unintended practical consequences. For instance, it would, arguably, be impossible to achieve hedge accounting for hedges of certain European sovereign debt given that non-interest rate related risks (liquidity and credit) may drive valuation of the instrument, more than offsetting any changes in the hedged risk, but (in most cases), the government is not expected to default. Further positive or negative changes in credit over the life of the instrument could dominate changes in interest rates. Dominance *per se* does not cause concern if the cash flows are still expected to be recoverable over the life of the hedge.

We request the Board to clarify the reference to credit risk for the hedged item is assessed on the same basis as is currently done under IAS 39 i.e. linked to whether the cash flows are likely to occur. As paragraph B6.3.18 of the new standard enables entities to designate a layer, such as the first 85% of cash flows expected to be received, in a fair value hedge, it should be possible to obtain hedge accounting for the cash flows expected to be received. It would also be helpful to provide guidance on the extent to which it will be possible to designate a derivative as a hedge of interest rate risk for a financial asset classified in 'bucket 2' under the new impairment methodology, drawing on this 'layering' approach.

(iv) Macro cash flow hedging

Our members took notice of the Board's stated intention "*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*" (BC6.15). However, if the guidance currently included in IAS 39.IG.F.6.1-3 is removed, our members are concerned that this intention will not be supported by the Standard as drafted. Our members fully support the grandfathering of fair value hedge accounting for a portfolio hedge of interest rate risk pending completion of a now separate initiative on open portfolio hedging and request the same transition approach for macro cash flow hedge accounting.

Consequently, our members strongly request the Board to retain IG.F.6.2-3 as grandfathered guidance. We highlight that for those members that are not able to benefit from the EU carve out, macro cash flow hedge accounting model under IAS 39 remains the only macro hedge accounting model that is available given that the review draft does not permit the designation of non-financial items or items without a predefined maturity (e.g. core deposits) as hedged items.

To illustrate some of our members' concerns, the IGC allows cash flow hedging of expected interest rate net cash flows, whereas paragraph 6.6.1 (c) of the staff draft permits a net risk position to be designated in a cash flow hedge only for hedges of foreign currency risk. Ideally, paragraph 6.6.1 (c) should be amended to permit the designation of net interest rate risk positions for cash flow hedges. While it might, alternatively, be possible to designate, for accounting purposes, the expected re-pricing of floating rate liabilities as the hedged item, we are concerned that this may not be consistent with the entity's actual risk management objective and strategy, as referred to in paragraph 6.4.1 (b). A similar concern arises with the application of paragraph 6.6.1(c): is an entity permitted to designate derivatives as a hedge of a portion of a gross position instead of a net foreign currency risk (and so maintain the simpler IAS 39 hedge accounting treatment), if the entity's actual risk management strategy is to hedge the net risk? We believe there needs to be clearer guidance on the extent to which the actual hedge strategy constrains the designation for hedge accounting purposes. As pointed out earlier, under IAS 39, IG F.6.1 clearly illustrates how such a designation of derivatives as a hedge of a portion of a gross position for interest rate risk is possible. We believe therefore, it is necessary to retain the IGs until the open portfolio hedge accounting standard is made available.

A second example of why our members are concerned is the wording of paragraph B6.5.24 (b), which deals with a fact pattern similar to that faced by most banks. It seems to require hedge accounting relationships to be de-designated and re-designated whenever the entity adjusts the hedging instruments it uses to manage its risks. This would be very problematic, since revised designations are likely to be a source of future ineffectiveness for cash flow hedges. It is not clear why entities cannot just de-designate hedges to the extent that they become surplus to requirements and to layer on new hedges to the extent there needs to be an increase, instead of de-designating and re-designating all the relationships. Our members assume that this reflects poor wording that should be amended, rather than any issue of principle.

We hope you find ISDA's comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,



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