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9 March 2011

Ref: Exposure Draft ED/2010/13 - Hedge Accounting

Dear Sir David,

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee appreciates the opportunity to provide comments and observations to the International Accounting Standards Board ("IASB" or "the Board") on the above referenced Exposure Draft, Hedge Accounting (the ED). ISDA's Accounting Policy Committee is represented by organisations that operate in various businesses across the globe. Therefore, our responses to the questions for respondents are intended to reflect the balanced views of our membership.

We are supportive of many aspects of the ED, such as the principles-based approach, the overall direction of the proposals of aligning hedge accounting with risk management activities, the elimination of any 'bright line' effectiveness tests, the confirmation that qualitative effectiveness assessment is permitted and the increase in eligible risk components. However, we do have concerns on a number of points, both with respect to lack of clarity in the wording of the ED on some topics and disagreement with the approach on others. Nevertheless, we hope these concerns can be resolved through the comment letter process, outreach activity and as part of the Board's re-deliberations before the final standard is issued.

Key areas of Concern:

Portfolio hedging Exposure Draft
Financial institutions tend to manage interest rate risk on a dynamic portfolio basis. Assets and liabilities are typically managed on a behavioral basis, as they may include prepayment or extension options where interest rates are not the only driver of behavior. Accordingly, many of our members heavily utilise the portfolio or macro hedging guidance within IAS39, both the cash flow and fair value approaches. We are aware that this ED focuses only on the general hedge accounting model and that the Board expects to issue an ED on macro hedging later this year. We await the content of the macro hedging ED, and note that this response to the general hedge accounting model ED can only be tentative as we will need to revisit it once the proposed macro hedge accounting guidance is also known.

Restriction on hedged risks that impact P&L
We do not agree with the restriction that hedge accounting should only be achieved where the hedged risk will impact P&L. Risk management activity does not focus solely on P&L, hence it could be argued that this prohibition contradicts the stated objective of hedge accounting to represent the effect of an entity's risk management activities. In particular, it is not an uncommon practice for many of our members to hedge the

foreign exchange risk on strategic investments that, under IFRS 9, can be designated at fair value through OCI and will not be recycled through earnings.

Linkage between hedge accounting and risk management

Whilst we support the proposal that hedge accounting represents the effect of an entity's risk management activities, we do have some concerns as to how this approach will work in practice as currently worded. In particular, the ED includes certain rules that could preclude hedge accounting that reflects actual risk management activity. We would welcome confirmation that where this is the case, it would be acceptable under the ED to make hedge accounting designations that best represent the actual risk management strategy, as is the approach under IAS39.

In addition, we are concerned that the ED has been written on the assumption that risk management activities are undertaken at a micro level and that risks management policies can forecast every eventuality. Whilst financial institutions may make transactional decisions at a micro level, risk management is usually applied at a higher, macro or portfolio level. Indeed, it is common for daily (or more frequent) changes to the profile of hedging transactions to occur as the underlying hedged portfolio changes, without any amendment to risk management strategy.

Voluntary Discontinuation

We do not believe the proposed guidance to prohibit voluntary dedesignations where the risk management strategy remains the same, or require mandatory terminations where the risk management strategy has changed, is appropriate. Our members believe that it is inconsistent to require that an entity continues with hedge accounting if it is no longer desirable under its management strategy or to prohibit voluntary dedesignations when it would improve the quality of financial information. In any case we believe that these decisions should be taken at a micro level.

Objective of the effectiveness assessment

Although we welcome the elimination of the 'bright line' 80-125% test required under IAS39, we do have concerns that as currently worded, the hedge effectiveness requirements under the ED could be even more onerous. The use of the words 'unbiased' and 'minimize ineffectiveness' could be interpreted as requiring zero bias (that is, an expectation of zero ineffectiveness) at inception and on subsequent assessment, and that any opportunity to minimize ineffectiveness must be taken, regardless of cost and operational difficulty. We note that there is some guidance in the ED that indicates that it was not the intent of the Board to introduce a more stringent effectiveness assessment requirement than under IAS39. Therefore, we strongly recommend that the wording used to describe the objective of effectiveness testing is reconsidered.

Given that the outcome of the hedge effectiveness assessment is a key driver as to whether rebalancing is required or not, it is essential to our members that the criteria for hedging relationships to pass or fail the effectiveness test should permit tolerance and allow judgment to be applied, in line with an entity's risk management strategy.

Furthermore, the objective as currently worded also assumes that minimization of ineffectiveness is a risk management objective. Often the risk management objective will be to transform the existing risks to be within management's agreed risk parameters. In particular the cost, flexibility or accessibility of potential hedging instruments may be given more consideration than expected levels of ineffectiveness.

Rebalancing

Whilst we welcome the opportunity to amend the hedging relationships to improve their effectiveness, we are not supportive of mandatory rebalancing. We believe that accounting rebalancing should be driven by risk management activity, and frequent accounting rebalancing without matching risk management activity can only add to the complexity of hedge accounting for users and preparers alike.

We note that the focus in the ED on rebalancing is explained almost entirely by reference to an increase or decrease in volume of the hedging instrument and/or hedged item. Whilst, in some instances, such a change to the hedged ratio will be appropriate, we believe there are a variety of other scenarios where rebalancing would be appropriate. These include a change in timing of the hedged item or a change in basis, where the inclusion of a different hedging instrument to reflect such changes would make sense. We therefore recommend that the guidance in the ED on rebalancing is amended to clarify that such matters could be addressed by rebalancing.

Our concerns with the objective of effectiveness assessment above are partly driven by our desire for any effectiveness test to be compatible with risk management strategy, but also because of the operational impact of frequent rebalancing. The impact of rebalancing on the 'lower of' test for cash flow hedges and the need to amortise fair value hedge adjustments should not be underestimated. Therefore, we believe that for most hedge relationships, rebalancing should be infrequent.

Hedging of credit risk

We note that one of the Board's aims was to propose a more principles-based standard, which we fully support. Therefore we are surprised that the ED includes a rule that credit is not an eligible risk component for hedge accounting. Whilst we understand some of the current difficulties associated with determining a separately identifiable and reliably measurable credit component, we do not believe that a specific rule to preclude hedge accounting for credit risk is appropriate.

Credit hedging is a key risk management activity for many of our members and we believe it is essential that an appropriate accounting solution is found. We do not support the alternatives proposed in the ED with the exception of alternative 3, which is similar to one of the approaches that we have included in our response to Question 15 for the Board's consideration.

Fair value hedge mechanics

We do not prefer the proposed changes to the fair value hedge mechanics as it introduces unnecessary complexity to fair value hedge accounting. Whilst we agree that it would be useful to show the impact of all hedging activity in one place, we think that it would be more appropriate to do this in the notes to the accounts rather than by grossing up OCI.

In addition, we do not support the inclusion of fair value hedge adjustments in separate lines on the face of the balance sheet. This will lead to a cluttering of the primary statements. Once again, we believe that this disclosure should be given in the notes to the accounts.

Suggested level of disclosures

ISDA believe that the information required to be disclosed is too extensive and places too much emphasis on hedge accounting relative to other reporting activities. In particular, we believe that our members may be forced to disclose sensitive and confidential information related to internal risk management strategies and the link between the risk management objectives and hedge accounting has to be better articulated before addressing the new disclosure requirements.

In addition to the above comments we have also considered your questions in detail, and our responses are provided in the appendix to this letter.

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,

Tom Wise
HSBC Bank plc
Chair of Accounting Policy Committee

Antonio Corbi
International Swaps and Derivatives Association
Tax and Accounting

Appendix:

Exposure Draft ED/2010/13 - Hedge Accounting – Questions for respondents

Appendix:

Objective of hedge accounting

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?

Our members agree with the proposed objective, to better represent the entity's risk management activities in the financial statements through hedge accounting. However, we have some questions as to how the proposed approach will work in practice to meet this objective.

In particular, we are concerned that the ED has been written on the basis that risk management is applied at a micro level. This is evident in the requirement for hedge relationships to be terminated when the risk management strategy changes, whilst precluding termination of hedges when the risk management strategy has remained the same. We discuss the impact of this further in our responses to Questions 6 and 7.

Even where financial institutions are able to apply micro hedge accounting relationships, risk management is usually applied at a higher, macro or portfolio level. By this we do not mean that financial institutions only wish to apply portfolio hedge accounting, but that risk management decisions about whether to transact hedges for particular hedged items are not taken in isolation, but reflect the wider risks of the business. Hence we do not believe that the risk management strategy should necessarily be considered on a hedge by hedge basis. Therefore, we request that it be made clear that the objective of hedge accounting is to best represent the entity's risk management activities at the level management deem appropriate for those activities.

For instance, it would not be uncommon for a financial institution's risk management strategy to remain the same, but as the assets and liabilities within a portfolio change the hedging derivatives may be transacted to ensure that the risk management strategy continues to be followed. Therefore we do not believe that accounting guidance written on the assumption that the risk management strategy for financial institutions is performed on a transaction by transaction basis would be operational.

Paragraph B29 of the ED states that one of the objectives of the hedge effectiveness assessment is to ensure that the hedging relationship minimizes ineffectiveness. If hedge accounting is expected to represent risk management activities then this indicates that there is an assumption that an objective of risk management activity is also to minimize ineffectiveness, which will not always be the case. Often the risk management objective will be to transform the existing risks so as to fall within management's agreed risk parameters. In particular the cost, flexibility or accessibility of potential hedging instruments will be given consideration as well as the expected levels of ineffectiveness. This issue is discussed further in response to question 6.

There are still some common risk management activities undertaken by financial institutions where hedge accounting cannot be documented and applied in a manner consistent with the risk management activities. Given the stated objective for hedge accounting to reflect risk management activities, in these instances it is not clear whether hedge accounting is therefore precluded, or whether hedge accounting can be achieved by designating the hedge in a way that is compliant with the ED and yet best represents the risk management strategy.

Examples include:

- hedges using intra-group derivatives entered into with the trading desk and the interaction with risk management strategies;
- fair value hedges of demand deposits (precluded since the IASB reiterated that the fair value of a demand deposit cannot be less than its nominal value);
- fair value hedges of a 'bottom layer' of assets prepayable at other than fair value;
- cash flow hedges of net positions where hedged items impact profit or loss in different reporting periods;
- basis swaps, for example swapping three-month LIBOR for one-month LIBOR;
- hedges of foreign exchange risk on forecast profits from overseas subsidiaries;
- hedges of foreign exchange risk on intergroup royalties and management charges;

- pre-hedges of foreign exchange risk, to lock in the functional currency equivalent of proceeds from forecast foreign currency issued debt; and
- hedges of counterparty credit risk.

Whilst we expect the ED on portfolio hedging will provide a solution for some of the above scenarios, we do not believe it will cover all of them and it is presently unclear exactly whether and how those future decisions will inter-relate with this ED. In particular, financial institutions often manage their interest rate risk from banking book activities through a central treasury function. Hedging activity will then typically be undertaken via internal derivatives with the trading desk. The trading desk is likely to manage the resultant position as part of its wider trading book. Consequently, there is unlikely to be an external derivative which is the same as the internal derivative. Thus, in these circumstances, there are two separate risk management strategies in operation: one for the banking book and one for the trading book, rather than a single strategy for the whole group. There is existing guidance in IAS39 IGC F1.4 which recognizes this issue and allows the use of an external trading book derivative as a proxy for hedge accounting purposes for the banking book exposure. However, without additional guidance, it is not clear whether the objective of hedge accounting as described in the ED would preclude such an approach.

To maintain consistency with the ED's overall hedge accounting objective (i.e., to represent in the financial statements the effect of an entity's risk management activities), the view of most of our members is that it should be acceptable to make hedge accounting designations that best represent the actual risk management strategy, as is the current practice under IAS39. In these situations, disclosure should be made as to why any hedge designations are not fully consistent with the risk management activities.

Most of our members do not agree that hedge accounting should be restricted to risks that affect profit or loss, as an entity's risk management activities can be much broader. For example, it is not an uncommon practice for our members to hedge foreign exchange risk on strategic equities which, under IFRS 9, can be designated at fair value through OCI. The ED would preclude such hedging and result in P&L volatility which would be inconsistent with the risk management strategy.

Instruments that qualify for designation as hedging instruments

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?

We agree that non-derivative financial instruments measured at fair value through profit or loss should be permitted as eligible hedging instruments.

We request that the requirements in paragraph 11 are clarified, such that individual written options are not excluded from being eligible hedging instruments if combined with other derivatives such that the combination is not a net written option. We believe that the net-written option criterion should only apply to the combined hedging instrument. In particular, many collars are documented as separate caps and floors. As currently written, the guidance in the ED could preclude hedge accounting with collars in some circumstances.

Derivatives that qualify for designation as hedged items

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?

We agree with the principle of permitting the designation of an aggregated exposure that is a combination of another exposure and a derivative as a hedged item.

We do not believe that the ability to include a derivative as part of the hedged item will result in accrual accounting for the derivative; however we think that implementation guidance on the mechanics of applying paragraphs 15 and B9 would be helpful to reduce diversity in application.

It is implicit in the ED that only derivatives included within hedge accounting relationships would be eligible for inclusion as part of a hedged item of a new hedge relationship. We believe that this should be made clearer in the ED.

The ED permits the inclusion of derivatives as hedged items in combination with other exposures. We believe that this guidance should also apply to highly probable forecast derivatives, as well as those already transacted.

For example, where it is highly probable that an entity will issue fixed rate foreign currency debt in six months time, on issuance of the debt, it is also highly probable that the entity will transact a cross currency swap, creating highly probable synthetic functional currency floating rate debt in six months time. The entity may wish to lock in the functional currency interest rate exposure and so transact a pay fixed, receive floating interest rate swap. We believe that paragraph 15 in the ED would permit designation of the interest rate swap as hedging the combination of the highly probable forecast foreign currency debt and the cross currency swap, i.e. a synthetic forecast floating rate functional currency debt. Once the debt and the cross currency swap are transacted the latter would be designated as a fair value hedge.

For any forecast derivative hedged in combination with other exposures, there would be an expectation that the forecast derivative would be designated in a hedge relationship once it was transacted.

When applying this guidance, we do not believe there would be any requirement for the possibility of the second hedge relationship to have been documented at the time the first hedge was designated. However, we recognize that in some circumstances the second hedge relationship could indicate that the risk management strategy had changed, in which case the first hedge relationship may be required to be terminated. As noted in our response to question 1, risk management can be conducted at a variety of levels and hence a change to an individual hedge relationship is not always indicative of a change in risk management strategy.

Whilst we understand how an aggregated hedged exposure that included a derivative would be treated for assessment purposes, we are less clear as to how the measurement or accounting would work. In particular, where the second relationship was a hedge of fair value, as part of the change in fair value of the hedged item (i.e. the derivative) may already have been recognised and recorded in OCI as part of a cash flow hedge. We believe additional practical application guidance in this area would be essential.

Designation of risk components as hedged items

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?

We welcome the change introduced by the ED, to permit a broader range of risk components to be eligible for hedge accounting for non-financial items. However, the key concerns for our members under IAS39 when hedging risk components of financial instruments are not resolved by this ED. These concerns are further detailed below.

The risk component hedging that is of particular concern to many of our members is the hedging of credit risk. The Basis of Conclusions (BC219-225) in the ED confirms that the Board does not consider credit risk to be an eligible hedged risk, as, in the Board's view, it is not reliably measureable. Given the Board's desire for hedge accounting to be based on principles rather than rules, we would prefer to rely on the principle within the ED (i.e. separately identifiable and reliably measurable) to conclude whether credit risk was an eligible risk component or not, rather than have a rule prohibiting it. See Question 15 for our response to the alternative solutions for hedging credit risk.

The ED (B24 -25) also makes it clear that where interest on financial instruments is priced 'Sub-LIBOR', entities are not permitted to identify LIBOR as a risk component for hedge accounting. Hedge accounting could still be achieved, but the whole interest flow must be designated as the hedged risk, not just the LIBOR component, resulting in some ineffectiveness. We encourage the Board to find a resolution to this issue within its macro hedging project.

Paragraph B12 confirms that the requirement that a risk component cannot be more than the whole is also applicable for non-financial items, although the ED is unclear what the treatment would be where the spread is not contractual, and there is a *possibility* that it could be negative. This is a possible situation when hedging commodities, where spreads rise and fall with changing demand and supply.

In addition, some of our members also consider inflation to be an eligible risk component of fixed rate debt, and transact hedges accordingly as part of their risk management strategy. However, inflation is also explicitly noted in the ED (B18) as not being eligible for hedge accounting for financial instruments, unless it is contractually specified. Consistent with our view on credit risk, we believe that a principle on risk components should be sufficient, without precluding hedge accounting for particular items. This is not least because market-practice and derivative products will evolve over the life of the new standard and will therefore require amendment of the standard if such rules are included.

Designation of a layer component of the nominal amount

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?

We support the Board's decision to permit designation of layer components as hedged items for both individual items as well as for groups.

It initially appears helpful that the Board has decided to relax the requirement in IAS 39 that the change in fair value attributable to the hedged risk for each individual item in the group must be 'approximately proportional' to the overall change in the fair value of the group for the hedged risk. However, the requirement in paragraph 36(c) seems to re-introduce this criterion with, "the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not dependent on which items from the overall group form part of the hedged layer)".

We believe the ability to hedge a bottom/top layer in a fair value hedge is a sensible approach, and indeed permits better alignment to risk management strategy, rather than a proportional approach.

A key outstanding requirement for our members is to have a suitable hedge accounting solution for the hedge of interest rate risk for layers of portfolios of assets prepayable at other than fair value. The guidance in the ED excludes hedging layers of such portfolios because of the prepayment terms, if the portfolio is closed. We do not agree with the ED in this respect and believe that closed portfolios that have a prepayment option should not be excluded from the layering approach, especially when the behavioral patterns of the portfolio are known to determine which portion will not be prepaid. We are pleased to note that this issue is being considered as part of the Board's deliberations on portfolio hedging, and based on the tentative decisions so far we support the direction the Board has taken on this issue. However, we are keen to ensure that the portfolio hedging guidance is not exclusive to open portfolios and will be equally applicable to closed portfolios. Thus, we believe that instead of using the prepayment criterion as a separation between the two hedging phases, it would be better to determine if the instrument is managed at a portfolio level or not.

Hedge effectiveness requirements to qualify for hedge accounting

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?

We generally agree with the direction of the hedge effectiveness requirements set out in the ED. We also agree with the proposal to permit qualitative effectiveness assessment, whilst maintaining the requirement to record actual ineffectiveness in profit or loss. In addition, we welcome the proposal for a purely prospective effectiveness assessment. However, we have a number of concerns and points on which we believe clarification is needed, as detailed below.

We are pleased to note that there is recognition in the ED, in paragraph B39, that ineffectiveness is not expected to be zero and that there is no requirement to transact the 'perfect' hedging derivative. For example, we would expect that hedge accounting would not be precluded if an entity chose to hedge, say, a five-year fixed rate exposure with three-month futures on a duration basis, if that was consistent with its risk management strategy. In particular, there should be no requirement for that entity to transact a matching five-year interest rate swap instead, even though it might provide a 'better' hedge accounting result.

However, this guidance does seem to conflict with the objective of hedge effectiveness testing which is described as to demonstrate that there is *no* bias and that ineffectiveness is *minimized*. We are concerned with the use of the word 'unbiased' as it indicates that *any* bias is not acceptable on inception or on subsequent reassessment. Paragraph B29 of the ED therefore appears to give inconsistent guidance as to whether all bias must be eliminated and all ineffectiveness minimized or whether judgement may be applied. Please also refer to our response to Question 1, where we noted that the hedge effectiveness assessment objective as worded is inconsistent with the hedge accounting objective of representing an entity's risk management activities in its financial statements, given that management may tolerate a degree of bias and ineffectiveness in its risk management strategy.

If there is a requirement to ensure that *no* bias exists on each assessment date, then we believe that this is a higher hurdle than achieving the 80-125% offset currently required by IAS39 and we would not support this approach.

If, however, as is indicated by some of the guidance in the ED, there is an opportunity for management to interpret the results of their effectiveness assessment and decide whether the outcome is still acceptable for risk management purposes, then we would support the overall approach to effectiveness assessment. Nevertheless, we believe that the use of the word 'unbiased' is inconsistent with the ability to apply judgment and should therefore be deleted.

We request that it be clarified that tolerance may be applied to the effectiveness assessment, consistent with an entity's risk management strategy, both at inception and for ongoing effectiveness assessment purposes.

Tolerance should be permitted, both in relation to the magnitude of any ineffectiveness and also the source of ineffectiveness. We understand that the time value of a hedged item and the full fair value movements of the hedging derivative must be considered for measurement purposes, however for risk management purposes entities may not consider all causes of fair value movements to be relevant. For example, we would not expect fair value movements from changes in the credit risk of derivative counterparties or the unwind of the 'financing' element of non-zero fair value derivatives to be a cause of concern within the effectiveness assessment. We would assume that, if judgment were permitted in determining whether the effectiveness assessment was met, then the impact of these sources of ineffectiveness could be ignored or excluded.

Throughout the ED there is reference to effectiveness being assessed by comparing the 'change in *fair value* of the hedging instrument with the change in *fair value* or *cash flows* of the hedged item'. In other instances hedge effectiveness is referred to with regard to the change in *fair value or cash flows* of the hedging instrument. As with IAS 39, it is not clear whether references to changes in 'cash flows' should be interpreted to mean the changes after discounting them to their present values. (Some of the Interpretation Guidance in IAS 39 implies that this is the case but other parts of that standard are inconsistent).

According to the ED, effectiveness assessment must be performed, as a minimum, at each reporting date or upon a significant change in circumstances, whichever comes first. This would require the use of judgment to determine whether or not an intra-reporting period assessment is necessary in some circumstances. If such assessments are not performed in a timely manner and appropriate action taken, then the ED indicates that hedge accounting would be precluded. It is our expectation that such significant changes in circumstances requiring intra period effectiveness assessment would be infrequent, and would usually coincide with proactive risk management activity. Therefore we believe it should be made clearer that the frequency of the effectiveness assessment should be driven by the risk management strategy.

We agree that it would not be appropriate for the ED to prescribe an effectiveness assessment method given the proposed link to risk management activities. We would envisage that the effectiveness method adopted would utilize existing risk management techniques where possible.

We do not believe it is clear from the ED as to whether it is possible to designate a partial term hedge, either as part of a rolling hedge strategy or otherwise, as it is under IAS39 (applying the guidance in IGC F1.13) and therefore recommend that the guidance in IGC F1.13 of IAS39 is carried forward in to the new standard.

Rebalancing of a hedging relationship

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?

We are generally supportive of the proposals in the ED that permit rebalancing of hedge relationships, although we do have some operational concerns about the rebalancing concept under the ED as it is currently worded. In particular, we do not believe that rebalancing should be mandatory.

As noted in our response to Question 6, we believe that the success of the effectiveness assessment should be driven by management judgment and that there should be tolerance for levels of ineffectiveness within the parameters of an entity's risk management strategy. Therefore, we would not expect rebalancing to be a common occurrence under the ED. Indeed, it is only likely to occur when proactive risk management activity is considered necessary. In most circumstances, the accounting outcome of requiring rebalancing where no change has been made to the actual hedging transactions will be minimal. This is because if the hedge is rebalanced the dedesignated proportion of the hedging derivative will be at fair value through profit or loss; however, if no change was made to the hedge designation, ineffectiveness will result, which is also reflected in the P&L.

If the Board expects rebalancing to be a common occurrence and makes it mandatory, then consideration must be taken of the operational impact of rebalancing. It would be onerous to reflect in systems the effects of amending proportions of hedged items and/or hedging derivatives, especially if the amendments are not driven by the risk management strategy. This is because of the requirement to consider the cumulative 'lower of' the change in fair value for the hedged item and hedging instrument for cash flow hedges, and, the need to take into account any amortisation requirements where the natural unwind of fair value adjustments will no longer occur for fair value hedges. We therefore believe rebalancing should not be mandatory.

The focus of rebalancing in the ED is almost entirely discussed by reference to changing the volume of the hedged item or the hedging instrument. We believe there will be other situations where rebalancing may be appropriate. For example, consider the following situations:

- A change in the expected timing of a hedged item: assume a six-month derivative was used to hedge a six-month cash flow and it was designated as a cash flow hedge. Subsequently the timing of the cash flow is expected to change, to occur two-months later than originally expected. We believe that it should be acceptable, as part of rebalancing, to layer on another swap such that the combination of derivatives better matches the revised timing of the hedged cash flow, rather than to dedesignate and redesignate the original hedge relationship.

- A change in basis: when hedging interest rate risk as part of a cash flow hedge, a borrower may switch its funding from a one-month to a three-month LIBOR basis, under the terms of its facility. The lender may have originally hedged the one-month rate based on its expectations of cash flows on designation, but may now wish to transact a one-month to three-months basis swap and designate that swap in combination with the existing fixed rate to one-month LIBOR swap, to eliminate effectiveness from the basis risk. We believe that it should be acceptable as part of rebalancing to layer on a one-month to three-month basis swap to better match the revised basis of the hedged cash flows.

It is not clear from the ED whether changes to hedge relationships such as those outlined above are part of rebalancing, or whether rebalancing is restricted to changes in the volume of the hedged item and/or the hedging instrument, such that the above scenarios would be deemed a change in risk management strategy. However, it could be argued that in the above scenarios, if an entity chose not to eliminate the one-month to three-month basis risk or reflect the change in timing of the cash flows, that would be inconsistent with the risk management strategy, which would have been to lock in interest rate risk on the loan or foreign exchange risk on the cash flows.

Making the assessment as to whether the risk management strategy has changed is not straight forward and is very dependent on the level at which the risk management strategy is applied. As discussed in our response to Question 1, we believe risk management should be considered at a level consistent with how it is actually managed. This could have a significant effect on whether hedges are rebalanced or terminated.

We agree that if an entity wished to rebalance, in anticipation that the hedge effectiveness assessment might decline in the future, it should be permitted to do so.

Discontinuing hedge accounting

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?

Prospective discontinuation

We agree that hedges should be discontinued prospectively when the hedge relationship no longer meets the qualifying criteria, provided that appropriate amendments are made to the objective of the effectiveness assessment as suggested in our responses to Questions 1 and 6.

Voluntary discontinuation

We do not agree with the ED’s proposal to prohibit voluntary discontinuations.

Given that hedge accounting is not mandatory, it seems inconsistent for there to be a requirement that an entity must continue with hedge accounting if it is no longer desirable. We do not believe that prohibiting voluntary dedesignations will improve the quality of financial reporting or increase comparability for users.

In particular, as noted in Question 1, a risk management strategy may operate at varying levels. Depending on the strategy applied by management, considering the nature and size of the hedged exposure and the type of risk hedged, the strategy will not always be specific to individual hedge relationships. Therefore it is not possible to make operational a determination of whether hedge accounting should or should not be terminated for a single hedge relationship as a result of a change in risk management strategy.

In addition, we envisage situations in which it may be desirable to terminate hedges, without any change in the overall risk management strategy, as more appropriate hedge designations become available elsewhere within the portfolio, or to take advantage of natural offsets, where additional balance sheet risk positions are transacted.

In our response to Question 1, we gave the example of where a financial institution’s banking book is hedged using internal derivatives with its trading book, but the external trading book derivatives are designated as hedging instruments. Elaborating on this example, a new external derivative may subsequently be traded which is a more effective hedge. Therefore, the entity may wish to dedesignate the original hedging instrument and substitute this with the new one, even though the overall interest rate risk management strategy has not changed.

In any event, voluntary discontinuation can always be archived by simply closing out the hedging derivative. Therefore, as currently proposed the guidance is not sensible since it only forces entities to incur additional expenses to achieve dedesignation.

IAS39 permits voluntary discontinuation, and that the impact is prospective. We do not believe that this guidance has been subject to abuse and therefore propose that it should be retained in the new standard.

Accounting for fair value hedges

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?

Fair value hedge mechanics

We do not support the ED's proposal to recognise the gain or loss on the hedging instrument and hedged item in OCI and to then transfer the ineffective portion to profit or loss; this seems to add unnecessary complexity, without providing any significant improvement in financial reporting.

In addition, we do not support the ED's proposal 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, as the primary financial statements will look very cluttered, particularly for entities that enter into a significant number of hedge relationships.

Paragraph 26(b) of the ED states that the separate line item should be presented next to the line item that includes the hedged asset or liability. By applying this requirement, it is likely that there will be hedge adjustments that are negative figures on the assets/liabilities sides of the balance sheet, which may accordingly add to confusion for users rather than simplifying the use of hedge accounting.

Therefore, we recommend that the hedged item should continue to be adjusted for gains/losses attributable to the hedged risk as is currently the case under IAS 39, and that information is given in the notes to the accounts separating the fair value adjustment from the hedged items' carrying value.

Use of hypothetical derivatives

The ED (B44 and B45) permits the use of hypothetical derivatives for hedge effectiveness assessment and measurement, for both fair value hedges and cash flow hedges (under IAS39 hypothetical derivatives are widely used to calculate effectiveness but only for cash flow hedges). The benefit of using hypothetical derivatives for fair value hedges would be to eliminate any ineffectiveness from the fair value of the most recently fixed floating leg on a hedging swap.

In addition, the guidance in B82 recognises that certain hedges that meet the ED's definition of fair value hedges are not always a hedge of the hedged item's fair value, but rather transform the cash flows of the hedged item. For instance if an entity's risk management strategy were to convert a fixed rate asset into a floating rate three-month LIBOR based asset, then it would seem appropriate that a hypothetical derivative be used for effectiveness testing and measurement purposes, to reflect the risk management objective. We therefore support the ability to use hypothetical derivatives as part of the assessment and measurement of ineffectiveness for fair value hedges as well as for cash flow hedges.

Linked presentation

There is not wide support for linked presentation amongst our members.

Accounting for the time value of options for cash flow and fair value hedges

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 (e.g. 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 (i.e. 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?

We welcome the proposal to defer changes in time value that arise from hedging with options in OCI. However, we believe that an accounting policy choice should be permitted since the proposed approach is operationally complex. Specifically, when only the intrinsic element of an option has been included within a hedge relationship, there should be a choice as to whether the treatment in the ED is applied or the current IAS39 treatment of recognizing the fair value changes in profit and loss is applied.

Paragraph B68 of the ED introduces the new term 'aligned time value'. This appears to be the time value of a hypothetical derivative, and if so, we recommend that the wording states this rather than introduce new terminology. However, we believe that in many instances the aligned time value and the actual time value will be similar.

The ED is not clear on the treatment for zero cost collars. It is our expectation that any changes to the time value of the collar could still be deferred in OCI, even though there would be no need for any amortization. We believe that this should be confirmed in the final standard.

Eligibility of a group of items as the hedged item

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?

We reiterate our expectation that the ED on portfolio hedging will resolve many of the outstanding concerns about the ability to achieve hedge accounting where a portfolio approach is employed to manage interest rate risk. The proposal for groups of hedged items in the ED makes little contribution to addressing our concerns in this regard.

Many of our members use the macro cash flow approach under IAS39, contained in IGCs F6.2 and F6.3. We would welcome confirmation from the Board that this approach will still be acceptable under the new standard (in which case we request this that these particular IGCs from IAS39 be carried forward to the new standard) or that the model be incorporated in the standard as part of the portfolio hedging project.

As noted in our response to question 5, we welcome the direction that the Board's discussions have taken on portfolio hedging to date. However, as well as considering hedging of assets prepayable other than at fair value we request that the Sub-LIBOR issue and preclusion of designating demand deposits in fair value hedges on an expected prepayment basis, should also be addressed by the macro-hedging project.

The ED restricts cash flow hedges of net positions to situations where cash flows are expected to occur and affect profit or loss in the same reporting period (paragraph 34(c)). Larger entities that produce interim reports will be disadvantaged by this requirement, compared with entities reporting on an annual basis, which will have more flexibility in demonstrating that the cash flows occurred in the same 'reporting period'. Therefore we do not believe that the new guidance on the hedging of net positions is helpful. Indeed, given the requirement for net presentation in the profit and loss account, some preparers may prefer the current IAS39 approach of designating a proportion of a gross exposure as the hedged item. It would therefore be helpful for the Board to confirm that the gross designation approach would continue to be permitted for accounting purposes under the new standard if the risk management strategy is applied to a net group of hedged items.

We further request that a requirement for cash flows to impact profit and loss in the same reporting period would not negatively impact an entity's ability to apply the IAS39 macro cash flow hedging guidance.

Presentation (groups of hedged items)

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 (e.g. 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?

We agree that if offsetting hedged positions affect different lines of the income statement, then the hedge adjustment should be presented in a separate line item. However, we are unclear as to the principle for this guidance. In particular, we are concerned that if hedging on a gross basis (i.e. transacting two, offsetting derivatives), the same economic position will be affected, but it will result in a very different presentation in the profit and loss account.

Disclosures

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?

In addition to the requirements in IFRS 7, paragraph 40 of the ED requires disclosure of further information about:

a) an entity's risk management strategy and how it is applied to manage risk;
b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity (in short, the overall effect on the financial statements).

Whilst we can see the value in some of the disclosures proposed in the ED, we are concerned that the information required is too extensive.

As mentioned under Question 1, we consider that the linkage between an entity's risk management objective and its hedge accounting strategies needs to be better articulated in the ED. This issue is also relevant to the proposed disclosures, which we believe require entities to explain their risk management strategy and the consequences of hedge accounting, without showing the extent to which they are aligned (or, indeed, the extent to which they are different). It seems that the disclosures have been written assuming a 1:1 mapping between the risk management strategy and hedging relationships, which as previously noted, is not necessarily the case.

In addition, although paragraph 44 of the ED is clearly only applicable where hedge accounting has been applied, guidance elsewhere in the ED (paragraphs 45-48) is not clear as to whether the disclosure requirements are only applicable where hedge accounting is applied, or whether this should be more widely applied to all situations where risk management activities are undertaken.

We also have concerns as to the relevance of certain disclosures and as to whether they can be audited. For instance, paragraph 46(a) requires disclosure of the amount of exposure for each risk, as well as the amount that is actually hedged. Whilst it may be possible to determine the extent to which forecast exposures are *highly probable*, it would be much more difficult for management to assert, or for auditors to attest, to the *most likely* forecast. Also, this level of disclosure seems disproportionate as it is not required when no risk mitigation activity is undertaken.

In addition we do not support the requirement to disclose notional amounts related to the hedging instruments (paragraph 49(b)). We do not believe that this will be useful information, especially where a combination of derivatives are used in a hedging relationship.

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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?

ISDA has no comments on this particular issue.

Accounting for credit risk using credit derivatives

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?

As noted in Question 4, the ED confirms the Board's view that credit risk is not separately identifiable and hence is ineligible as a risk component for hedge accounting purposes. As stated in our response to Question 4, we do not support this view or the inclusion of such a specific rule as part of a principles-based standard.

This is a significant issue for many financial institutions. The prohibition on hedge accounting for credit risk can result in significant P&L volatility in respect of what are valid risk management activities. Therefore, we see it as essential that a solution is found for the hedging of credit risk.

We outline below our suggested approaches for consideration, in order of preference:

1. The ability to designate credit risk as an eligible risk component for hedge accounting. Hence, we recommend that the Board does not have a rule within a principles-based standard prohibiting hedge accounting for credit risk.

2. Introduce the ability to designate 'everything but the LIBOR' component' as an eligible risk component for hedge accounting. We believe that such a component will be separately identifiable and measureable, (consistent with the approach to the measurement of own credit within IFRS7). This would enable entities to compare changes in the fair value of 'everything but the LIBOR component' to changes in that of hedging credit default swaps ('CDS'). Although this would not result in perfect effectiveness, it would permit hedge accounting.

3. Amend the general hedge accounting guidance specifically for credit hedging, i.e. state in the guidance that CDS spreads may be regarded as a risk component of financial instruments, representing the credit risk. Whilst we are aware that it is the Board's aim to reduce the number of rules in the standard, it appears that some specific amendments may be required in this area. Amending the hedge accounting guidance rather than applying the fair value option has the advantage of providing a better linkage to actual risk management practices, as mitigating credit exposure by transacting derivatives would be considered a hedging activity

4. Use alternative 3 of the different approaches proposed by the Board in the ED. Whilst alternative 3 does provide the necessary flexibility to make the designation at any time and to discontinue the designation to match risk management activity, making the designation could actually increase P&L volatility as fair value movements from all risks must be included. Therefore, if a fixed rate exposure was hedged for credit risk, the fair value of the fixed rate leg for interest rate risk will also be taken to P&L if the fair value option is applied.

5. Consider CDSs transacted for hedging purposes as providing protection similar to an insurance contract and, accordingly, amortise the cost to the profit and loss account. This would be similar to the proposed treatment for the time value of options.

Effective date and transition

Question 16 Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

Consistent with our response to the IASBs consultation on *Effective dates and Transition Methods*, we support 1st January 2015, as the earliest mandatory adoption date for the new standard.

We agree with the proposal that the ED should be applied prospectively, although we also believe that the Board should consider whether entities could be permitted to apply the revised hedge accounting guidance to the comparative information if it is practical to do so.