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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the Exposure Draft *Hedge Accounting* (ED/2010/13). Principal authors of this comment letter are Peter Bitzyk, Werner Fleischer, Peter Geyer, Andreas Gilly, Michael Hammer, Heiner Klein, Gerhard Margetich, Andreas Rauter, Ernst Schönhuber, Gerhard Schröder, Martin Svitek, Raoul Vogel and Roland Nessmann (chairman of the working group). The professional background of these authors is heterogenous (preparers, academics, and audit companies) in order to assure a balanced Austrian view of the ED.

GENERAL REMARKS

We appreciate the intention of the ED to align risk management and accounting. We hope that some side-steps from this goal – e.g. regarding the use of risk management practices within the layer approach – are changed when the final standard is published.

SPECIFIC REMARKS

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?

We agree.

BC 9 sets out the differences between market expectations about what should be accounted for and disclosed using hedge accounting and what was permitted under IAS 39. We strongly believe that, in accordance with the objectives of IFRS financial statements as established in IAS 1.9, the management approach should have a stronger influence on accounting, even if inter-company

comparability is reduced. And as risk management between reporting entities differs, the results of risk management practices should differ, too. In order to reach this new goal a solution for the hedge accounting of portfolios has to be developed in the near future.

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.

Hedge accounting based on risk management practices should allow non-derivative financial instruments as eligible hedging instruments. The restriction of eligibility to financial instruments being valued at fair value through profit or loss is reasonable. What IASB should further investigate, however, is the possible treatment of non-derivative (financial) instruments not being recorded at fair value through profit and loss as eligible hedging instruments, provided that they are used in risk management and the other requirements for hedge accounting as set out in this exposure draft are also met.

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.

As explained in BC 50, risk management using financial instruments available on the market may mean that derivatives form part of a hedged item, which should not preclude these economically effective risk management practices from being adequately reflected in hedge accounting.

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 (i.e. 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 agree.

We welcome the proposal to allow individual risk components of non-financial assets and non-financial liabilities to be eligible for hedge accounting purposes. Hedge accounting based on risk management practices should allow risk components of financial instruments as well as of non-financial instruments as eligible hedged items, providing that these items are separately identifiable and reliably measurable. Otherwise, we doubt that these items can be properly managed as part of

risk management.

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?

We agree.

Hedge accounting based on risk management practices should allow a layer of the nominal amount of an item as a hedged item, provided that these practices provide for an adequate tracking system. This should be taken into account when formulating the upcoming rules for portfolio hedge accounting.

(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?

In principle we agree, unless it can be demonstrated that the prepayment option is clearly taken into account for risk management purposes and the option has never been exercised in the respective layer in the past, and thus the respective layer is not affected by the prepayment option at all.

An example of when a bottom layer approach may be relevant for prepayable loans is a group of granted loans for which a bank decides to swap from fixed interest rate payments to variable interest rate payments and identifies a certain layer which, from experience, is not affected by any prepayments. This is often the case in the retail banking business. In such case it is irrelevant that fair value changes related to the hedged interest rate risk are affected also by a prepayment option that is not part of the designated hedge relationship. The bottom layer is generally not affected by any prepayments and is held until it matures in accordance with the original payment schedules. The prepayment option risk is therefore not relevant for such loans when looking at them only as a layer. This approach is also used for market transactions when there is an assumption for the portion of a retail portfolio that will be taken into account when determining fair value. We would also mention bank stress tests performed by supervisors, which show significant portion of retail deposits not being withdrawn even if interest rates change.

We believe that when making this decision IASB was more concerned about the fact that the bottom layer approach might be used to replicate the hedges of net positions. In such case the fact that the loans are prepayable would matter.

Two agenda papers from August IASB meetings discussing the layer approach mention that the exclusion of prepayable items was introduced deliberately because fair value interest rate hedges of fixed rate loans with prepayment options need special consideration which will be addressed in a separate paper. These issues are discussed in the agenda papers 10-10D from the 16 November IASB meeting and are part of the macro hedges phase of the hedge accounting project. The papers

initiated a promising development that would allow the bottom layer approach for prepayable instruments. We fully support this development, because it would align hedge accounting with actual portfolio management of interest rate risk in practice.

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?

In principal we agree. What should be specified more precisely are the conditions and circumstances under which an entity can demonstrate not only a statistical but also a substantive economic relationship. Although we strongly support the elimination of the 80% and 125% thresholds, we would propose a discussion of the desired offsetting levels in somewhat more detail than is included in B29 at present. Also, the circumstances that force an entity to switch between qualitative and quantitative hedge effectiveness testing in B37 should be explained: According to B30, it could be read as strictly following risk management procedures and decisions.

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?

In principle we agree, but in our view the requirements, the effects and the available methods should be explained in more detail in the interests of consistent implementation.

(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 agree.

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?

We agree.

(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?

We agree.

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?

We cannot see the reason for reporting the effective part of the hedge accounting relationship in OCI: the financial statements should show the most relevant information with explanations being shown in the notes. Since this is an important source of information, these notes should also be disclosed in interim statements in accordance with IAS 34.

The value of the changes in the value attributable to the hedged risk should be shown in the statement of financial position and the ineffective part of the hedge accounting should be shown in the statement of income. In our view, to disclose identical figures on debit and credit side would add no value to the statement of other comprehensive income: all disclosures relating to hedge accounting should therefore be in the notes.

(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?

See our answer to 9(a) above.

(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?

We share the Board's conclusion in IN 32 of the ED and agree.

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?

We agree.

(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?

We agree.

(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?

Generally, we see the treatment of the time value of options in hedge accounting as a great step forward. This recommended treatment is, however, highly complex. As risk management should be the basis of hedge accounting, in our view the solution should follow the way risk management treats the time value of options.

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?

In principle we agree; but the solution for hedge accounting of open portfolios and macro hedges forms part of the second phase of the hedge accounting project.

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; but the effects should be shown in a single line item in the statement of financial position for fair value hedges and for cash flow hedges, which are hedged as a group too.

Question 13

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

We agree.

(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

We see no need for any additional disclosures.

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?

We agree.

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?

With CDSs being frequently traded on active markets with publicly available prices and enough liquidity in the markets, we see no reason why some kinds of hedge accounting should not be done with CDSs, too. It is common practice in some industry sectors to use CDSs as hedging instruments for the risk of changing credit spreads, and in our view this is consistent with all the requirements of the exposure draft. Of course, CDSs cannot be hedging instruments for all types of risks: from our point of view they should be allowed for risks when all requirements of hedge accounting could be and are fulfilled, e.g., for the hedging of the risk of changes in the value of credit spreads.

(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?

See our answer to (a) above.

Question 16

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

We agree.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl

Chairman