Review Draft: Hedge Accounting

Dear Sir or Madam,

MAZARS welcomes the opportunity to comment on the IASB Review Draft (thereafter “RD”) *Hedge Accounting*. We understand that the objectives of the RD are to ensure that the cumulative tentative decisions made by the Board during the redeliberation process are adequately reflected in the document, and to allow constituents to detect potential fatal flaws.

We acknowledge that the RD achieves significant improvements compared to current IAS 39 requirements to better align hedge accounting with risk management, notably by:

- Removing the arbitrary 80%-125% thresholds when assessing effectiveness
- Extending to non-financial instruments the possibility to hedge risk components
- Allowing to designate an aggregated exposure as a hedged item
- Reducing the volatility of the time value of options and of the forward element of forward contracts when derivatives are documented in a hedging relationship
- Introducing the notion of rebalancing

However, we bring to the Board’s attention the following fatal flaws that we have identified in the RD:

- **Designation of a financial asset / liability accounted for at amortized cost as hedging instrument in a hedge of foreign exchange risk**

RD 6.2.4 (c) sets forth that in a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset / liability may be designated as hedging instrument except in some circumstances. At the same time, RD 6.2.2 indicates that only non-derivative financial assets or non-derivative financial liabilities measured at fair through profit or loss may be designated as hedging instrument.

This creates an uncertainty as whether a financial asset / liability accounted for at amortized cost will be eligible as hedging instrument in a hedge of foreign exchange risk under IFRS 9.
- Interaction between IAS 39 and IFRS 9 for macro-hedging

For macro-hedging, the Board should clarify whether entities shall (i) apply current IAS 39 guidance in its entirety without any reference to IFRS 9, or (ii) refer to paragraphs 81A, 89A, and AG114-AG132 of IAS 39 only while using other paragraphs of IFRS 9 for some other areas (e.g. eligibility criteria). We believe that entities implementing macro-hedging should apply only current IAS 39 requirements in order to avoid referring to two standards with potentially contradicting guidance, and to ensure that practices are not changed before the macro-hedging project is complete.

The Board should also clarify that hedge accounting of an open portfolio of future cash-flows (macro-CFH) is not in the scope of the RD. Indeed, RD 6.1.3 explicitly scopes out macro-FVH only. This may be interpreted as macro-CFH being within the scope of the RD, although the Implementation Guidance on macro-CFH (IAS 39 IG F.6.1, F.6.2 and F.6.3) is not carried forward in IFRS 9. We believe that both macro-FVH and macro-CFH should be addressed as part of the macro-hedging project.

- Hypothetical derivative example in B6.5.5 is inconsistent with hedging strategies

We believe that the systematic exclusion of the currency basis from the effective part of the hedge may lead to profit or loss volatility (due to ineffectiveness) that is inconsistent with risk management strategies. The currency basis may be analyzed as a cost component of an effective hedging strategy, and as such, should benefit from the same accounting treatment as the forward element of forward contracts.

- Ineligibility of intragroup monetary items as hedging instruments

BC6.60 precludes intragroup monetary items from being designating as hedging instruments without explaining the economic rationale supporting the Board’s decision. In particular, there is no information explaining to what extent the documentation of an intragroup monetary item as a hedging instrument contrasts with the documentation of an external monetary item. The Board’s prohibition leads to counter-intuitive accounting outcome:

- An external EUR debt issued directly by a subsidiary with a CHF functional currency may be documented as a hedging instrument.
- The same external EUR debt issued by the group’s central treasury and whose cash proceeds are transferred to the subsidiary with a CHF functional currency creates volatility in the consolidated profit or loss because the intragroup EUR debt cannot be documented as a hedging instrument at the subsidiary level.

BC6.60 states that not to allow intragroup monetary items to be eligible hedging instruments has the effect to retain the restriction in IAS 39. However, the RD provides no further indication so as where the restriction is explicitly stated in IAS 39.

- Option to designate a credit exposure as measured at fair value through profit or loss

The qualifying criteria listed in § 6.7.1 to designate a financial instrument hedged with a credit derivative as measured at fair value through profit or loss contain no restriction on the nominal of the credit derivative.
We believe that IFRS 9 should include an additional qualifying criterion (e.g. similar to a
hedge ratio) in order to impede applying the fair value option to an entire portfolio of assets
that is partially backed by a smaller credit derivative.

• **Accounting for the time value of options and forward element of forward
contracts**

We believe that IFRS 9 should clarify that the accounting for the time value of options (when
the option is documented based on its intrinsic value) and the forward element of forward
contracts (upon election when the forward contract is documented based on its spot
component) applies for all types of hedging relationships (FVH, CFH, NIH). Indeed, some
may consider that to defer in OCI changes in fair value of the time value (or of the forward
element) is not compatible with the mechanisms of FVH accounting.

• **RD does not take over IAS 39 Implementation Guidance, thus raising risks on the
eligibility under IFRS 9 of commonly-used hedging strategies**

Partial term hedging may be supported by § 6.3.7 (c) in the RD: “An entity may designate an
item in its entirety or a component of an item as the hedged item in a hedging relationship
[…] A component comprises […] one or more selected contractual cash flows”. However,
the RD does not carry forward to IFRS 9 the IG F.2.17 that presents how the effectiveness test
shall be adapted to document a 5-year swap in a fair value hedge of a 10-year bond classified
in available for sale: “the swap may be designated as hedging the fair value exposure of the
interest rate payments on the government bond until year 5 and the changes in value of the
principal due at maturity to the extent affected by the changes in the yield curve relating to
the five years of the swap”. The removal of IG F.2.17 may raise uncertainties as whether
partial term hedging may still be achieved under IFRS 9.

Among the other Implementation Guidance widely used to document hedging relationships
under IAS 39 and not carried forward to IFRS 9, we have identified the following:

- F.1.9: Delta-neutral hedging strategy
- F.1.12: Hedge of more than one type of risk
- F.1.13: Hedging instrument: dual foreign currency forward exchange contract
- F2.5: Cash-flow hedge: all-in-one hedge

Even though the RD achieves significant improvements compared to current IAS 39
requirements, we consider that the IFRS 9 project missed the opportunity to provide adequate
answers to some important issues commonly faced by entities. We believe that those issues
should be further considered by the IASB in the future (e.g. during the post-implementation
review of IFRS 9):

• Hedging of risks not impacting profit or loss (IAS 19 actuarial gains or losses, treasury
shares bought in the frame of IFRS 2 equity-settled plans, foreign currency risk of
future dividends from subsidiaries, etc.)
• Documentation of CFH on a net basis limited to foreign exchange risk while
commodity risk is largely operationally hedged on a net basis
• Accounting for sub-LIBOR hedges
• Impact of prepayment options on effectiveness testing when using a layer approach under FVH
• Presentation in the profit or loss of the impact of hedges documented on a net basis
• Impossibility to hedge the equity price risk of a forecast acquisition of an equity instrument
• Impossibility to consider credit risk as a separately identifiable and reliably measurable risk component

Do not hesitate to contact us should you want to discuss any aspect of our comments.

Best regards,

Michel Barbet-Massin
*Head of Financial Reporting Technical Support*