



March 9, 2011

Sir David Tweedie
Chairman
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Ms. Leslie Seidman
Chairman
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Re: File Reference No. ED/2010/13, Hedge Accounting

Dear Ms. Seidman and Sir David:

The Clearing House Association L.L.C. (“The Clearing House”),¹ an association of major commercial banks, appreciates the opportunity to comment on the above-referenced Exposure Draft (“ED”).

Executive Summary

The Clearing House supports the efforts of the International Accounting Standards Board (the “IASB” or the “Board”) to improve the quality of financial statements, while at the same time reducing complexity. We note that the proposal under consideration by the Board is a comprehensive reconsideration of hedge accounting, and we support the efforts of the IASB to improve and simplify this important area of accounting.

¹ Established in 1853, The Clearing House is the nation’s oldest banking association and payments company. It is owned by the world’s largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House’s web page at www.theclearinghouse.org.

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In summary, The Clearing House:

Supports the efforts of the Board to simplify hedge accounting and align the accounting more closely with the underlying economics of hedging transactions and *recommends* both the IASB and FASB reflect this objective in a converged standard;

Objects to the proposed hedge effectiveness requirements, as we believe this may be interpreted in such a manner that would require an entity to hedge to the “theoretically perfect hedge ratio” even when that is not in accordance with the risk management objectives of an institution; and *recommends* instead that the Board either clarify the criteria or consider, as an alternative, adopting the “reasonably effective” criterion recently proposed by the FASB;²

Strongly recommends that the Board permit dedesignation of hedge accounting relationships, as this would more closely align the accounting for hedge activities with the way in which such relationships are actually managed for economic purposes;

Strongly recommends that the Board articulate the principle that a hedge relationship is eligible for hedge accounting as long as the risk component is separately identifiable and reliably measurable, without making any determination or comment as to whether certain risks, such as credit risk, meet this threshold; and *suggests* that the Board reconsider alternative 3 for hedging credit derivatives, wherein an entity could elect fair value through profit or loss at initial recognition or subsequently, as this would more closely align the accounting model to the underlying economics, and the benefits of this model strongly outweigh the slight increase in complexity;³

Believes that the potential benefits of the proposed presentation changes to the accounting model for fair value hedges do not outweigh the significant additional costs involved in making these changes;

Recommends that the proposed disclosures remain principles-based and *suggests* that the Board remove many of the more detailed, rules-based disclosures as we are concerned they may prove too confusing to investors; and

Recommends that the Board proceed with the next phase of its project to reconsider the hedge accounting model for macro-hedging, as many large financial institutions economically hedge their risks on a macro basis, and this would therefore further the Board’s goal to align hedge accounting with risk management practices.

Our responses to the Board’s specific questions follow.

² Proposed ASU on Accounting for Financial Instruments, paragraph 113.

³ Basis for Conclusions and Illustrative Examples Exposure Draft, Hedge Accounting, paragraph BC226.

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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 it would be extremely useful to have a clearly articulated objective that underlies the guidance for hedge accounting, as this would be helpful in the ongoing application of the guidance and lay a robust foundation for the standard. In addition, we agree that the proposed objective, to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss, is an appropriate one. We believe that under the current guidance, analysts and investors have a difficult time deciphering the impact of hedge accounting on an entity's business, because the detailed rules do not accurately reflect how companies actually manage their risks. That said, we believe there are numerous practical issues to be resolved in order to make the standard operational. In sum, we support the IASB's objective to align the accounting for hedge relationships with the underlying economics, and we recommend that both the IASB and the FASB reflect this objective in a converged standard.

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 with this change. We note that in practice, many institutions economically hedge their risks with non-derivative financial assets and liabilities and, thus, this change would meet the Board's objective of more closely aligning the accounting for hedging with the way companies actually manage their risk exposures.

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 this change as, again, it reflects how many institutions economically hedge their risks in actual practice. However, it is unclear how this type of a hedge relationship would be required to be documented and/or designated in practice in order to achieve hedge accounting. For example, assume a company decides to hedge a loan with a credit default swap as well as an interest rate swap. It is not clear how hedge effectiveness on this combination of exposures would be required to be designated and documented. Which derivative would be combined with the loan and which would be considered the hedging instrument? We believe management should be permitted to define how the relationship is designated, as long as this is consistent with the entity's risk management approach. Accordingly, we recommend that the ED be clarified regarding this point.

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 agree that this is an appropriate principle on which to determine whether hedge accounting is permissible, and we believe it should be articulated as one of the fundamental principles of the standard, since we believe this would more closely align hedge accounting with risk management. However, we believe that it is not appropriate for the Board to offer opinions or statements in the standard as to what risks are or are not “reliably measurable,” such as those regarding credit risk, prepayment risk, and inflation.⁴ We believe such statements will inevitably lead to a more rules-based application of the standard, which we believe runs counter to the Board’s expressed objective of issuing a more principles-based standard.⁵ We note that the financial markets continue to evolve and innovate at a very rapid pace and are constantly developing new indices and instruments, such that what may be considered difficult to measure today may become a standardized metric tomorrow. Accordingly, we believe the Board should set forth the general principle that a risk component should be separately identifiable and reliably measurable, but should eliminate the references to credit risk, prepayment risk, and inflation as not meeting this definition.

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 agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item, if such designation is consistent with management’s hedge objective(s) for the item. However, we do not agree with the Board’s reasoning for not permitting hedge accounting to be applied to contracts that include a prepayment option as we do not believe it is appropriate for the Board to include specific language stating that prepayment risk cannot be reliably measured. As noted above, we believe this type of prohibition is too rules-based and does not further a principles-based approach to standard-setting. We believe the Board should set forth the general principle that a risk is eligible for hedge accounting, if it is separately identifiable and reliably measurable, and allow constituents to make the determination of what types of risks meet this definition.

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?

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?

⁴ Paragraphs IN46, IN22 and B18, respectively, of the ED.

⁵ Press Release December 9, 2010, *IASB proposes improvements to hedge accounting*.

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(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 strongly support the efforts of the IASB to develop a hedge accounting framework that reflects the dynamic and constantly changing economic hedging strategies of large financial institutions; however, we do not believe that the proposed hedge effectiveness criteria accomplish this. In this regard, we note that large financial institutions closely monitor their risk exposures and frequently rebalance their hedge relationships to ensure that their hedging strategies are aligned with their risk objectives. At the same time, we note that an institution's risk management objectives may not always be designed to produce "an unbiased result" and "minimize expected hedge ineffectiveness".⁶ In fact, an institution may choose, for various reasons, to intentionally overhedge or underhedge an instrument or a portfolio of instruments. This may be because there are "natural hedges" that exist elsewhere in the institution (perhaps in another portfolio), or because, in the case of smaller portfolios, it might be too costly to hedge to the theoretically "optimal hedge ratio" and maintain this hedge ratio over time. Thus, for example, assume that the theoretically optimal hedge ratio for a particular hedge relationship (such as the one described in paragraph B30 of the ED for a forecasted purchase of a commodity) is 1.11:1. However, an entity may decide, for reasons such as those cited above, to hedge only to a 1:1 ratio. We are concerned that, as written, the proposed guidance would require an entity to hedge to the 1.11:1 ratio. We therefore do not support the objective of the hedge effectiveness assessment as it is currently defined in the ED, as it would not be in alignment with risk management objectives of a company.

Similarly, a company's risk management objectives may evolve over time, such that a company's objective in one period may not be the same as it was in a prior period when it originally entered into a particular hedge transaction. Thus, a company may initially elect to hedge to the "optimal hedge ratio" at the inception of the hedge, but it may later decide not to hedge to this ratio in a subsequent period. We are concerned that the ED may be interpreted to require entities to rebalance their hedge relationships to the optimal hedge ratio on a regular basis, even in instances where the optimal hedge ratio is no longer targeted by the entity's risk management function. Such a requirement could, therefore, separate the accounting requirements from the risk management objectives of a company. Accordingly, we believe that the IASB should permit, but not require, an entity to rebalance its hedge relationships, as we believe that would most closely align the accounting for hedge relationships with the underlying economic strategies.

Accordingly, we strongly encourage the Board to clarify the proposed criteria to explicitly permit overhedging, underhedging and rebalancing. Alternatively, we recommend that the Board consider the criterion proposed by the FASB in its Proposed ASU on *Accounting for Financial Instruments*, namely, that a hedge be expected to be "reasonably effective" in offsetting changes in the hedged item's fair value or variability in cash flows of the hedged transaction in order to qualify for hedge accounting. Although we are aware that the ED differs in many respects from FASB's Proposed ASU, we believe it would be quite helpful if the Board and the FASB could converge in this one criterion, as it is one of the fundamental aspects of the proposed standard and would therefore lay the groundwork for future convergence. We understand the Board was concerned that adopting this suggested approach could

⁶ Paragraphs IN24, B16, B29 and B50 of the ED.

introduce an implicit requirement to measure hedge effectiveness using quantitative methods. However, we believe that a “reasonably effective” standard can be implemented in practice using qualitative methods only. Furthermore, we believe that the threshold of “reasonably effective” is also consistent with the way many institutions actually manage their hedging relationships today and would, therefore, be both more operationally efficient and consistent with economic reality. Finally, we believe that the FASB’s proposed criterion is both more understandable and practicable than the criteria currently proposed by the IASB.

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?

We strongly believe that the IASB should not prohibit dedesignation of hedges. We note that a key goal of the ED is to align an entity’s accounting with its risk management practices. Since institutions regularly designate and dedesignate hedge relationships for risk management purposes as part of their routine business practices, prohibiting dedesignation would be contradictory to risk management practices and would unnecessarily restrict the use of many valid hedge programs.

For example, instead of hedging on a macro basis, which is not permitted under current IFRS or the ED, entities frequently designate specific transactions which are representative of a larger group as hedged items. As changes occur in the risk profile of the larger group, an entity will typically adjust its hedging relationships through dedesignation of the existing hedging instruments and immediate redesignation of those hedging instruments as hedges of similar but not identical transactions. These types of hedging programs, which are prudent and cost-effective risk management tools, would no longer be permitted under the ED. Thus, an entity’s accounting would not match its risk management practices, which is a key goal of the ED.

To achieve similar risk management effects, the ED would require the entity to either terminate the hedge position and enter into a new hedge or add hedging instruments to adjust the hedging relationship to the change in the hedged risk (either in offsetting or additive form). These new hedging instruments could be quite costly, particularly when considering that the hedged items may change as frequently as daily, requiring continuous rebalancing of the hedging instruments. As we see no economic benefit to this approach, we do not agree that incremental costs related to this amendment are warranted.

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?

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(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?

We appreciate the conceptual merits of the proposed change in accounting for fair value hedges as likely eliminating a potential point of confusion regarding the existing hedge accounting standard (i.e., why fair value hedges and cash flow hedges are accounted for differently). However, we have significant practical concerns regarding the detailed accounting that would be required in order to track the amounts to be released from other comprehensive income and we do not believe that the potential benefits of the change would outweigh the significant costs.

With regard to the presentation of the gain or loss on the hedged item, we believe that based on our members' collective experience, it is unlikely that the amount of the gain or loss would ever rise to a level of materiality such that separate presentation in the balance sheet would be required. Furthermore, we believe that the current approach of adjusting the basis of the hedged item has proved to be both operationally efficient and well understood by investors. Accordingly, we suggest that the Board continue the existing accounting treatment wherein the gain or loss on the hedged item is recorded as an adjustment to the carrying value of the hedged item.

Finally, we believe that linked presentation should be allowed for fair value hedges, as we believe this approach would clearly display the hedged item along with the offset provided by the hedging instrument, thus providing the most useful and transparent information to investors by prominently displaying both the gross and net exposures on the face of the financial statements.

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 (eg 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 (ie 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?

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We agree with the proposed accounting model for the time value of options. Many financial institutions have long considered the time value of options as the cost of obtaining risk protection, analogous to an insurance premium. The proposed accounting model would therefore align the accounting for the time value of options with the risk management view as well as with the treatment for similar areas of accounting.

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 agree with the criteria for the eligibility of groups of items as a hedged item. We believe that they appropriately reflect the way in which an institution may choose to manage its risk by capitalizing on the natural hedges provided by offsetting risk positions. In this regard, we urge the Board to commence consideration of macro-hedging, in the next phase of this 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 (eg 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 a gross presentation would be potentially confusing and therefore agree with the Board's decision to require a net presentation for these types of hedge relationships. We presume that if the net amount is not material, it could be included with Other Income or Expense with the amount separately disclosed in the footnotes.

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?

As an overall matter, we believe that the proposed disclosure requirements, in conjunction with the existing requirements, may be too voluminous and difficult for users to understand. We agree that hedge accounting disclosures should provide information about an entity's risk management strategy and how hedges are applied to manage risk. We are concerned, however, that the proposed disclosure requirements, such as the requirements to disclose:

the monetary amount or other quantity to which the entity is exposed for each particular risk;

the amount or quantity of the risk exposure being hedged;

how hedging changes the exposure of that risk in quantitative terms;

the carrying amount of the hedging instruments;

the notional amounts or other quantity related to the hedging instruments,⁷

are far too prescriptive and detailed and may prove confusing to investors. Instead, we recommend that the disclosure requirements be more objective-based, wherein an entity would be required to disclose quantitative information to enable users of its financial statements to evaluate the types of risk exposures being managed and the effect of the hedging strategy on the risk exposure and the financial statements. We also recommend that this information be provided only for a company's significant hedging programs, as opposed to each category of risk. In addition, we believe that the proposed disclosure requirements should be aligned with existing disclosure requirements for financial instruments, such as those required by IFRS 7, *Financial Instruments: Disclosures*, so as not to result in any duplication of disclosure. Once a streamlined approach is developed, it should be field tested with users of financial statements to ensure that it will provide the information they need.

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 with this proposal since it reflects the current practice of many companies that use commodities in the same way as derivative contracts to hedge commodity risks. Accordingly, we support this change since it further aligns the accounting with the associated risk management activity and thereby provides more useful information to investors.

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?

We strongly urge the Board to consider the third alternative as described in paragraph BC226. Hedging credit risk is of vital importance to financial institutions, and we believe that alternative 3 most closely aligns the accounting for hedge relationships with the dynamic approach to hedging credit risk that is typically employed by most large financial institutions. Although we acknowledge that this alternative adds some complexity to the ED, we believe that it is no more complex than many existing accounting standards, with the added benefit of aligning the accounting for these transactions with the underlying economics. In addition, we believe that the measurement change adjustment can be presented transparently in the financial statements with additional disclosure in the footnotes as necessary.

⁷ Paragraphs 46 and 49 of the ED.

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Regardless of the Board's decision, we strongly suggest that the Board delete the sentence in paragraph IN46 that states: "However, financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item as a component that meets the eligibility criteria for hedged items" (emphasis added). We disagree with this statement as it is inconsistent with other accounting standards that require entities to measure and in some cases separately disclose the change in an instrument's value attributable to credit risk.⁸ More broadly, however, we believe that the Board should articulate the general principle that hedge accounting is permitted where the hedged risk is separately identifiable and reliably measurable, and leave the determination of what meets this criterion to the reporting entity. To do otherwise leads to an overly rules-based standard that does not contemplate the evolution of future new measurement techniques and financial instruments that allow for the reliable measurement of credit risk.

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 with the prospective transition requirements as proposed. Since large financial institutions enter into literally thousands of hedging relationships each period, it is not practicable or cost-effective to require any type of retrospective application of the proposed guidance.

Thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email:

⁸For example, IFRS requires an entity to disclose the change in value of loans and receivables carried at fair value through profit and loss that is attributable to changes in credit risk (IFRS 7.9(c)); both IFRS and U.S. GAAP require entities to disclose the estimated amount of gains and losses from fair value changes included in earnings that are attributable to changes in credit risk for liabilities (IFRS 7.10 (a) and ASC 825-10-50-30); U.S. GAAP requires an entity to record the impairment of a debt security attributable to credit loss separately in earnings if an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before its recovery (ASC 320-10-35-34D); and U.S. GAAP requires an entity to consider counterparty credit risk in assessing the effectiveness of a fair value hedging relationship (ASC 815-20-25-77A).

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Sincerely yours,



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