

23<sup>rd</sup> March 2011

To

**Financial Accounting Standards Board (IASB)**

401 Merritt 7  
PO Box 5116  
Norwalk,  
CT 06856-5116  
United State of America

Dear Sir/Madam,

**Sub:** Selected Issues about Hedge Accounting

**Ref:** Your reference No. 2011-175 & IASB ED/2010/13 on Hedge Accounting

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I thank the FASB for the opportunity to comment on your Discussion Paper, Selected Issues about Hedge Accounting. I would like to state at the outset that the comments that are expressed herein are solely my personal views and strictly do not reflect those of any organisation to which I may be associated presently and/or previously in any capacity.

There are several welcome proposals in the IASB ED/2010/13 on Hedge Accounting cited above (IASB ED) as mentioned more elaborately in my comments attached herewith. However there are at least two new proposals that are conceptually not correct in my view and it is pertinent to mention here in the covering letter that such proposals are also diametrically different from the corresponding provisions of current US GAAP.

The following two items in the current US GAAP are proposed to be modified by the IASB ED. I strongly feel that US GAAP current position is conceptually correct and this should not be changed by the new IASB proposals:

Hedging Instrument	
Current US GAAP	IASB proposal
Non-derivative financial instruments are not permitted to be a hedging instrument. Exception being net investment hedges of foreign exchange risk	A non-derivative financial asset/liability measured at fair value through profit or loss may be eligible for designation as a hedging instrument.
Aggregated exposure as a hedged item	
Current US GAAP	IASB proposal
US GAAP does not permit hedging aggregated exposure that is a combination of an exposure and a derivative	An aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item

I am attaching here the detailed comments/changes suggested and sent to IASB on the relevant exposure draft on the subject for immediate reference.

Thanking you,

Sincerely,

**R. Venkata Subramani**

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27<sup>th</sup> February 2011

To

**International Accounting Standards Board (IASB)**

30 Cannon Street  
London, EC4M 6XH  
United Kingdom

Dear Sir/Madam,

Sub: Response/comments to ED/2010/13 Hedge Accounting

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I thank the IASB for the opportunity to comment on the Exposure Draft on Hedge Accounting. I would like to state at the outset that the comments that are expressed herein are solely my personal views and strictly do not reflect those of any organisation to which I may be associated presently and/or previously in any capacity.

This ED is undoubtedly a giant leap forward in the hedge accounting literature as the entire concept of hedge accounting has undergone a paradigm shift by this exposure draft. Apart from moving closer to the principle based accounting literature, this ED expands the objective of hedge accounting from being a mere ‘accounting mismatch’ mechanism to a broad based system that tracks the effect of an entity’s risk management activities that use financial instruments to manage exposures from different risks.

Proposals that simplify the hedge accounting requirements include doing away with the rigid bright line of specified range while testing the effectiveness of a hedging relationship, thereby ‘eliminating’ the rule-based requirement presumably borrowed from its counterpart on the other side of Atlantic.

Proposals that have complicated the hedge accounting requirements include the introduction of the notion of ‘rebalancing’ hedging relationship as there could be several practical situations in which rebalancing and the ineffectiveness measurement might become extremely complex when a hedging relationship is continually ‘rebalanced’ over a period of time.

**Paragraph 29 & BC134 – BC140:**

A major but welcome proposal that is brought out by this exposure draft (not identified and asked as a specific question for commenting) is the treatment of effective portion in a cash flow hedge of a forecast transaction that subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset.

Para 98 of IAS 39 is reproduced below:

*If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:*

*(a) It reclassifies the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95 to profit or loss as a reclassification adjustment (see IAS 1 (revised 2007)) in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify from equity to profit or loss as a reclassification adjustment the amount that is not expected to be recovered.*

*(b) It removes the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95, and includes them in the initial cost or other carrying amount of the asset or liability.*

This choice is now withdrawn as the Board decided to eliminate the accounting policy choice in IAS 39 and require basis adjustments. The Board proposes that when the entity removes the associated gain or loss that was recognised in other comprehensive income in order to include them in the initial cost or other carrying amount of the asset or liability that gain or loss should be directly applied against the carrying amount of the asset or liability.

*No specific question is asked in the exposure draft for commenting, presumably because this treatment is the same that is accorded for the time value of option in a transaction related hedged item.*

For question 15, I have come up with a suggested method of hedge accounting for credit default swaps and it is only a suggestion open for discussion with the other erudite members of the profession along with guidance from IASB.

The detailed comments/changes suggested are given herewith.

Thanking you,

Sincerely,

R. Venkata Subramani

**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?*

**Response:**

1. Yes I fully agree with the proposed objective of hedge accounting.
2. The predecessor IAS 39 did not provide any objective of hedge accounting, except that it mentions that hedge accounting provides relief to ‘accounting mismatch’ when certain conditions are fulfilled.
3. This exposure draft proposes that the objective of hedge accounting is 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. This aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.

**Changes recommended:**

4. Earlier since the (intended) objective was to give relief to ‘accounting mismatch’, hedge accounting was regarded as a privilege granted to entities and the entities were supposed to fulfil the conditions laid down to earn that privilege by way of documentation, compliance with effectiveness tests prospectively and retrospectively and so on.
5. Now that there is a paradigm shift in the objective of hedge accounting, I feel that **hedge accounting should be made mandatory**.
6. There are some doubts expressed as to how hedge accounting could be made mandatory given that the compliance authorities/regulators have no clue of the risk management policy of the entity.
7. IASB through IFRS 7 already mandates an entity to disclose to the users of financial statements about an entity’s exposure to risks and how those risks are managed.
8. Where the exposure to different types of risk are managed through the process of hedging using different financial instruments, the entity should be made to account for such hedging instruments, as per the hedge accounting methodology prescribed in this proposal.

**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?*

**Response:**

1. No. I do not agree with this. As per the new IFRS 9, a non-derivative financial instrument is required to be designated in its entirety and the disaggregation into risk components other than foreign exchange risk is not allowed.
2. So there is nothing fruitful achieved in allowing a non-derivative financial asset as a hedging instrument.
3. The foreign exchange risk component anyway gets accounted for by IAS 21 – Effects of changes in Foreign Exchange Rates.
4. It is submitted that a non-derivative financial asset/liability other than the foreign exchange risk does not provide a purposeful hedging instrument and as such this proposal is redundant.

**Changes recommended:**

1. No changes suggested except that this proposal may be discarded.

### 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?*

#### Response:

1. I completely **disagree** with this proposal. I am unable to see any logic in designating a derivative or a combination of an exposure and a derivative as a hedged item.
2. The current Exposure Draft BC48 states: "... As the sole exception, paragraph AG94 in the application guidance in IAS 39 allows a purchased option to be designated as a hedged item." Since AG94 anyway permitted a purchased option to be designated as a hedged item, a synthetic instrument combining an exposure and a derivative should be permitted to be designated as a hedged item seemed to be the major reasoning of the Board in coming up with this proposal. I am afraid that this reasoning is conceptually flawed.
3. It is pertinent to note that AG 94 of IAS 39 (as of year 2008) permits a purchased option as a hedging instrument and not as a hedged item. AG94 is reproduced below:

#### **AG 94:**

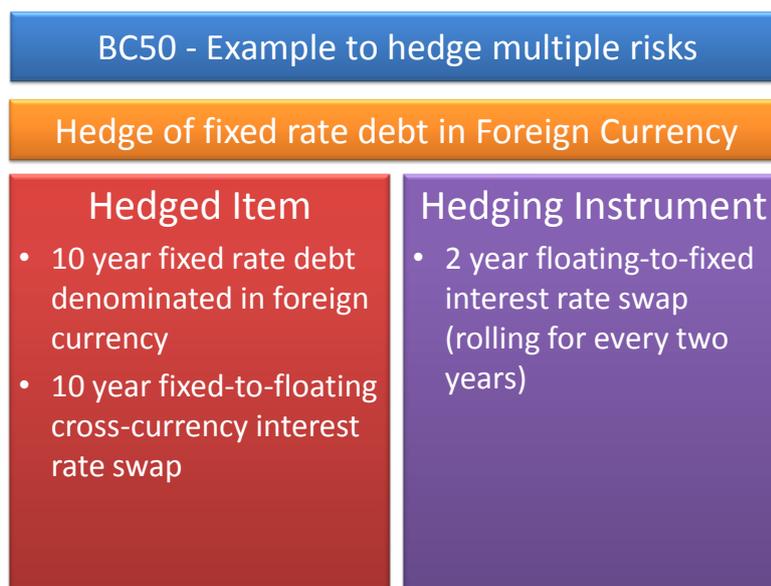
*The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. **Accordingly, it can qualify as a hedging instrument** (emphasis added).*

4. There is also an implementation guideline available in F.2.1 which is given below along with the answer.

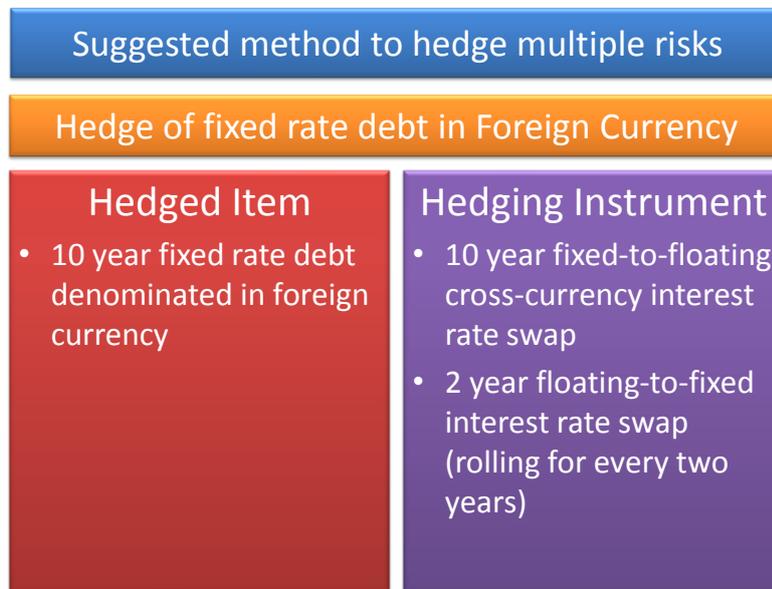
***F.2.1 Whether a derivative can be designated as a hedged item Does IAS 39 permit designating a derivative instrument (whether a stand-alone or separately recognised embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?***

*No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognised in profit or loss unless they are designated and effective hedging instruments (IAS 39.9). As an exception, IAS 39.AG94 permits the designation of a purchased option as the hedged item in a fair value hedge.*

5. In the above answer it mentions (erroneously?) that IAS39.AG94 permits the designation of a purchased option as the hedged item in a fair value hedge. Reading AG94 clearly mentions that purchased option can qualify as a hedging instrument (not as a hedged item).
6. As per BC49 of the current Exposure Draft, the major rationale behind this proposal seems to be the inference drawn out of IAS39.AG94 that if a stand-alone purchased option can be a hedged item then prohibiting derivatives that are part of an aggregated exposure to be part of a hedged item is arbitrary. As mentioned above, the requirement of IAS 39.AG94 itself is not represented correctly in this exposure draft and hence the inference drawn from this is also flawed.
7. As per BC50 of the current Exposure Draft, to hedge a 10 year fixed rate debt that is denominated in foreign currency, 2 year floating-to-fixed interest rate swap is used on a rolling basis. And to convert the fixed exposure in foreign currency to variable exposure in local currency, a 10 year fixed-to-floating cross-currency interest rate swap is used.
8. As per this proposal, the entity should treat the fixed rate debt exposure along with the derivative viz., 10 year cross currency swap as a synthetic instrument and designate this as hedged item.



9. Why should this be complicated like this for hedge accounting purposes? Why not treat only the fixed rate debt exposure as hedged item. All other derivatives are in fact meant to hedge only this position and it is only logical that all the multiple derivative instruments that are intended to hedge this position be treated as hedging instrument and hedge accounting principles of effectiveness testing etc applied accordingly.



**Changes recommended:**

1. This proposal looks conceptually incorrect to me. Derivative instruments should not be designated as a hedging instrument either on a stand-alone basis or in combination with any other non-derivative exposure. It is submitted that this proposal may be discarded.
2. While IAS 39 permits a combination of a derivative with another derivative to be designated as a hedging instrument, it is silent on explicitly permitting a combination of two or more non-derivative exposures to be designated as a hedged item. This should be explicitly permitted.
3. The proposal should be changed as: “An aggregated exposure that is a combination of an exposure and another exposure may be designated as a hedged item, provided none of the exposure is a derivative instrument”.

**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?*

**Response:**

1. Yes I agree with this proposal. It actually rectifies an anomaly in the current provisions.

**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?*

**Response:**

1. Yes I agree with the proposal. This gives more flexibility and robustness for the hedge as the hedging relationship is more likely to be effective if it is based on a layered component of a hedged item.
2. As for (b) above, it is logical 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. Again I am afraid that the 'rule-based approach' is creeping in if this were to be included in the standard. IASB has rightly laid out the principle that only risk component that is separately identifiable and reliably measurable alone can be designated in a hedged item. Application of this 'principle' results in the answer to (b) above.

**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?*

**Response:**

1. This is undoubtedly the most welcome proposal and I fully agree with this proposal.

### 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?

### Response:

1. I fully agree with the proposal to allow entities to rebalance the hedging relationship so long as the risk management objective for the particular hedging relationship remains the same.
2. Though rebalancing as a 'term' is introduced for the first time in the accounting standard, as a 'concept' this is prevalent in the existing standard though for a particular case of hedging in a delta-neutral strategy.
3. The relevant portion from the implementation guideline of IAS 39 is reproduced below:

#### ***F.1.9 Delta-neutral hedging strategy:***

*To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in IAS 39.88 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.*

4. In a delta-neutral strategy, the entity adds or removes either the underlying exposure (hedged item) and/or the derivative instrument viz., put or call (hedging instrument) in such a way that the original delta of the combined position remains the same throughout the life of the strategy that is deployed. This is very similar to what has now been proposed which is altering the ratio of the hedging relationship as envisaged in B54 as follows:

*B54: If a hedging relationship is rebalanced the adjustment of the hedge ratio can be effected in different ways:*

- a) *The weighting of the hedged item can be increased (which at the same time reduces the weighting of the hedging instrument) by:*
  - i. *increasing the volume of the hedged item; or*



**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?*

**Response:**

1. Yes. I 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.
2. I also 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.
3. In fact I have recommended that the hedge accounting itself should be made mandatory as per my response to Question 1 given above.

### **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?*

### **Response:**

1. Yes I 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. This is in line with the treatment for cash flow hedge, where the effective portion is routed through the other comprehensive income and the ineffective portion is transferred to the profit or loss immediately. While the overall impact on the profit or loss would remain unchanged, the treatment would become aligned with the cash flow hedge, which is a welcome proposal.
2. Yes I 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. However it should be specifically stated that this may be done at a gross level for all the fair value hedges on the face of the statement of financial position. Showing it individually on the face of the statement of financial position would become cumbersome and would defeat the purpose. A sample disclosure is shown below in Table A. Table A is basically derived from the disclosure requirements as per the Exposure Draft dated 28<sup>th</sup> January 2011 – ED/2011/1 on Offsetting Financial Assets and Financial Liabilities. Of course this is over and above the Illustrative examples given in the current Exposure Draft.
3. Yes I agree that linked presentation should not be allowed for fair value hedges and the reasoning given in the background for conclusion is very logical.

Comments on the Exposure Draft ED/2010/13 on Hedge Accounting

**Table A:**

As at 31 December 20XX	(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)		(viii)
	Gross amount of assets	Gross amount of liabilities offset against assets in the statement of financial position	Net amount of assets in the statement of financial position	Gross amount of liabilities subject to conditional rights of set-off	Gross amount of liabilities subject to an unconditional and legally enforceable right of set-off but the entity does not intend to settle net or simultaneously	Net amount of assets before deducting collateral	Collateral held		Net Exposure
Description							Cash	Fair value of other financial instruments received	
Exchange traded financial instruments									
OTC derivatives, repurchase and stock lending agreements and similar financial instruments - gross amount									
<b>Add/Less:</b> <i>Adjustment made in fair value to reflect the effect of the entity's net exposure to the credit risk</i>									
	This is the Credit Value Adjustment (CVA) shown as a deduction from the gross fair value of assets as per the requirement of the Exposure Draft of IASB/FASB issued on 28 <sup>th</sup> Jan 2011 – ED/2011/1 on Offsetting Financial Assets and Financial Liabilities								
<b>Net amount</b>									
Other financial instruments									
Financial assets at fair value through profit or loss									
<b>Total</b>									
<b>Add/Less:</b> <i>Gain/loss on the hedged item in a Fair Value Hedge (to the extent it is effective)</i>									
	This is the adjustment of carrying amount in respect of fair value hedges (to the extent it is effective) pursuant to the Exposure Draft issued on 9 <sup>th</sup> Dec 2010 – ED/2010/13 on Hedge Accounting. The details of individual hedges are shown in the notes on accounts separately as per note XXX.								
Financial assets at amortised cost									
<b>Total</b>									

### **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?*

### **Response:**

1. Yes I 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).
2. This perfectly aligns with the same treatment accorded to a cash flow hedge of a forecast transaction that subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset where the entity shall remove the associated gains and losses that were recognised in other comprehensive income and include them in the initial cost or other carrying amount of the asset or liability.
3. I 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.
4. I 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).

**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?*

**Response:**

1. No comments on this as this looks more like a macro hedging which is not covered by this exposure draft. May be there are some subtle differences between a group of items hedged and a macro hedge, but I would prefer to look into the provisions of macro hedging before commenting on this.

**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?*

**Response:**

1. No comments on this as this looks more like a macro hedging which is not covered by this exposure draft. May be there are some subtle differences between a group of items hedged and a macro hedge, but I would prefer to look into the provisions of macro hedging before commenting on this.

**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?*

**Response:**

1. Yes I agree with the proposed disclosure requirements which seem to be quite exhaustive and well thought out.
2. The disclosures proposed seem to be sufficient for now.

**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?*

**Response:**

1. Yes I 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.

### 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?

### Response:

1. Yes I 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.

### Reasoning for changes recommended:

2. Where an entity buys protection for an underlying bond or loan that it holds, the fair value of the credit default swap (CDS) represents the credit risk component of the underlying. A simple way of looking at hedge accounting for a credit default swap could be to just aggregate the fair value of the CDS with the underlying exposure. Since only bought protection is eligible as a hedging instrument, a CDS contract will always have a positive value or at best can be of nil value as it cannot have a negative value.
3. The Board has rejected the theory that the fair value of the CDS contract is the best measure of the credit risk component of a financial asset as laid out in BC221. BC221 of the Exposure Draft is reproduced below:

*Some believe that credit default swap prices are the best measure of the credit risk component of a financial asset. However, the Board noted that using credit default swap pricing to measure the credit risk component of a financial instrument (eg a bond) might be conceptually flawed, at least because of the following structural differences between a credit default swap and a debt instrument:*

- a) *funding—a credit default swap is a synthetic instrument and does not require funding, whereas a debt instrument is a cash instrument that requires initial cash outlay;*
- b) *coupon accrual on default—a defaulted debt instrument does not pay the coupon accruals between the last coupon date and the date of default whereas a credit default swap protection buyer pays the accrued premium until the date of default;*
- c) *counterparty credit risk—a protection buyer of a credit default swap has the risk that the protection seller will default on the credit default swap contract; and*
- d) *defined credit event—events that trigger the payout of the credit default swap may not necessarily be a default.*

4. The Board has articulated that using credit default swap pricing to measure the credit risk component of a financial instrument (eg a bond) might be conceptually flawed because of certain structural differences between a credit default swap and a debt instrument.

Issue	Board's apprehension	Counter
Funding	Credit default swap is a synthetic instrument and does not require funding, whereas a debt instrument is a cash instrument that requires initial cash outlay	CDS is a derivative that is used as a hedging instrument. Derivative instruments by definition have an initial outlay much less than the underlying that it hedges. The outlay can also be zero in which case it becomes non-funded in certain cases like zero cost collar. So there is nothing wrong in a CDS being a non-funded derivative instrument to hedge the underlying bond or loan.
Coupon accrual on default	A defaulted debt instrument does not pay the coupon accruals between the last coupon date and the date of default whereas a credit default swap protection buyer pays the accrued premium until the date of default	Once the debt instrument is defaulted, the hedging relationship ceases and the process of de-designation starts. Till the credit event is triggered, the contract subsists and the valuation of the CDS instrument takes place with the information available as on that date. The fact that premium is paid by the protection buyer till the date of default while the defaulted debt instrument does not pay the coupon accruals from the last coupon date till the date of default is not relevant from the hedge accounting point of view.
Counterparty credit risk	A protection buyer of a credit default swap has the risk that the protection seller will default on the credit default swap contract	Counterparty credit risk is prevalent in all OTC derivatives and CDS is no exception. All other OTC derivatives are in fact recognized as hedging instruments in the usual way. So why this concern for CDS alone?
Defined credit event	Events that trigger the payout of the credit default swap may not necessarily be a default	When a credit event gets triggered, the CDS contract becomes enforceable and as such technically the contract is matured and would cease to exist. The hedging relationship would also cease at this stage and hence it is immaterial how the credit event gets triggered. It is no different from being triggered due to default or any other credit event.

5. BC222 of the Exposure Draft is reproduced below:

*Other aspects that give rise to differences between the value of a credit default swap and the credit risk inherent in the reference obligation are:*

- a) features such as 'cheapest to deliver' options;*
- b) differences in liquidity between the credit default swap and debt markets;*
- c) the effect of auction processes when credit default swaps are settled as a result of a credit event; and*
- d) the interpretation of the 'restructuring' credit event (and any related uncertainty about that interpretation).*

6. The issues mentioned in BC222 of the Exposure Draft no doubt affects the price of the CDS contract and this according to me truly reflects the 'credit risk component' of the financial asset.

**Changes recommended:**

7. To account for the fair value of the CDS contract, the entity should debit the CDS derivative account and credit the same to the underlying exposure – bond or loan. There should be no burden to check effectiveness etc in the case of CDS used as a hedging instrument. Of course naked CDS obviously does not qualify for hedge accounting as there would be no underlying exposure in that case.
8. If the entity has hedged the interest rate risk or any other risk (apart from credit risk) of the same bond or loan, then the carrying cost of such underlying exposure should be taken as the original cost as reduced by the fair value of the CDS contract.
9. On de-designation, the fair value of the CDS contract should be basis-adjusted with the value of the underlying exposure like any other fair value hedge.

### Question 16

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

#### Response:

1. Yes I agree with the proposed transition requirements.

2. BC247:

*To be consistent with the effective date for IFRS 9, the Board proposes an effective date for accounting periods beginning on or after 1 January 2013. Earlier application would be permitted. However, in conformity with earlier decisions, an entity would be able to apply the proposed hedge accounting requirements only if it has adopted all of the existing IFRS 9 requirements, or will adopt them at the same time as the proposed hedge accounting requirements are adopted.*

I agree with this reasoning.

3. BC254:

*The Board recently published the request for views Effective Dates and Transition Methods. That document was issued to obtain views on the expected time and effort involved in properly adapting to the new financial reporting requirements and on the implementation timetable and sequence of adoption that facilitates cost-effective management of the changes. The Board will take into consideration the comments received on that document and on the transition proposals in the exposure draft when finalising the transition requirements for hedge accounting.*

I fully agree that several transitional issues would crop up subsequently. It would be ideal if the Board thinks through all the possible complexities that would arise and outlines broad principles on how these should be resolved in order to bring about consistency among the different entities adopting the new proposals for the first time. This would also eliminate the different interpretations that would emanate from several entities on the transitional aspects of hedge accounting. It is suggested that the Board should refrain from going into 'rule-based approach' and stick as usual to the 'principle-based approach' as it has been following.