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By email: commentletters@hkicpa.org.hk & post

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IASB Exposure Draft – Hedge Accounting

Dear Steve

Thank you for your letter dated 17 December 2010 inviting comments on the Exposure Draft of the International Accounting Standards Board (“IASB”) on Hedge Accounting (“ED”). We support the proposed objective to better align hedge accounting with risk management practices and believe that many of the proposals in the ED achieve this objective.

We believe that convergence on this topic with the FASB should be a significant objective of this project given the importance of hedge accounting, particularly to large internationally active entities that engage in similar hedging strategies across their business. By retaining the existing underlying hedge accounting model, the proposed ED is significantly converged with the proposed FASB model in many fundamental respects. Where the IASB has expanded the use of hedge accounting beyond the FASB model, we see these as differences on the margins rather than challenges to the principles underlying both the IASB and FASB proposals. However, there is significant divergence in regards to the hedge accounting eligibility criteria.

While we are supportive of eliminating the current highly effective threshold, we have serious concerns regarding requirements to minimize hedge ineffectiveness and mandatory rebalancing. We believe the criteria are highly conceptual and likely to result in significant diversity in practice. The minimize criteria could be interpreted to be an even higher threshold to achieving hedge accounting eligibility. When the minimize criteria is combined with mandatory rebalancing, we believe the ongoing documentation requirements could be significantly more onerous than current practice.

We support a reasonably effective threshold, consistent with the FASB's earlier proposals. Such a threshold will allow more qualitative assessments, reduce the burden of hedge

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documentation and achieve substantial convergence. In addition, we believe that many hedges of credit risk would meet such a threshold, thereby reducing or eliminating the need for an expanded fair value option.

We understand the Board's desire to issue a final standard in the second half of 2011. However, we believe that the standard as written would require significant modification to be operational. Such an important area of accounting should not be dictated by arbitrary deadlines. While there is still much work to be done, convergence with the FASB on the hedge accounting eligibility criteria would significantly reduce the time to a final standard and achieve the objective of high quality principles based accounting standards.

Our comments on the specific questions raised in the exposure draft are attached. We would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely

A handwritten signature in black ink, appearing to read "Eva Wong", is written over a light blue circular stamp.

Eva Wong
Secretary

Enc.

**Responses of the Hong Kong Association of Banks (“HKAB”) to
Specific Questions in the International Accounting Standards Board’s
Exposure Draft on Hedge Accounting**

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

HKAB’s response: We generally support the proposed objective. We believe that aligning hedge accounting more closely with risk management practices will provide better information to users of financial statements. While we understand the desire to develop principles based standards, we have concerns that the exposure draft (“ED”) does not include application guidance, which is currently extensive under IAS 39. Given that many of the core principles of hedge accounting are not changed by the ED, we believe that much of the existing application guidance will continue to be applicable and should be incorporated into the final IFRS with appropriate revisions.

We would also support expanding the objectives beyond exposures arising from particular risks that could affect profit or loss (“P&L”) to include items classified in other comprehensive income (“OCI”) without recycling to P&L. In addition to items affecting P&L, risk management strategies also attempt to mitigate volatility in OCI such as from pensions and equity investments measured at fair value through OCI.

We acknowledge that under IFRS 9 classification of gains and losses on an equity instrument through OCI is an election and, if the equity instrument is hedged, the effective portion of the hedging instrument could be offset in the P&L by not electing OCI treatment for the equity instrument. However, because such classification is an irrevocable choice, a hedging relationship that is established subsequent to the initial classification of an equity instrument as at fair value through OCI would result in gains and losses on the hedging instrument not being off-set in the P&L.

The Board expressed concern that applying hedge accounting to items in OCI would either contradict the hedge accounting principle that hedge ineffectiveness should be recognized in P&L (if changes in value of the hedged item attributable to the hedged risk remain in OCI when such changes are greater than changes in the fair value of the hedging instrument) or contradict the prohibition on recycling gains or losses on equity instruments from OCI to P&L (if hedge ineffectiveness were recognized in P&L). In our view, we do not see these concerns as valid objections to prohibiting hedge accounting for items in OCI. In the first case, there is no contradiction with classifying the gains or losses of a hedged item entirely within OCI when that is how the item would be treated had it not been hedged. In the second case, classifying the ineffective portion of a hedging instrument through P&L (similar to a cash flow hedge) would reflect that the OCI election is particular to the hedged item rather than the hedging instrument.

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?

HKAB's response: We agree with the proposal. There is no conceptual reason why a non-derivative financial instrument that is measured at fair value through P&L should not be eligible as a hedging instrument. This is entirely consistent with the requirement that all derivative instruments be measured at fair value. However, we do have concerns in this context regarding the irrevocable classification of instruments under IFRS 9. If an instrument, that otherwise qualified for classification as amortized cost or fair value through OCI, were classified as at fair value through P&L merely to reflect its use as a hedging instrument, such instrument would irrevocably be classified as at fair value through P&L even if the entity's risk management strategy changed such that the item no longer was used as a hedging instrument.

In addition, we would support expanding the number of eligible hedging instruments as this will better align hedge accounting with actual risk management and provide greater flexibility in adopting hedging strategies. Specifically, we would support allowing embedded derivatives to be eligible hedging instruments. Given the existing guidance on identifying embedded derivatives, we do not believe that permitting an embedded derivative to be designated as the hedging instrument (as opposed to the entire item that contains the embedded derivative which would be required to be measured at fair value through P&L under IFRS 9) creates significant questions as to how to disaggregate hedging instruments into components. We would also support permitting components of non-derivative financial instruments to be eligible as hedging instruments as well as differences arising from translation under IAS 21 of an intra group monetary item.

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?

HKAB's response: We support the proposals. We believe that such restrictions are unnecessary and inconsistent with the current exception that allows some purchased options to qualify as hedged items. Allowing an aggregated exposure to be a hedged item will allow hedge accounting to apply to certain hedging strategies that are currently used in practice. We believe that there would likely be many practice issues that arise in documenting and testing such aggregated exposures and would support additional clarification as to how they should be assessed for effectiveness (e.g. must the derivative that is part of the aggregated exposure meet the effectiveness criteria before the net exposure can be assessed for effectiveness?)

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?

HKAB's response: We support the proposal to allow risk components of non-financial assets and liabilities to be designated as the hedged item. There is no conceptual basis to permit such designation for financial assets and liabilities, as is the current practice, but deny such treatment for non-financial assets and liabilities. This change will further align hedge accounting with the actual risk management practices for those entities that hedge individual risk components (whether contractually specified or not), which we believe may be applied by a substantial number of entities. In addition, we would also support the eligibility of non-contractual inflation as an eligible hedged item. The reasons for the Board's opposition to this are unclear. The basis for conclusions noted that there is no "bright line" to determine eligible risk components of non-financial items. Given that identifying and justifying non-contractually specified risk components as hedged item may involve subjective judgment and measurement, we suggest that the IASB provide further guidance on this.

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? If not, what changes do you recommend and why?*

HKAB's response: We agree with the proposed changes that would allow the layer component of existing transactions (e.g., firm commitments) to be designated as eligible hedged items. We agree that there is uncertainty for both existing and anticipated transactions and see no reason to treat them differently for hedge accounting purposes. We agree, in the case of an individual debt instrument, there may be an argument that a layer component 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, as the risk component would not be separately identifiable. We do not, however, consider that the same argument holds true for a portfolio (whether open or closed) made up of many such debt instruments. Prepayment patterns in portfolios can be reliably estimated in practice and the proposed restriction on fair value hedge accounting, if applied to portfolios, would prevent valid risk management practices from being reflected in the

accounting. We, therefore, suggest that the IASB consider this point in its coming phase 2 proposal for macro hedging.

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?

HKAB's response: We strongly support the decision to eliminate the effectiveness threshold of highly effective. The current requirement that the actual results of the hedge be within a range of 80% -125% can result in recording all changes in the fair value of a derivative (either because the hedge relationship is not initially highly effective or because the relationship subsequently fails to meet the highly effective criteria) in the income statement, without any offset, even when that derivative provides an effective economic hedge.

We broadly agree with the principle in the ED that the objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result. Analyzing the sources of ineffectiveness, ensuring appropriate weightings between the hedged item and the hedging instrument, and ensuring that the offset is other than accidental are all sound principles of how hedge effectiveness should be assessed.

However, we have concerns regarding the proposed effectiveness criteria that the hedge relationship minimizes expected hedge ineffectiveness. While the ED states that a hedging relationship does not have to be perfectly effective in order to qualify for hedge accounting, the ED is not clear whether the guidance proposes to reduce the current range of 80% - 125% or allows for more flexibility outside that range. The reference to minimize could be interpreted to be even more restrictive than the current threshold, particularly when the requirements for mandatory rebalancing are considered.

In addition, the requirement to minimize could be inconsistent with an entity's risk management strategy. In many cases, an entity may decide that a hedge that is substantially less than 100% effective may meet that entity's particular risk tolerance, given the costs of hedging and other factors. It is unclear how a requirement to minimize and rebalance is consistent with a principles based standard intended to align hedge accounting with risk management practices.

While we understand that a hedge is not required to be perfectly effective, we are concerned that the use of minimize in connection with the other principles of assessing effectiveness may require an entity to search for the hedging instrument that most significantly reduces ineffectiveness regardless of whether it is economically advantageous or consistent with the entity's risk management strategy and those hedging instruments that make operational sense for the entity to utilize. For example, an entity could seek to develop a bespoke hedging instrument that minimizes ineffectiveness or use

an exchange traded instrument that, while not minimizing ineffectiveness, provides an effective economic offset for which hedge accounting should be attributed.

We acknowledge that the Board noted in the basis for conclusions that "... many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of basis risk that the entity accepts in order to achieve a cost-effective hedging relationship. Consequently, when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item." There is a difference between something that cannot be eliminated at all and something that cannot be cost effectively eliminated. While the Board appears to be acknowledging that some trade off between hedge effectiveness and cost effectiveness is part of an entity's risk management strategy, it remains unclear where that boundary lies, particularly in view of the mandate to minimize hedge ineffectiveness.

Based on participation in the IASB's roundtables, we understand that the IASB Staff's interpretation of the ED is that the minimize criteria relates only to the hedge ratio; therefore, one should not interpret the ED such that it dictates designation of a hedging instrument that minimizes ineffectiveness. Given the hedging instrument and the hedged item chosen by the entity in accordance with its risk management strategy, this view indicates that the hedge ratio should initially be set as to minimize ineffectiveness by designating the appropriate components of the hedged item. It is unclear to us whether the staff believes that the designated volume of the hedging instrument can also be reduced upon initial designation. (This would be in conflict with paragraph 8 of the ED which requires that a hedging instrument be designated in its entirety.) The staff's view would lead to a conclusion that timing differences (which typically cannot be eliminated by rebalancing) can be ignored, despite the fact that the definition of ineffectiveness clearly includes timing differences.

We do not believe that the staff's view can be discerned from the text of the exposure draft. Given the concerns that we have already expressed, this leads us to conclude that the principles underlying the qualifying criteria for hedge accounting are insufficiently clear to ensure appropriate and consistent application across entities. We do not believe that effective guidance will emerge from additional editorial changes to the highly abstract principles underlying the hedge accounting qualifying criteria in the ED.

We believe that a qualitative threshold such as reasonably effective should be adopted in connection with the broader proposed hedge accounting principles, as it would provide a necessary measurement basis against which to assess the competing objectives of minimizing hedge ineffectiveness and achieving cost effectiveness. It would also allow for more qualitative hedge assessments, which would reduce the need for onerous quantitative effectiveness testing. In addition, we believe this would largely address the issues surrounding whether credit risk is sufficiently measurable to be designated in a

hedge relationship (see our response to Question #15). A reasonably effective threshold would also be consistent with the FASB's proposal in its exposure draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (which we have previously supported) and result in a better matching of hedge accounting with an entity's risk management objectives.

We appreciate that the qualifying criteria for hedge accounting is intended in large part to prevent the deferral or offset of gains and losses on hedging instruments that are essentially speculative in nature. However, we believe that the current requirements place too high a burden on proving the existence of a relationship between the hedged item and the hedging instrument, given that ineffectiveness is recognized immediately in P&L. The emphasis on achieving high levels of hedge effectiveness for fair value hedges of existing assets and liabilities is particularly unwarranted when the "special treatment" afforded the hedged item is to designate such item as fair value through P&L, a measurement basis that some commentators have supported as preferable for nearly all assets and liabilities. While the risk of cash flow hedge accounting is that the hedging instrument may not be truly associated with the hedged item resulting in the inappropriate deferral of gains and losses, we do not believe that the threshold to establish such a relationship need be at the current highly effective or the proposed minimized level to ensure that the matching principle is met. Consequently, we believe that a reasonably effective threshold will not result in misleading accounting and is more operational in practice.

In addition, we support eliminating retrospective testing as discontinuing hedge accounting due to a retrospective failure is unnecessary when the hedge is expected to be prospectively effective. This is also consistent with the proposals regarding rebalancing. However, we do not support reconsideration of the effectiveness of the hedge relationship at each reporting period. Given the proposed mandate to rebalance and minimize hedge ineffectiveness, recurring reconsideration may result in a perceived need to repeatedly adjust the hedge relationship to achieve even greater levels of hedge effectiveness. We believe this could result in even more onerous documentation requirements than currently exist. Consistent with the FASB's proposals, we would support a requirement to reconsider the hedge relationship only when there has been a change in circumstances.

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?

HKAB's response: We believe that rebalancing should be permitted, but not required, both when the hedging relationship no longer meets and when it is anticipated to no longer meet the hedge effectiveness criteria. Such latitude will better match hedge accounting with the entity's risk management objectives. As discussed in our response to Question 6, the requirement to rebalance (potentially at each reporting period) may result in more onerous documentation requirements than currently exists. Rebalancing may result in a single hedged item having two different measurement attributes with multiple layers if rebalancing is frequent. Mandatory rebalancing effectively limits the ability of an entity to voluntarily discontinue a hedging relationship because it forces the entity to create an effective hedge relationship if possible. (See our response to Question 8 below regarding discontinuing a hedging relationship.)

We also note that the requirement to rebalance may in some cases necessitate a decrease in the designated volume of a hedging instrument (as discussed in paragraph B54 of the ED) despite the statement in paragraph 8 that a hedging instrument must be designated in its entirety in a hedging relationship. We suggest that paragraph 8 be modified to allow for rebalancing as well as the designation of embedded derivatives (see response to Question 2).

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?*

HKAB's response: Given the requirements to properly document and continually assess the effectiveness of hedging relationships, we believe that entities should have the option to discontinue a hedging relationship even when that relationship would otherwise qualify for hedge accounting. We do not believe that there has been any significant misuse of the current option that should preclude continuing such option in the future. We also believe that elective discontinuance of hedge accounting is consistent with the principle that hedge accounting is elective at inception.

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 recognized 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?*

HKAB's response: We see little benefit to classifying fair value hedging gains and losses into OCI. In particular, we believe that classifying all gains and losses on fair value hedges into OCI with simultaneous reclassification of the ineffective portion into P&L is cumbersome and does not provide useful information to users of financial statements. There is a fairly significant distinction between the nature and risks associated with fair value hedges and cash flow hedges, and we believe that the current presentation properly reflects these distinctions.

We do not support the separate presentation on the statement of financial position of the gain or loss on hedged items as this will eliminate the mixed measurement for the hedged item. Hedge accounting results in a change in basis of the hedge item, and the hedged item should reflect this. In addition and notwithstanding our view on this matter, we would not support the proposed requirement that the separate line item be presented next to the line item that includes the hedged asset or liability. Given the potential diversity of hedged items, this could result in a significant expansion of the requirements for the face of the statement of financial position.

We do not support linked presentation for fair value hedges. We agree with the Board's conclusion that linked presentation does not differentiate between the types of risk that are covered by the hedging relationship and those that are not. In addition, linked presentation is not found elsewhere in IFRS and raises conceptual issues such as whether the net position is an asset or liability in itself or whether the hedged item and hedging instrument retain their respective characteristics. These questions may create interpretation issues for regulatory capital, debt covenant calculations and other uses of 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 capitalized 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?*

HKAB's response: We support the Board's attempts to address the issue of the treatment of time value of options. Currently, the undesignated time value of options can give rise to significant volatility in the P&L. However, we are concerned that the proposals add an unnecessary level of complexity to hedge accounting. We do not believe it is necessary or desirable to make distinctions between transaction related hedged items and period related hedged items. One model should be sufficient. Unaligned time value essentially represents ineffectiveness and, accordingly, should be recognized in P&L.

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?

HKAB's response: We generally support the proposed changes that will more readily allow groups of items to be eligible to be designated as hedged items. However, we believe that the guidance on designating net hedged group positions for fair value hedges needs clarification. Paragraph B73 of the ED states: "When a group of items that constitute a net position is designated as a hedged item, an entity shall designate the overall group of items that includes the items that can make up the net position. An entity is not permitted to designate a non-specific abstract amount of a net position." We find the reference to non-specific abstract amount to be particularly unclear. The ED provides an example of net firm commitments that off-set in different time periods as representing a non-specific abstract amount. However, the fair value of the commitments would offset with the exception of time value. The underlying principle is simply not clear and the example serves to increase the confusion. In addition, any final evaluation of the proposals for groups of hedged items must be made in connection with the yet to be proposed changes for portfolio/macro hedges.

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 recognized 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?

HKAB's response: We agree with the proposal to present as a separate line item on the income statement the gain or loss on a hedging instrument designated as the hedge of a net position. Any grossing up of gains or losses would be artificial.

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?*

HKAB's response: We are generally supportive of the objectives of the disclosure requirements. We believe that appropriate disclosure of hedging activities represent important information to the users of financial statements. However, we would encourage the Board to consider how the proposed disclosures will interact with the existing hedge accounting disclosures in IFRS 7 *Financial Instruments: Disclosures*.

In addition, for financial institution currently implementing the Basel II Accord, they are already required by their regulatory bodies to disclose quite significant information on their risk management practices embodying market risk, interest rate risk and foreign exchange risk etc. in accordance with Pillar 3 (Market Discipline) of the Accord. To a certain extent, there may be overlapping aspects of disclosure with those proposed by the ED, despite that they may be of different focus. We would request that the Board to consider existing regulatory capital disclosure requirements and the Basel III disclosure requirements to ensure that the proposed IFRS disclosures are not duplicative or inconsistent with the Basel accords.

Question 14

Do you agree that 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 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?

HKAB's response: We support the objective to permit those entities that manage their business on a fair value basis to account for certain contracts as derivatives when they are

currently precluded from doing so because of the expected purchase, sale or usage exception (“own use”) scope exception. However, we are concerned that the ED as worded would require entities for which the own use scope exception is appropriate to demonstrate both (i) that the contract is in accordance with the entity’s expected purchase, sale or usage requirements and (ii) the contract does not relate to a fair-value based business model.

We find the reference to a fair value based business model to be unclear. The proposed change would require that such contracts be accounted for as derivatives if that is in accordance with the entity’s underlying fair value based business model and how the contracts are managed. In most cases, such contracts are entered into (i.e., managed) to hedge changes in the fair value or forward price risk of the underlying commodity, but business models can vary considerably. The reference to underlying business model is also unclear as to whether the entire business must be managed on a fair value basis or not. The proposed change could require many commodity contracts that are not currently accounted for as derivatives to be recognized on balance sheet and recorded at fair value. This would require many entities to apply hedge accounting that currently do not do so or otherwise record volatility in the P&L. If hedge accounting for commodity inventories were to be the result of such a change, there would be significant changes in the measurement bases for different types of inventory across different entities and industries, reducing comparability in reporting.

Given the subjective nature of the criteria, we believe that ability to account for such own use contracts as derivatives should be optionally permitted rather than required. More specific guidance should be provided as to what conditions lead to a conclusion that an entity has a fair value based business model.

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 BC226-0BC246 should the Board develop further and what changes to that alternative would you recommend and why?*

HKAB’s response: Ideally, we believe that the issue of hedging credit risk should be addressed within the principles of hedge accounting. While we understand the historical concerns regarding the ability to isolate and measure credit risk in a manner that meets the eligibility for hedged items, such concerns are inconsistent with the requirement in IFRS 9 to classify within OCI changes in the fair value of a liability designated as at fair value. We suggest that the Board consider permitting credit risk to be measured using a residual method (i.e., designate credit risk as the remaining risk after interest rate, foreign exchange and other identifiable risks have

been removed.) In addition, if the threshold for hedge effectiveness was set as reasonably effective (see our response to Question #6), many hedges of credit risk using credit derivatives that do not have perfectly matching terms with the hedged item would qualify for hedge accounting. Consequently, the need for an expanded fair value option would not be necessary.

Notwithstanding our comments above, we generally support the proposal to expand the fair value option to financial instruments not permitted to be measured at fair value, when the credit risk of the instrument is hedged with a credit derivative that is required to be measured at fair value and for which the hedge relationship is not eligible for hedge accounting. To the extent that there is increased complexity, it will be offset by the benefit of better alignment of financial reporting with active and flexible risk management strategies that are frequently engaged in.

To not permit an election subsequent to initial recognition (as is the case in Alternative #1) would be inconsistent with many risk management strategies whereby an entity obtains credit protection for exposure at some point after initial recognition, when perhaps the credit profile of the instrument has changed. We believe that concerns that the ability to elect fair value through P&L would be susceptible to earnings management are overstated.

We believe that the immediate recognition in P&L of gains or losses related to the difference between fair value and carrying amount at the date of election as set out in Alternative #2 would involve immediately recognising in P&L changes in fair value that are not related to credit risk. This may discourage some entities from electing the fair value option. Alternative #3 would permit fair value through P&L to be elected at initial recognition or subsequently, with the difference between the then carrying amount and fair value of the hedged item being amortised or deferred. This alternative would require operational changes to track the deferral and amortization of the difference. We suggest that the Board permit an entity to elect either Alternative 2 or Alternative 3 with appropriate disclosure.

Question 16

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

HKAB's response: While we support the requirement for prospective application, we do not agree with the proposed transition date of 1 January 2013. The proposals in the ED will require entities to undertake a fundamental review of their hedging strategies, hedge documentation and associated accounting. In addition, all existing hedge relationships will need to be reviewed to ensure that they continue to qualify for hedge accounting at transition. We believe an effective date of 1 January 2015 would be more appropriate. This view is consistent with our response to the IASB's Request for Views on Effective Dates and Transition Methods.