



IFRS 9: Proposals to reflect the long term investments' business model

Policy makers and international regulators around the world should work not only to assure financial stability, prevent global crisis and “level the playing field” to allow for fair global competition on the markets of global savings; but they should work on creating a regulatory and international accounting framework that enable managers of financial institutions to focus more on long-term rather than short-term results, and more on investments with significant positive externalities for growth than on financial short-term investment.

Since the beginning of the crisis the LTIs Club, in several occasions, has posed these questions to policy makers and international organizations. Last September, four prominent European long-term public investors (EIB, KfW, CDC and CDP) presented a working paper to the EU Commissioner Michel Barnier¹ on this same subject.

At the European political level, the need of a new regulatory framework, more favourable to LTI, has been strongly emphasized by the European Commission – following the De Larosière's and Mario Monti Reports - in the Communications on *A New Single Market Act*, on *A Comprehensive European international investment policy*, and on *The EU Budget Review*. In fact, without a substantial increase in investment in infrastructure, energy, environment, innovation and research, and therefore without major changes in prudential, accounting and tax regulations, the objectives set in the EU 2020 strategy and in the Mario Monti Report could hardly be achieved. Major investments in the fields of innovation, renewable energies, water networks, telecommunications and transport infrastructures are in any case required for shifting to a low-carbon economy, coping with the scarcity of natural resources or adapting to rapid urbanization. These are all sectors which themselves can yield high investment returns, stimulate follow-on investment and, as a result, create growth and jobs.

For these reasons, policy makers and regulators should pay particular attention to the impact of regulatory and accounting standards on LTI, given the positive externalities they have on the economic system. Looking forward this should be taken into account both when implementing and reviewing existing rules and developing new ones.

¹ Letter to Mr. BARNIER, *Proposals to adapt the EU's financial regulatory framework to long-term investments requirements*, 20th September 2010, with annex *Proposals to promote Long-term investments in Europe – Conclusions of European long-term financial institutions' working group on banking supervision*.

In this context, accounting rules should be partially revised to increase long term institutional investors potential and to better represent their long term nature²

In particular, among the accounting proposals of the LTIC's working group, the need to give more prominence to the business model criterion was highlighted.

The purpose of this document is to present to the IASB for further discussion the detailed findings of the LTI club Working Group with respect to the issues within IFRS 9.

The comments and proposals reported in this document, while reflecting the particular point of view of four long-term financial institutions, can contribute to improve the accounting principles also from the perspective of long term investment and long term investors in general. Therefore we believe that the proposals in this document are in the European public interest.

1. **Classification and measurement of financial assets**

Issue 1: Prominence of the business model

We agree with the European Commission that the business model should have a more prominent role. In our opinion, IFRS 9 (as published in October 2010, including additions on liabilities) does not give enough prominence to the investor's holding horizon criterion

In order to achieve a true and fair representation of a business model of long term investments, there is a need for an alternative to the classification requirements proposed for assets under IFRS 9. Indeed, this standard extend the use of fair value through profit and loss.

Hence, fair value through profit & loss would be extended to equity instruments, some hybrid instruments and some subordinated instruments, even if those instruments are held on a long term basis in accordance with the business model of the holder, which raises difficulties in assessing their fair value and leads to unreliable fair value changes being shown as profit & loss.

Specifically, in relation to equity instrument, IFRS 9 allows entities to make an irrevocable election to measure value adjustments through equity, without any recycling through P/L. But this option to measure these securities at fair value through equity, without the possibility for subsequent "recycling" through profit and loss, would be equivalent to denying the very concept of the income statement. Now, we consider that the income statement is the best indicator of performance.

² See J. de Larosi re, *Long term investment: what appropriate regulatory framework?*, The Long-term Investment in the Age of Globalisation, Rome, 17th June 2010 (all papers in <http://www.astrid-online.it/Dossier--d1/DISCIPLINA/The-Long-T/index.htm>).

Therefore, in our view, the two options offered under the proposed reform for the recognition of securities are equivalent to:

- In one case (fair value through profit and loss), denying the very concept of a long-term investor (which would be assimilated with trading in terms of financial communications),
- In the other case (fair value through other comprehensive income), denying the possibility for a long-term investor to measure its actual "performance" (assimilation of unrealised and realised earnings with equity).

It seems evident that the general principle (i.e recognition of equity instruments at fair value through profit and loss) would increase dangerously the volatility of the income statement published by most of financial institutions.

And this volatility could increase pro-cyclicality of financial markets.

To illustrate, one of our institutions tried to simulate what the consequences of IFRS 9 would have been on net incomes if this standard had been applied on the current available-for-sale portfolio (period 2006 to 2010)

The results of this simulation are mentioned below:

| | Net income under IFRS 9 (Billions euros) | Net income actually published (IAS 39) (Billions euros) | Volatility Under IFRS 9 | Volatility Under IAS 39 | Increase in volatility |
|------|---|--|-------------------------|-------------------------|------------------------|
| 2006 | +6.7 | +3.7 | | | |
| 2007 | +1 | +2.5 | 5.7 | 1.2 | x 4.7 |
| 2008 | -9.2 | -1.5 | 10.2 | 4 | x 2.5 |
| 2009 | +4.9 | +2 | 14.1 | 3.5 | x 4 |
| 2010 | +5.4 | +2.1 | 0.5 | 0.1 | x 5 |

The differences between the calculated net incomes under IFRS 9 and the published net incomes under IAS 39 are linked to the **unrealized** gains and losses on equity instruments classified as available-for-sales.

This volatility would obviously be lower if the option provided by the standard (i.e : changes in market value recognized in equity) was used.

But, in this case, the financial institutions would not be allowed to recognise the gains and losses realized in the future on these financial assets, what we consider to be a denial of the most important performance indicator, which is the income statement.

As long term investment can play an essential contra-cyclical role on markets and contribute to a sustainable recovery, it appears essential to adapt accounting rules to their specificities, or at least adopt rules that do not hamper long term investment.

In that perspective, here are our suggestions:

Retention of a mixed measurement model for the classification of the financial instruments, including the following three categories, based on a business model classification criterion:

- a) Amortised cost category: financial instruments that the entity holds (or issues) for the purpose of collecting (settling) contractual cash-flows.
- b) Fair value through P&L category: actively traded financial instruments which are held for trading purpose by the entity
- c) A third category: financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or the fair value through P&L category.

Financial instruments included in the last category would be measured at the lowest between the acquisition cost and value in use. Reversal of impairment through profit and loss should be allowed.

The concept of “value in use” is already defined by IAS 36 - §6: “*value in use is the present value of the future cash flows expected to be derived from an asset*”

In our opinion, this definition could be extended to financial assets when the business model applied is to hold these assets for a long period.

As you know, the position described above is far from isolated.

Most of the stakeholders involved in long term investments have expressed strong criticism on the proposed standard.

As a matter of interest, you will find below extracts of the answers sent to the IASB by different national and international bodies on this issue:

French accounting standard setter (ANC)

The proposal of this national standard setter is to “*Create a third category (for which an appropriate measurement attribute should be determined): financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or of the fair value through P&L category.*

As this last category would not be measured at fair value through P&L, it implies that an impairment model, which should take into account investors’ holding horizons, should be determined. Moreover, it should require recognition in profit or loss of impairment on debt instruments relating to credit risk and should allow for reversal (for all instruments) in case of a change in the circumstances leading to impairment”

French Banking Federation:

The point of view of this Federation is that ***“The business model should be the primary criteria”***.

“When the business model leads to hold the position until maturity or for a long period, cost is the best measurement attribute to reflect the cash flows the firm can collect in the foreseeable future”

“Equity instruments held for long period, strategic investments for example, must also be recorded at cost, with impairment if...dramatic changes in the markets parameters lead to believe that the intrinsic value of the security is lower than its cost”.

Even if EFRAG and the European Banking Federation didn't argue clearly in favour of recognition at cost for all the financial instruments held on medium and long term, they didn't support the proposals of IFRS 9, as we can see in the extracts below:

European Banking Federation

The European banking Federation:

- *“do not support the concept of fair value through Other Comprehensive Income (OCI) with no recycling in income for certain equity investments”*

- *“believe that there are circumstances where the Available For Sale (AFS) category could provide the most useful information about certain equity investments, although we acknowledge that further consideration should be given to when and how to measure impairment and that impairment should be reversed if there are indications that the causes of the impairment no longer exist”*.

- *“firmly believe that the “business model” should be the primary criteria for the classification and measurement of a financial instrument”*

EFRAG:

This position expressed by this body is to *“recommend the IASB grant entities an instrument by instrument option to apply the existing available-for-sale model to equity instruments, except that (it) also urge the IASB to consider simplifying the impairment recognition model for financial instruments (including reconsideration of the prohibition on reversal of impairment on available-for-sale equity securities)*

To summarize our point of view on this issue n°1:

- **the ideal solution to give a fair view of financial assets held for a long period (including equity instruments), should be a recognition at the lower of cost or value in use,**
- **the proposal (made particularly by EFRAG and EBF) to maintain the current AFS portfolio while modifying the current rules of impairment, including reversal in profit and loss, raises the issue of equity volatility. Also, this solution do not avoid the difficulty of determining when and how to measure the impairment. Nevertheless, this solution could be an acceptable compromise compared to the IFRS 9 proposals.**
- **IFRS 9, because of its impacts on income statement volatility and because of the unsuitable option it offers for equity instruments (i.e : recognition of changes in market value in OCI without recycling in profit and losses) would be the worst solution for long term investors.**

Issue 2: “Characteristics test” not suited

With regards to the instrument “characteristics test”, we believe that under the business model of long term investments, the line between the amortised cost and the fair value categories as it is drawn by IFRS 9 results in the recognition of certain instruments in the wrong category.

As it stands today, the current “characteristics test” circumscribes the notion of “interest” in a far too narrow fashion. This implies that some instruments might be excluded while others that are not so dissimilar are included.

Indeed, if we look at the examples developed in appendix B.4.14 of IFRS 9, we note that, for reasons that can be disputed, an instrument which interest is linked to inflation (Instrument A) is eligible for measurement at amortised cost whereas an indexation to another tenor than the frequency of payment is disqualified (Instrument B).

The same issue also arises when trying to draw a bright dividing line on the basis of credit seniority of the instrument. The consequence of the seniority (or lack thereof) of the tranche will have to be catered for within the impairment principles and not within the classification principles.

Consequently, we believe that IFRS9 should not restrict the characteristics test to the notions of “interest”, “principal” or “seniority” but instead, focus on the existence of “contractual cash flows” no matter what is the formula used to determine the interest rate. Indeed, interest formulas are becoming more and more sophisticated and accounting standards cannot be based on a simplified definition of the “interest” notion.

Accordingly, we favour a principle-based pronouncement on the characteristics that an instrument must have in order to be a possible candidate to be held for the collection of its contractual cash flows. This principle should be as wide as possible and focus on the notion of “contractual cash flows”, given that the business model test (which should be the prominent one) will determine whether the instrument actually is held for either its cash flows or its value.

We list hereafter some examples where the application of a more principle-based pronouncement would better reflect the business model of the entity:

- when a treasury bond is stripped and either its principal or coupon series element are withheld as asset by the entity, to collect their cash flows. The cash flow characteristics of the resulting instruments are indeed often sought after by long-term investors as natural hedges to certain liabilities and therefore the new requirements of IFRS 9 can lead to counter-intuitive results due to the accounting mismatch.
- the same problems might arise when the contractual terms of a loan contain a feature that changes the interest rate so that a new interest rate may be based on a term that exceeds the loan’s remaining life.
- according to appendix B.4.14 of IFRS 9 , reverse floater instruments do not meet the characteristics test, as required by IFRS 9, and therefore are not eligible for measurement at amortised cost. Such instruments may well be

acquired by an entity for the purpose of collecting contractual cash flows, in line with its business model.

Finally, we believe that the current long list of examples in IFRS 9 with regards to the instrument “characteristics test”, induces a rule-based behaviour of attempting to pass the apparent bright line and will result in re-packaging exercises in order to comply with the rules. Accordingly, we believe that the examples developed by the IASB in appendix B of the Standard should be presented as illustrative examples instead of a binding regulation.

Issue 3: Clarification of the reclassification requirements

Finally, we believe that the requirement for reclassification needs some more precision.

Indeed, in practice there may be sales out of a cash flow collecting portfolio with the aim to realise gains in a special market situation however, the general aim of the portfolio that is to collect cash flows in the long term is still valid. In such situation, the need not to reclassify the entire portfolio should be made more explicit in paragraph B.5.9 of IFRS 9.

2. Hybrid financial instruments

Issue 4: Maintain bifurcation for financial assets

The current IAS 39 provisions on hybrid financial instruments have been a successful approach to represent adequately determinable contractual cash flows which are managed on a cash flow basis (i.e. the host contract) and on the other hand to consider a possible variability of cash flows to be presented on a fair value basis (i.e. the embedded derivative). Such an approach better reflects the way in which these financial assets are managed by the entity for risk management purposes.

A usual long term funding of start-up enterprises in the context of our promotional business is for example a financing which includes a remuneration based on key performance figures of the borrower. Such a contractual feature, according to IFRS 9, does not qualify to be accounted for at amortised cost. However, as it is funded by liabilities accounted for at amortised cost there is an accounting mismatch between assets and liabilities.

Consequently, the opportunity for bifurcation of financial assets should be maintained under IFRS 9 in order to treat financial assets and financial liabilities consistently. Those amended requirements could replace the “characteristics test” test currently required by IFRS 9 for hybrid financial assets.

However, we would welcome a more principle based approach when determining the requirements for bifurcation of embedded derivatives. Indeed the current IAS 39 requirements are rule-based and difficult to apply in practice.

3. Measurement of financial liabilities

Issue 5: Recognition of own credit risk

Generally speaking, the Working Group welcomes the fact that, under IFRS 9, changes in own credit risk would not impact profit or loss for liabilities designated under the fair value option.

However, we do not support the new requirements i.e. to have the portion of fair value changes attributable to credit risk recognised in Other Comprehensive Income (OCI). We believe that in general the inclusion of the entity's own credit risk in the valuation of financial liabilities is inappropriate as it would create artificial volatility in the entity's own funds leading to a counter-intuitive outcome. Indeed, the prudential regulators themselves have expressed that "measurements subsequent to initial recognition that incorporate a change in an entity's own credit standing should be limited to situations in which this is clearly necessary to provide users with relevant information"³. Accordingly, the Working Group pleads in favour of a proposal whereby the fair value of financial liabilities would only incorporate the level of own credit risk observed at inception (known as the "frozen credit spread" approach), thus avoiding undue volatility of own funds. The "frozen credit spread" approach has been discussed in the 2009 IASB staff paper "Credit Risk in Liability Measurement". The most frequent objection made against this method is that it might be difficult to apply, in the sense that there is not a unique and simple way to separate the effects on fair value of credit spreads from those of risk-free interest rates. While it is a matter of fact that isolating the effect of credit risk from the effect of other factors is not straightforward, this calculation is already required under several circumstances under both IAS 39 and IFRS 9. The clearest example is the requirement, under IFRS 9, that the portion of fair value changes attributable to credit risk is recognised in Other Comprehensive Income, separately from fair value changes attributable to other factors: in order to comply with the IFRS 9 proposal, an entity which measures a liability at fair value will be required in any case to isolate the effect of credit risk from other factors that affect fair value. Moreover, a very similar type of "attribution" exercise is already required under IAS 39. For example, when an entity establishes a fair value hedge relationship among a fixed rate loan subject to credit risk and an interest rate swap, it is required to measure the portion of the fair value changes in the loan which are "attributable" to the hedged risk (interest rate risk) and not to credit risk. We deem therefore that the application of the "frozen credit spread approach" would imply no greater complexity than is already required under IAS 39 or that would be required under the current IFRS 9 proposals.

4. Impairment

Issue 6: Use of the allowance account

Generally speaking, the Working Group agrees on a « periodic expected loss » as a reasonable component of provisions for loan losses. However, it believes that the

³ Extract from the Basel Committee comment letter on the IASB's Exposure Draft *Fair Value Option for financial liabilities*

original IASB proposals did not address the difficulties attached to the particular situation of long-term investors as preparers of financial statements (e.g. limited availability of observed credit loss parameters, difficulty to define reliable credit loss expectations over a very long period of time).

The Working Group takes note of the recent IASB publication on impairment⁴ which does address some of the operational concerns identified by the Working Group.

However, the IASB does still not address all of the impediments attached to the particular situation of preparers committed to long term investment. These include the limited availability of observed credit loss parameters over a time span equivalent to the future life of the loan, in particular in the case of loans subject to a particular creditor/debtor relationship or other “niche products”, rendering peer group comparison not so relevant. Therefore, we would propose to choose a reasonably close proxy.

With respect to the allocation of expected losses we generally agree with a time-proportional and “decoupled” approach to allocate the lifetime EL to relevant (future) periods. However, we do not support the overall concept of the proposed model to partially allocate expected losses to past periods (partial catch up) for the following reasons:

- Expected losses for past periods are always zero because they have been materialised through actual losses. Expected losses are economically always related to future periods and hence should be allocated to future periods (no catch up)
- By allocating expected losses to past periods there is a double accounting of losses because in past periods incurred losses have already been recognised in full. Therefore there is no need to build any further provisions for past periods
- With the partial catch up approach a synchronisation between expected losses and incurred losses is not possible. In contrast, the proposed model will always overstate loss provisions because it recognises incurred losses in the bad book and additionally it allocates expected losses to past periods. Therefore, economic cycles will have a disproportionate impact on profit or loss because of jumping provisions in times of excessive rating downgrades.
- In the "partial catch up" approach provision will be **to much, to early and never used**. Therefore the allowance will form a stable component of equity instead of providing for actual future losses.

Furthermore, the proposed approach does not reflect the economics of risk management calculating a risk premium for the single item on a statistical basis to cover portfolio losses. In cases of defaults the proposed approach will always affect the P&L even when the defaults are in line with former expectations. Expected losses are a probability-based measure of default-risks. An actual default can be seen as the crystallisation of former expected losses. Therefore an actual loss in case of a default should be recognised through the allowance account and not affect the P&L (insurance principle).

⁴ Supplement to ED /2009/12 « Financial instruments : Impairment” (January 2011)

For these reasons we favor a model to build up an allowance to be used in cases of defaults. Only when actual losses exceed formerly expected losses they should be recognised through P&L to avoid a negative allowance account.

This model would reduce pro-cyclical P&L effects considerably and therefore avoid the effect of a “self-fulfilling prophecy” in economic downturns. Beyond that, the user will get a better information on the quality of measurement of expected losses. Entities that are predicting precisely future losses can reduce their P&L volatility considerably. On the other hand, a bad estimation of future losses will be reflected by a significant P&L volatility.

Finally, we note that the Supplement introduces the concept of “foreseeable future” (when determining the floor for the “good book” expected losses) and at the same time it requires the entity to calculate the time-proportional amount of expected losses over the remaining lifetime of the portfolio. In our opinion, the distinction between the two concepts should be clearer. As it stands today, there seems to be a contradiction between the use of the term “foreseeable” and the requirements to expect losses beyond the “foreseeable future”, in particular for long term investors who hold financial assets over a very long period of time.

5. Hedge accounting

If the financial statements are to give a faithful representation of the entity’s financial position, hedge accounting is not to be regarded as an exception to “normal accounting”, but rather as the reference accounting technique used whenever there is an economic (i.e. risk reducing) hedge in place, giving way to mixed measurement.

We believe that, in general, the hedge accounting proposals should recognise the fact that in a long term investment business model, derivatives can be held for collection of their contractual cash flows.

5.1 Individual fair value hedge accounting model

Overall, we welcome the IASB proposals in the Exposure Draft dated December 2010. In particular, the proposed objective of hedge accounting which establishes now a clear link between hedge accounting and the entity’s risk management strategy and activities. We believe also that the reliance on internal risk management methodologies used by the entity to assess their economic hedges will improve the link between risk management and accounting. In our opinion, this is a first step towards a better representation of the entity’s business model in the financial report.

Issue 7: Measurement of hedge ineffectiveness

However, with regards to the measurement of hedge ineffectiveness, we think that the current IASB proposals should be reconsidered in the case of fair value hedges.

According to the exposure draft, the ineffectiveness portion of the gain or loss from remeasuring the hedging instrument and the hedged item must be transferred to profit and loss. We notice that, despite the emphasis on the entity’s risk management strategy in assessing effectiveness, the final number which will represent the impact of a hedge relationship on profit and loss will be determined in terms of dollar offset.

We believe that this is not coherent with the stated objective of hedge accounting: linking accounting with risk management.

We therefore suggest the following alternative approach:

- the entity chooses a method for measuring ineffectiveness according to its risk management strategy and consistently with the requirements for measuring effectiveness set out in B33-B39;
- the method must lead to a retrospective effectiveness measure ranging from zero (total ineffectiveness) to one (perfect effectiveness);
- the cumulative gain/loss on the hedged item is set equal to the opposite of the cumulative change in fair value of the hedging item times the effectiveness measure;
- the amount transferred to profit and loss is the net effect of the change in cumulative gain/loss on the hedged item and the change in fair value of the hedging item.

The proposed approach has the following features:

- several metrics which are commonly used in risk management, such as volatility reduction, naturally lead to an effectiveness measure in the range from zero to one;
- when there is total ineffectiveness, the amounts transferred to profit and loss are equal to the changes in fair value of the hedging item, as if no hedging relationship had been established
- if there is risk reduction, the resulting profit and loss volatility is less than the one recorded if no hedging relationship had been established and the derivative had been accounted for at fair value through profit and loss (i.e. in the absence of hedge accounting).

Issue 8: FVO revocation

Finally, in the context of transition to the new accounting principles of IFRS 9, the Working Group strongly emphasises the need to revoke the previous designations to the FVO and all other previous decisions that would need to be reversed with hindsight to the prescriptions of the new standard.

Therefore, transition requirements in IAS 39 and IFRS 9 should be modified to allow a reclassification both when a financial liability was designated as fair value through profit or loss to reduce an accounting mismatch (IAS39.9(b)(i)) but also when it was designated as fair value through profit or loss because it contained an embedded derivative (IAS39.11A). Furthermore, we believe that the standard should explicitly state that there will be an opportunity to revoke all previous FVO designations to allow for a smooth transition towards the revised hedge accounting requirements.

5.2 Portfolio hedge accounting model

Issue 9: Macro - hedging

Asset Liability Management (ALM) is concerned with managing risks and rewards in the context of the balance sheet structure. The most apparent risk in ALM is the interest rate risk which arises when assets and liabilities differ in terms of maturity, interest rate type and embedded options. To close maturity gaps between assets and liabilities, derivative instruments are used. Derivatives are - in contrast to most assets and liabilities - accounted at fair value through profit or loss. This leads to an accounting mismatch when hedge accounting is not applied. The current IAS 39 portfolio hedge accounting requirements are not fully compatible with the economic logic underlying the most common approaches to Asset and Liability Management (ALM).

The major features of the most common ALM methodologies which should be considered in developing a new portfolio hedge accounting approach are:

- assets and liabilities can be analysed based on outstanding notional amounts, on an amortisation scheme or on interest and principal payments. The analysis can generally be made on an aggregated basis. Usually the ability to identify single financial instruments is not a requirement;
- the analysis of assets and liabilities is generally based on a specific structure of time buckets;
- methods used to measure the interest rate risk vary from a gap analysis to sensitivity-measures like a present value of a basis point (PVBP) or an interest rate modelling combined with a VaR analysis;
- Prepayment rights are generally considered by hedging a bottom layer of the identified exposure in a time bucket;
- the identified gaps will be closed by derivative instruments. These are generally interest rate swaps but could also be cross currency swaps, inflation swaps, caps, floors, swaptions and other exotic products;
- the hedging derivatives generally link long term capital market transactions with short term money market transactions. The controlling of both parts of the balance sheet is often executed in different departments. Sometimes, for controlling purposes the hedging instrument might be split into two different components (e.g. floating leg and fixed leg) contributing to different controlling units.
- Risks are generally controlled on a daily basis with daily hedging transactions

Therefore, we believe that the proposals to be published by the IASB on portfolio hedging should consider the following issues arising with the IAS 39 portfolio fair value hedging:

- Consideration of prepayment options: The application of a bottom layer approach (according to the proposal made in the IAS Staff paper 6A from 15 April 2011, § 49) should be allowed. This implies that only a pre-defined layer of the exposure in a time bucket is considered as hedged exposure. Derecognitions of individual items within the underlying population of financial assets/liabilities are considered as unhedged as long as the pre-defined layer is not affected.
- a dynamic hedge designation should be allowed and operational: A hedge portfolio should incorporate daily transactions of financial instruments without a daily frequency of designation. To avoid the requirement to formally document the hedge relationship on a daily basis hedge accounting should rely on sound risk management processes. This could be achieved if a hedge relationship is not constituted by documentation of the individual items but by documentation of well defined portfolios e.g. if there is a clear definition of an ALM portfolio every single transaction which falls into the definition of this portfolio should automatically be designated without a formal documentation of the individual item. This is a precondition to accurately account for ALM businesses where daily transactions are regularly involved. It is only by such an alignment of accounting requirements with the internal risk management strategy that economic effects can adequately be reflected in the Profit or Loss account.
- effectiveness test: In order to make hedge accounting operational on an open portfolio basis we opt for using risk management methods to measure effectiveness of the hedge portfolio. Therefore a gap analysis, sensitivity analysis or VaR analysis should be allowed.
- measurement of changes in fair value: According to the current IAS 39 requirements a synchronization of changes in fair value of the hedging instrument and the hedged item is hardly possible. This is due to the need to amortise the hedging derivative based on the effective interest rate method which can not be applied to an aggregated cash flow of the hedged item. It should be explicitly allowed to use the designated cash flow of the hedging instruments as a hypothetical financial instrument for the purposes of measuring fair value changes attributable to the hedged risk as well as amortisation of hedge adjustments accumulated in former periods (hypothetical derivative method). To consider, however, ineffectiveness resulting from unhedged risk components of the derivative (e.g. counterparty risk, change in fair value of the variable leg of an interest rate swap) we propose an analytical valuation approach to identify the change in fair value attributable to the unhedged risk components of the derivative and to deduct them from the overall change in fair value to achieve the change in fair value of the hedged item attributable to the hedged risk.

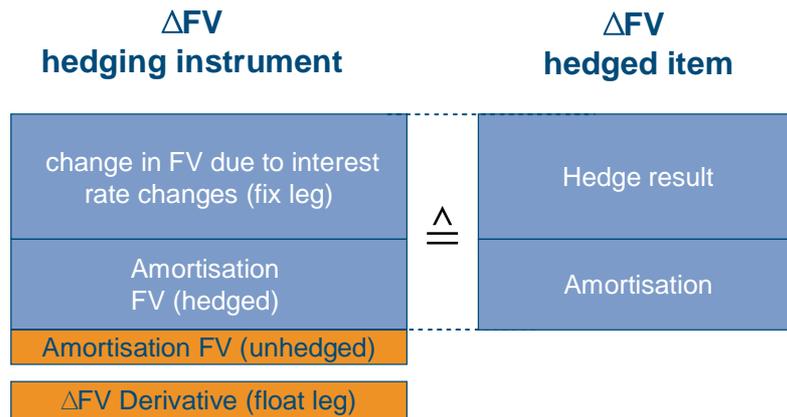


figure 1: analytical approach to measure the change in fair value of the hedged item

- Hedging of foreign exchange rate risks:** In the context of Asset Liability Management foreign exchange rate risks and interest rate risks are often hedged in combination by the use of cross currency swaps. According to the current IAS 39 those derivatives can not be designated in the portfolio fair value hedge accounting because it is allowed exclusively for interest rate risks. Under IFRS 9 the portfolio fair value hedge accounting should be allowed for interest rate risks as well as for exchange rate risks.
- Designation of a part of the hedging derivative:** Beside the two exceptions made by IAS 39.74 there are other cases in which it makes economic sense to designate a part of a derivative instrument in one hedging relationship: Therefore, we would appreciate if in the final standard it would be allowed to decompose a hedging derivative and to designate a part of it (e.g. the fixed leg of an Interest Rate Swap) in a hedge relationship. Under IAS 39 it is specified (IAS 39 F.1.12) that a derivative can be designated for more than one type of risk in two different hedge relationships. At least, this kind of designation should explicitly be considered in the final standard.

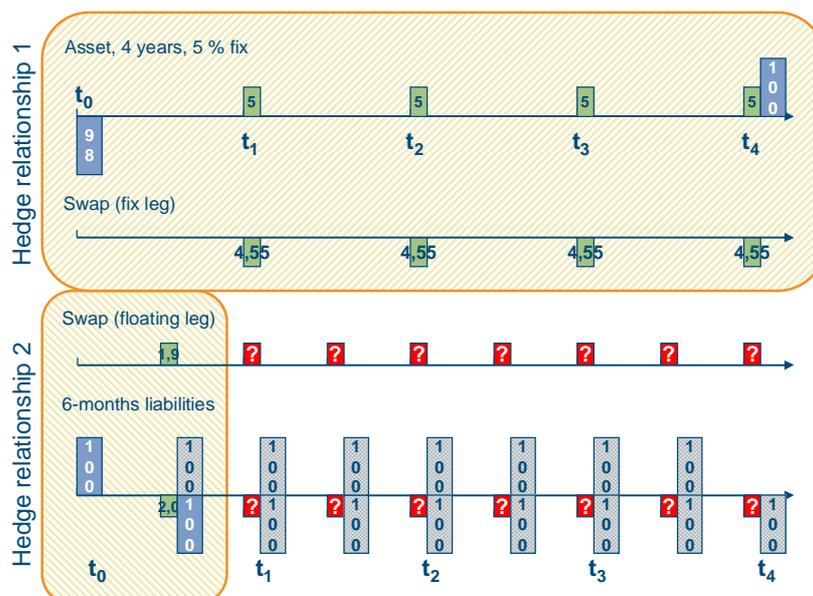


figure 2: designation of a part of a derivative