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International Accounting Standards Board
30 Cannon St
London EC4M 6XH

Re: IFRS 9, Chapter 6, Hedge Accounting Review Draft

We welcome the opportunity to comment on the Draft Standard. Visual Risk is a leading vendor of hedge accounting, treasury management and risk management software. Our client base covers both financial institutions and corporates spanning a broad range of industries in several countries. The majority of our clients are active derivatives users, rendering us well qualified to comment on this Draft.

Visual Risk believes that the new approach to using the hypothetical derivative in hedge accounting as currently detailed in paragraph B6.5.5 of the Draft and as described in the Staff Paper published in September 2010, is invalid. In the Draft, the treatment of different sources of ineffectiveness is inconsistent, specifically currency basis rates, time value of options and credit risk. However, in our opinion, credit risk is a special case which should be treated differently.

When using the hypothetical derivative to determine hedge effectiveness, it is not correct to state that "the hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change [in the fair value of the cash flows of the hedged item] was determined by a different approach".

By its very nature, a derivative hedging instrument that is designated in a cash flow hedge relationship is composed of variable cash flows which offset the hedged item and fixed cash flows whose fair value will initially offset the fair value of the variable cash flows. For an entity which is hedging, this achieves a reduction in the variability of future cash flows that affect the income statement.

When an entity calculates hedge effectiveness by determining the change in fair value of the variable cash flows of the hedged item and of the hedging instrument and these offset exactly, then clearly there will be no offset for any change in fair value of the fixed cash flows of the hedging instrument. This will result in ineffectiveness. For example, the fair value of future interest flows of floating rate debt based on LIBOR will exactly offset the fair value of future interest flows on the floating leg of a matching LIBOR swap. However any change in value of the fixed flows will not have an offset and will flow through P&L. This situation is clearly not sensible when the true economic outcome is reduced cash flow variability.

The IASB Staff paper circumvented this problem by "calibrating a fixed bond" to determine the change in the fair value of the cash flows of the hedged item. This resulted in a comparison of fixed interest flows from the calibrated "fixed bond" for the hedged item with fixed interest rate flows of an interest rate swap leading to a perfectly effective hedge. However, this method does not make sense for a number of reasons:

- The cash flows of the underlying debt are variable so any change in value of the cash flows should refer to future variable interest cash flows rather than fixed interest cash flows.
- This method will lead to the value of the floating rate set on the interest rate swap being ineffective and potentially affecting P&L. If the floating rate set of the swap exactly matches the floating rate set of the debt, then this outcome would be illogical.
- This method could actually hide ineffectiveness which is present in the economics of the hedge. For example, consider a case where the underlying floating interest rate flows of debt were based on six month LIBOR, but the interest rate swap was paying three month LIBOR floating and receiving fixed semi-annually. The method of the staff paper would lead to a comparison of fixed semi-annual flows leading to a fully effective hedge, whereas there is economic ineffectiveness and potential variability in cash flows that will affect P&L.
- It is unclear how this method would apply to other hedge relationships. For example if the hedge was a cross currency swap converting fixed foreign currency debt into functional currency debt, would the calibrated instrument then be based on fixed functional currency debt?

As others have pointed out, when an effective economic hedge results in no variability of cash flows, then it is logical that there should no ineffectiveness in P&L. To put it another way, if the objective of hedge accounting is to represent "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" then if the effect of a hedge is to eliminate P&L volatility there should be no volatility in P&L. In our opinion, the only approach that will achieve this outcome is to compare the change in fair value of the hedging instrument with the hypothetical derivative to determine ineffectiveness.

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However, we also understand that there are many examples where the hedge is economically effective but the economic value of the combination of the hedged item and hedged instrument can change. The Standard does address some of these examples, albeit in an inconsistent manner as will be shown by considering the three issues below:

Time value of options: This is now allowed to be amortised with any change in time value taken to the hedge reserve. This is because "entities typically consider the time value of an option (at inception, i.e. included in the premium paid) as a cost of hedging" and an accounting treatment which required a change in time value to affect P&L would be "disconnected from the risk management view".

This seems sensible to us, but we would note that the value of an option can change significantly due to volatility as well as spot movements. So the economic value of an entity can change without this change being reflected in P&L.

Currency basis: The draft standard is quite clear in B6.5.5 that the change in value of a cross currency swap due to currency basis needs to be taken to the income statement. We think this is completely inconsistent with the treatment of time value. Currency basis is also considered to be "a cost of hedging" foreign debt back into domestic debt and thus taking this change in value to P&L is also "disconnected from the risk management view". For this reason, any change in value of the hedging instrument due to movements in currency basis should be posted to the cash flow hedge reserve.

We agree with the Swedish Banker's Association who stated in their submission[i] that debt investors will include "a basis risk element in the pricing of debt instruments when there are reference debt instruments traded in other markets".

Credit risk: In the September 2010 paper, the IASB Staff noted that the approach suggested in the FASB Accounting Standard Update for ASC 825 and ASC 815 would allow entities to "ignore ineffectiveness caused by the changes in the credit quality of the hedging instrument".

We agree that this is a valid concern. We think this is a different issue to the previous two issues because while the cash flows are still fixed, the present value of these cash flows will have changed for reasons other than considering the time value of money. In this case, the fair value may also have changed because the likelihood of receiving these cash flows has changed.

We would make the following qualifications:

- It is difficult to adjust the value of derivatives for creditworthiness. Each future cash flow may need to be discounted at a different rate. There is a question as to whether credit spreads that are derived from debt instruments are applicable for derivatives. Also potential credit exposure may have to be considered as detailed in IFRS 13 and the calculation of this can be very complex.
- If credit spreads are used, then this will lead to frequent ineffectiveness because these numbers vary with market movements. However, it could be argued that small movements in credit spreads reflect supply and demand and changes in investor risk preferences rather than any change in the creditworthiness of a counterparty. Note that we believe this argument is also applicable for currency basis swaps.
- For derivatives, a small move in credit spreads will lead to a very small move in the valuation adjustment for credit. For example if a foreign exchange derivative with one year to maturity has a value of five per cent of notional and the applicable spread moves by 20 basis points, this will lead to a change in value of 0.01% of the notional of the hedge. As this would generally be true for derivatives with stable investment grade counterparties, it could be argued that these value movements could be ignored unless there was significant improvement or deterioration in the credit quality of a counterparty to a derivative. Long dated cross currency swaps would be an exception to this.

In summary, Visual Risk believes it is correct to compare the hedging instrument with the hypothetical derivative to determine ineffectiveness in cash flow hedge relationships as it is consistent with the risk management principle that there should be no income volatility when there is no underlying cash flow volatility. Finally, we think it is correct that changes in fair value due to changes in credit should affect P&L, but we think this effect will generally be relatively small and, given the complexity in its calculation, should be monitored and approximated rather than calculated exactly.

Yours sincerely

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Managing Director

[i] Swedish Bankers Association, Position Paper: IASB: Draft Standard IFRS 9, Chapter 6, Hedge Accounting, 16 October 2012