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Friday, 11th January 2008

Exposure Draft of Proposed amendments to IAS 39 Financial Instruments: *Recognition and Measurement* Exposures Qualifying for Hedge Accounting

Dear Sirs

ISDA previously wrote to IFRIC in July 2007 expressing industry concerns at the likely impact of proposed draft wording for a tentative decision rejecting an agenda item relating to the hedging requirements of IAS 39 (this letter is attached). At the time our member firms felt that the wording had the potential to change the way IAS 39 was being applied in practice and change the way firms and their clients manage their risks. It was our view at the time that a public debate was required and appropriate consideration given to a complicated area of IFRS interpretation. We are therefore delighted to be given the opportunity to comment on the IASB's Exposure Draft (ED) outlining proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement Exposures Qualifying for Hedge Accounting (published in September 2007).

ISDA has over 815 member firms from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective to the IASB's work.

ISDA remains very concerned that the rules-based solution proposed by the IASB in the ED, unless worded much more carefully, will have unintended consequences. In the Appendix to this letter we provide examples of the unintended consequences which we believe will arise from the proposed amendments. Further, the proposed changes will most definitely restrict innovations in the marketplace. As a result, we do not believe that the proposed amendments should be made.

We understand that the ED was driven by two key concerns: (i) the designation of an option in its entirety; and (ii) the hedging of an inflation component of interest cash flows. Firstly, as we set out in our letter of July 2nd 2007 we believe that it is appropriate for an entity to be able to designate an option in its entirety as a hedge of a forecast cash flow, without the recording of ineffectiveness due to changes in the time value of the hedging instrument. As we summarise in the Appendix to this letter, we disagree with the Board's conclusion and also have concerns with the way in which paragraph AG99E is expressed. Secondly, we are not aware that the designation of the change in fair value attributable to inflation gives rise to significant diversity in accounting practice, but if this is regarded as a concern, then it would be better dealt with by limiting the proposed revisions to clarification that this is not permitted.

However, if after reading these comments, the Board still decides to proceed with the proposed amendments, we believe the wording should be revised and improved to reflect the issues we set out in detail in the Appendix to this letter. We encourage the Board to take a principles based approach to addressing these issues, including bringing non financial items as well as financial items within the scope of proposals.

We would be pleased to discuss our comments further with the IASB or staff and to answer any questions you may have and to arrange this contact either Melissa Allen at Credit Suisse (0207 883 3598) or Ed Duncan at ISDA (0203 088 3574).

Yours sincerely

Melissa Allen

Melissa Allen
Chair of ISDA's European Accounting Committee
Managing Director, Credit Suisse

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Director of European Policy at ISDA

Appendix 1

Question 1 – Specifying the qualifying risks

Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why? Are there any other risks that should be included in the list and why?

We do not believe that it is feasible to provide an exhaustive list of risks that qualify for hedge accounting due to the continued innovation in the financial markets. A new generation of financial products based upon, for example, mortality and climate change would not be catered for by the list set out in paragraph 80Y and thus the proposed list of risks and portions may quickly become obsolete.

We also note that the list as currently proposed is incomplete. A key risk that is currently omitted is "equity risk". An example of a consequence of the omission is that if an entity with the Euro as its functional currency were to hedge a US$ denominated equity security, recorded as available-for-sale, using a derivative denominated in US$, according to the proposals in the ED, hedge accounting would not be permitted for this relationship.

In addition, a number of the items set out in the list in paragraph 80Y are not well defined. In particular, neither prepayment risk nor credit risk are defined in IAS 39. The use of the term "credit risk" in the ED is presumably not the same as intended by the definition of "credit risk" in IFRS 7. Paragraph 80Y(a) also appears to be inconsistent with 80Z(f), where the former refers to "market interest rates" and the latter refers to a "quoted" rate. Is there intended to be a reason for this difference in wording? We also note that while LIBOR is a published rate, it is more accurate to describe it as an average of quoted rates rather than a quoted rate itself.

Furthermore, while we believe the first sentence of 80Y(e) to contain a principle, the example that follows highlighting what is, and is not, permitted would be more logically expressed in Application Guidance. We also think that the last sentence is unclear, in part because it tries to address two separate issues that would be better dealt with singly. We suggest the following wording as an improvement:

> *"This is because the inflation component is not a contractually specified cash flow. It is also not permitted to designate as a hedged item a contractually specified cash flow such as the change in inflation, if a further cash flow is contractually specified as a residual (a fixed rate of interest less the change in inflation)."*

Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item

Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why? Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item? If so, which situations and why?

Unintended consequences

As with question 1, we are concerned that an exhaustive list of portions of risk could soon be obsolete. In addition, the way in which paragraph 80Z is worded is likely to have unintended consequences.

One likely unintended consequence concerns the impact of the proposed amendments on existing hedge accounting provisions for non financial items. IAS 39 (paragraph 81) permits the risks associated with a portion of a financial instrument to be designated in a hedge relationship, but there is no similar permission for non-financial items in paragraph 82. Non-financial items may be designated only for foreign currency risks or in their entirety. Because the ED gives as examples of a "portion" of a financial instrument, both a proportion and a one-sided risk, it implies that a proportion or a one-sided risk of the cash flows of a non-financial item would also constitute "a portion" and so would not be eligible as a designated hedged risk. This would be extremely unfortunate as it is common practice for entities to hedge a percentage of a forecast item, such as a foreign currency sale, or the risk of that foreign currency sale declining in functional currency terms by using an option as the hedging instrument. This issue would most easily be addressed by extending the scope of the ED to include non-financial items.

There are other risks and portions specified in the ED which could appropriately be applied to non-financial items without "difficulty in isolating and measuring the appropriate portion" as required by paragraph 82. These include designation of contractually specified cash flows (such as when a refined commodity purchase contract has a two part price formula, one of which refers to a traded commodity price and the other to a refining cost), or interest rate risk (for example in a prepaid commodity purchase contract). These are not currently allowed to be designated as a hedged risk but logically should be, consistent with the proposals set out in the ED.

The wording "the following portions of the cash flows" used in paragraph 80Z, can be understood to mean that it is possible to designate a portion of risks only in a cash flow hedge and not in a fair value hedge. To avoid this interpretation, the wording should be revised, possibly to:

> "*An entity may designate as a hedged item the change in fair value or the exposure to variability in cash flows, of one or more of the following portions of the cash flows...*"

Further, paragraph 80Z(d) refers to specified cash flows that are "independent" from each other, but the meaning is unclear. There are many cash flows that can be contractually distinguished but are not economically independent, such as foreign currency and interest rates. We suggest replacing the word "independent" with the word "separate".

Designation of an option in its entirety

As we wrote in our letter to IFRIC of July 2nd 2007, (see Appendix 2), we believe that it is appropriate to be able to designate an option in its entirety as a hedge of a one-sided risk, for the reasons set out in that letter. Our approach, in summary, is as follows:

1. The hedged item is designated at inception of the hedge as a "one-sided risk", such as the decrease in the foreign exchange rate below a certain level;

2. As the hedged item is a one-sided risk, it is appropriate to measure the change in fair value of the hedged item using a probability-weighted outcome approach when measuring hedge effectiveness under IAS 39; and

3. Changes in fair value of the one-sided risk measured using the probability-weighted outcome approach will mirror the changes in fair value of the purchased option (provided that certain conditions are met), resulting in little or no ineffectiveness being recognised in the income statement.

The crucial element of this conclusion is the view, taken by many, that the fair value of the one-sided hedged risk should be measured using the probability-weighted outcome approach, and so the hedged item implicitly has time value. This is consistent with IAS 39, including Implementation Guidance F3.11 which specifically requires that "it is necessary to ensure that changes in the **fair value of the cash flows** are offset by changes in the fair value of the hedging instrument" (emphasis added).

It should be noted that the basis set out in our letter does not involve imputing or inferring cash flows arising from a hypothetical written option, as suggested by paragraph AG99E. Further, the statement in that paragraph "cash flows arising from the time value" appears to misunderstand the issue, since cash flows never arise from time value, rather time value arises from cash flows.

Because the ED applies only to financial instruments, the example given in paragraph AG99E is a hedge of a portion of a financial instrument. Does this, therefore, mean that it is possible to designate an option in its entirety as a hedge of a non-financial item? More importantly, the example given is of a fair value hedge and yet refers to a hypothetical derivative. Is the Board suggesting that it is possible to use the hypothetical derivative method in designating the hedged risk in a fair value hedge? This is normally regarded as possible only for a cash flow hedge.

Part of the problem with paragraph AG99E is that a hedge of a one-sided risk is not a hedge of a portion of cash flows. If any entity designates an option as a hedge of a decline in the functional currency value of foreign currency sales, it hedges the entire cash flows, but only for the effect of the movement in the exchange rate below a certain level.

Question 3 – Effect of the proposed amendments on existing practice

Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

We are concerned that the proposals contained in the ED would have significant unintended effects on existing practice (as detailed in responses to Questions 1 and 2).

As we set out in response to Question 2, we believe it is appropriate to allow an option to be designated in its entirety as a hedging instrument, and we believe the revised wording would therefore have an impact on those firms who are currently hedging in this manner.

We are not aware that the clarification of the designation of inflation risk in a fixed rate of interest will have a significant effect on accounting practice.

Question 4 – Transition

Is the requirement to apply the proposed changes retrospectively appropriate? If not, what do you propose and why?

As it is not possible to designate a hedge retrospectively, any retrospective change in what can be designated as a hedged item will usually result in the need to unwind the hedge accounting in its entirety. For instance, if an entity has designated an option in its entirety in a manner not permitted by paragraph AG99E, it would not be possible, retrospectively, to change the hedged designation to refer only to the option's intrinsic value. Therefore, we believe that the ED should be applied prospectively.

We also note that the ED does not explicitly say that the application is retrospective, except in paragraph BC15.

Appendix 2

(ISDA letter to IFRC from July 2nd 2007)

Tricia O'Malley

IFRIC Coordinator

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United Kingdom

IFRIC Tentative Agenda Decision: IAS 39 *Financial Instruments: Recognition and Measurement* – Hedging future cash flows with purchased options

Dear Ms O'Malley

ISDA would like to raise concerns on behalf of our members over the likely impact of the draft wording for a proposed IFRIC tentative decision rejecting a potential agenda item. The issue that we refer to relates to the cash flow hedging requirements of IAS 39 and how to assess effectiveness for cash flow hedges of highly probable future transactions with purchased options. ISDA fully supports the views and technical analysis contained in a letter produced by the London Investment Banker's Association (LIBA), which we have included in the appendix to this letter.

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 797 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective to the IASB's work on accounting for financial instruments.

ISDA believes that the existing cash flow hedging requirements of IAS 39 are open to different interpretations and perhaps more crucially, are currently being read differently by the major independent audit firms. This much was recognized and recorded during the relevant discussion at the IFRIC meeting in May. There is therefore real evidence to suggest that in this particular area the requirements of IAS 39 are less than clear.

We believe that issuing the agenda decision in its current form could change the way IAS 39 is currently being applied and more importantly potentially change the way in which many of our member firms and their clients manage their risks. The decision as currently drafted may deter corporates from pursuing existing hedging strategies, and potentially result in exposures being left un-hedged. The result may also lead to accounting that does not accurately reflect the underlying economics of the transactions.

Furthermore, it is our view that the IFRIC wording effectively interprets a complicated area of IFRS without going through the due process of releasing a full interpretation. As with other interpretations, the appropriate level of consideration and public debate is needed, and we recommend IFRIC address the questions raised in the LIBA letter attached below. ISDA members do not have access to the original IFRIC submission together with any theoretical arguments put forward and therefore find it difficult to follow IFRIC's technical reasoning. More importantly we do not agree with the conclusion IFRIC reached and believe that it is possible to eliminate ineffectiveness for cash flow hedges using purchased options under the current provisions of IAS 39.

When the equivalent provisions of US GAAP were considered, the conclusions reached were consistent with ISDA's view and confirmed in FASB Statement No. 133 Implementation Issue No. G20 'Cash Flow hedges: Assessing and Measuring the Effectiveness of a Purchased Option used in a Cash Flow Hedge' (DIG Issue G20). We were therefore surprised by IFRIC's decision to interpret IFRS differently.

We therefore strongly encourage IFRIC to take this issue onto its agenda to enable IFRS filers to consider the issue and facilitate a proper open and transparent public debate.

We would be pleased to discuss our comments further with the IFRIC or staff and to answer any questions you may have and to arrange this contact either Melissa Allen at Credit Suisse (0207 883 3598) or Ed Duncan at ISDA (0203 088 3574).

Yours sincerely

Melissa Allen
Chair of ISDA's European Accounting Committee
Managing Director, Credit Suisse

Ed Duncan
Director of European Policy at ISDA

Appendix

DRAFT LETTER TO IFRIC FROM LONDON INVESTMENT BANKING ASSOCIATION (LIBA):

29 June 2007

Liz Hickey, IFRIC Coordinator

International Financial Reporting Interpretations Committee

First Floor

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Dear Ms Hickey

IFRIC Tentative Agenda Decision **-** Hedging future cash flows with purchased options

I am writing on behalf of LIBA (the London Investment Banking Association) to express our concern over the IFRIC's tentative decision (as reported in the May 2007 edition of IFRIC Update – "the Decision") not to take onto its agenda the request for an interpretation on how to assess effectiveness for cash flow hedges of highly probable future transactions with purchased options. LIBA is, as you will know, the principal UK trade association for investment banks and securities houses; a list of our members is attached.

In summary, we do not fully understand the Decision and we are therefore unsure as to its potential impact; we also have concerns relating to some procedural elements as well as to its technical merit.

From a procedural standpoint, we understand that the IFRIC intended to produce an agenda decision that was factual and without interpretation. We believe, however, that some of the statements within Agenda Paper 11(ii) and, more importantly, in the May 2007 IFRIC Update are effectively equivalent to issuing an interpretation (in a controversial and complicated area of IFRS) without the normal due process of inviting comments on a published draft.

It is not clear to us whether the IFRIC's intention was purely to clarify that the "Submission Approach" for achieving hedge accounting (as set out in Agenda Paper) is not permitted under IAS 39. If this is the case, we recommend that the Decision should include a statement to the effect that, although the suggested approach is not allowed under IAS 39, it is still possible to eliminate hedge ineffectiveness using an alternative approach when hedging future cash flows with purchased options.

If, however, the Decision is intended to mean that hedge ineffectiveness can never be eliminated in a hedge of future cash flows with a purchased option, then we believe this amounts to an interpretation of IAS 39. In this case we believe the Decision should not be issued in its current form; we strongly recommend that the IFRIC should instead take this issue on its agenda so as to ensure that there is an appropriate level of consideration and public debate, and that the questions set out below are adequately addressed.

We note that this issue is important to many IFRS reporters and that any decision may have a significant impact on the use of hedge accounting by these entities.

A separate concern is that the interpretation implied by the Decision will result in accounting that might not reflect the underlying economics of the transaction. In particular, while we agree with the position of the Agenda Paper that "the purpose of hedge accounting is not to minimize or eliminate hedge ineffectiveness", we think it is important that where (as in this case) a transaction that qualifies as a hedge under IAS 39 results in a perfectly effective economic hedge, this should also be reflected in the accounting.

We also understand that there is diversity in practice in this area, not only amongst the IFRS reporting community, but also amongst the major audit firms. Indeed it was because US GAAP reporters faced the same problems that the FASB decided to consider in detail the similar requirements of FASB Statement No. 133 Accounting for Derivatives and Hedging Activities (Statement 133) through the development in 2001 of Statement 133 Implementation Issue No. G20 Cash Flow hedges: Assessing and Measuring the Effectiveness of a Purchased Option used in a Cash Flow Hedge (DIG G20).

The fact that the FASB felt the need to take this step demonstrates that this is a complex area; it also illustrates the scope for alternative interpretations of corresponding parts of IAS 39. The conclusion reached by the FASB when considering similar rules under Statement 133 (through the issuance of DIG G20) is that it is possible to eliminate hedge ineffectiveness when hedging with purchased options.

From a technical standpoint, we understand the basis for the Decision is that the IFRIC believes it is clear from IAS 39 and existing Implementation Guidance that the following requirements preclude the Submission Approach from achieving hedge accounting:

a) The hedged item used for assessing and measuring hedge effectiveness should be the same as that designated at inception of the hedge; and

b) a hypothetical or actual written option is not eligible for designation as a hedged item.

However, we believe that one valid conclusion under the existing requirements of IAS 39, including those highlighted by IFRIC and set out above, is that it is possible to eliminate ineffectiveness for cashflow hedges using purchased options. This conclusion may be reached by applying the following approach:

1. The hedged item is designated at inception of the hedge as a "one-sided risk", such as the decrease in the foreign exchange rate below a certain level;

2. as the hedged item is a one-sided risk, it is appropriate to measure the change in fair value of the hedged item using a probability-weighted outcome approach when measuring hedge effectiveness under IAS 39; and

3. changes in fair value of the one-sided risk measured using the probability weighted outcome approach will mirror the changes in fair value of the purchased option (provided that certain conditions are met), resulting in little or no ineffectiveness being recognized in the income statement.

The crucial element of this conclusion is the view, taken by many, that the fair value of the one-sided hedged risk should be measured using the probability-weighted outcome approach, and so the hedged item implicitly has time value. We have set out the basis for this view, along with a more detailed discussion of the logic described above, in the Appendix to this letter.

I hope that the above comments are helpful. We would of course be very pleased to expand on any particular points if there are aspects which you find unclear, or where you would like further details of our views.

Yours sincerely

Appendix

Detailed technical considerations

We have set out below in more detail the technical analysis that underlies the view that it is possible to eliminate hedge ineffectiveness when hedging with purchased options, and have also provided our comments on the basis provided by the IFRIC for rejecting the submission that was received.

We understand the basis for the rejection decision is that the IFRIC believes that IAS 39 and existing Implementation Guidance provide sufficient guidance on two questions that must be considered in addressing the treatment of option time value in cash flow hedges with purchased options:

a) Whether a hedged item used for assessing and measuring hedge effectiveness should be the same as that designated at inception of the hedge; and

b) what items are eligible for designation as hedged items at inception of the hedge.

When hedging the FX risk of a highly probable forecast sale with a purchased FX option, we agree that the hedged item should be the variability in cash flows due to decreases in FX rates below a certain level – i.e. a one-sided risk designation. We do not however agree with the Submission Approach of assessing effectiveness and measuring ineffectiveness in such a hedging relationship using a "hypothetical written option with the same maturity date and notional amount of the forecast sale".

Paragraph 96 of IAS 39 states:

"More specifically, a cash flow hedge is accounted for as follows:

(a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):

(i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;

(b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in profit or loss; and …"

This Paragraph requires a comparison of two potentially dissimilar amounts when measuring ineffectiveness of a cash flow hedging relationship. Under Paragraph 96(a)(i) the cumulative gain or loss on the hedging instrument in this case is clearly the change in fair value of the purchased option, while Paragraph 74 is clear that both the intrinsic and time value of the option may be included in this fair value amount. Paragraph 96(a)(ii) is however less clear, and we believe that there are at least two interpretations of what is meant by "the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge". The implication from the Agenda Paper is that the submission sets out that this is simply the difference between the FX rate at the inception of the hedge and the FX rate at the date of assessment, hence the requirement to designate a hypothetical written option as the hedged item.

There is however a sound theoretical basis that the "fair value (present value) of the expected future cash flows on the hedged item" for such a one-sided hedged risk should be interpreted as an expected value notion, i.e. the fair value should be calculated using the probability-weighted possible outcomes within the hedge strategy. Under this interpretation, the change in fair value of the expected future cash flows of the one-sided hedged risk would be calculated using a similar function to that used when valuing options using a binomial tree option pricing model. It follows that changes in the fair value of the option (gains or losses on the derivative) would be equal to changes in fair value (i.e. present value) of the expected future cash flows (to the extent that the notional and maturity date of the purchased option match the forecast future sales). Put another way, because the hedged item is a one-sided risk it does include an element of time value, it is not an artificial feature that does not exist in the hedged item. Therefore, it is necessary to include time value in both the option and the hedged item when testing and measuring effectiveness.

Given the above analysis the first question considered by the IFRIC ("Should the hedged item used for assessing and measuring hedge effectiveness be the same as that designated at inception of the hedge?") would seem somewhat moot. The hedged item, for the purposes of designation and assessing effectiveness/measuring ineffectiveness, is always a change in value resulting from a movement in the relevant FX rate below a certain level. The method to assess and measure ineffectiveness remains the hypothetical derivative method. Because the hedged item is not a hypothetical written option as suggested by the submission, and the fact that IAS 39 explicitly permits a one-sided risk to be designated as the hedged item, there is no basis under question (b) to conclude that the hedged risk is not an eligible hedged item.