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Belgium

By email: [stig@efrag.org](mailto:stig@efrag.org)

Dear Mr. Enevoldsen

### **Comments on IAS 39 ‘carve-out’**

We are writing in response to your recent call for comments on the technical aspects of the Commission’s proposed carve-out of certain parts of IAS 39 as part of its endorsement of that standard.

These comments are based on extensive consultation around the Deloitte Global network, and in particular our member firms in Europe, and are offered in the context of seeking to help the Commission to find a way forward. Nothing in this letter should be taken as indicative of a change in our often stated and still held position as a global organisation of support for full and immediate endorsement of the IAS 39 in the form in which it has been issued by the IASB.

Given the depth and duration of the technical debate that has taken place over several years in relation to IAS 39, it is not surprising that we see real technical problems with what has turned out to be a rapidly developed proposal for the carve-out. We recognise that the Commission is endeavouring to find a practical solution that accommodates the concerns of those banks which believe that they need to be able to apply hedge accounting for demand deposits. Therefore whilst we have identified in the appendix to this letter a number of intractable technical issues connected with the carve-out proposals, we have also sought to identify, in order to minimise the internal contradictions within the Standard, those further changes that will be required if the Commission does chose to proceed with its current proposals.

We are sure that the Commission will agree that care must be taken to ensure that any pragmatic solution developed for certain constituents does not (in so far as it can be practicably avoided in the circumstances) open the door for misapplication or abuse elsewhere. The further changes we have identified should help in this regard although, inevitably, the deletions in combination reduce the rigour of the standard’s compliance with the IASB’s framework.

In the circumstances, we believe the best outcome would be a situation where the carve-out proposals are an option that is available only to banks, thereby achieving the Commission's objectives without exposing the standards and users in other sectors to the weaknesses and inconsistencies described in the appendix. Most importantly, in seeking to resolve difficulties for some banks, the Commission needs to avoid creating new difficulties for others. The Commission will be aware that whilst there are very few who would regard IAS 39 as anywhere near perfect, there are still many banks which would prefer full adoption rather than a carve-out solution. Not only does the Commission need to find a way to restrict the carve-out option to banks that need to apply hedge accounting to demand deposits, but it must also ensure that the carve-out is not made the only option available to banks. If it was to become the only option, we believe it could create as many problems for the EU banking industry as a whole as the Commission is endeavouring to solve with its carve-out proposals.

Yours sincerely,

Ken Wild  
IFRS Global Leader

## **Appendix:**

The comments provided in this Appendix are in response to your request for observations as to whether the proposed “carve-out” is a “technically robust, sound and consistent solution”.

We have segregated our comments on the carve-out between those on the hedge accounting for demand deposits and the fair value option for financial liabilities (including other IASs/IFRSs affected), recognising that some comments are, in our view, fatal flaws and some are merely drafting.

If the Commission were to find a way of making the carve-out proposals an option that is only available to banks, then the impact of these fatal flaws would of course be greatly reduced.

### ***Fatal Flaws***

#### *Hedge accounting for demand deposits*

When taking into account the impact of all the carved out paragraphs it is evident that the objective of the proposal is to allow the application of a macro-hedging solution that is equivalent to the “bottom-layer” approach as described in the original exposure draft on “Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk” issued by the IASB back in August 2003. This hedge accounting technique has been clearly rejected by the IASB, as well as by many other commentators, including the Federation Bancaire De L’Union Europeenne (FBE) in their response to the exposure draft. This carve-out is not limited to allowing a modification of hedge accounting for demand deposits, but goes far further and fundamentally changes how demand deposits, as well as any other asset or liability, are designated in a hedge accounting relationship.

The proposal continues to retain the provision that the fair value of a demand deposit cannot be less than its demand amount (IAS 39.49 and IAS 39:IN19). We understand that the Commission considers that the application of IAS 39.49 is restricted to a *single* financial liability with a demand feature, and therefore this paragraph is not applicable to a *portfolio* of financial liabilities with demand features, i.e. portfolios of demand deposits can be subject to different measurement principles compared to a single demand deposit. IAS 39:AG72 states that “the fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted price”. We interpret this paragraph as underlying a general valuation principle that is also applicable to non-quoted instruments. Therefore, we do not consider that, under the current IFRS requirements, with or without the application of the current hedge accounting methodology, a portfolio of financial liabilities with demand features can be measured at an amount that is not equal to the sum of their parts.

IAS 39:AG107A prevents an entity from purposely “under-hedging” (i.e. when the fair value of the hedging instrument is less than the fair value of the hedged item). This paragraph was originally introduced in IAS 39 as an anti-avoidance paragraph to ensure that when hedge accounting is being applied, an entity could not purposely designate an amount of assets or liabilities as being hedged, then measure hedge effectiveness based on a different amount of assets or liabilities. We consider that this requirement is particularly relevant to cash flow hedge accounting as ineffectiveness is not recognised in profit or loss when there is “under-

hedging”. We strongly believe that assessment and measurement of hedge effectiveness must be consistent with the hedge designation. Any opportunity for an entity to apply a different principle would permit either gains/losses on derivatives to be either ‘hidden’ in reserves in a cash flow hedge, or the hedge ineffectiveness not to be reflected in profit or loss in a fair value hedge because the hedged item is not adjusted for the designated hedged risk. Either way, we believe that allowing “under-hedging” to avoid recognition of hedge ineffectiveness is a fatal flaw.

IAS 39:AG99A & B provides guidance as to how entities can hedge “portions” of cash flows. This is a fundamental concept in IAS 39, not offered under the US GAAP equivalent, SFAS 133, as it allows entities the flexibility as to which cash flows can be designated in a hedge relationship. The carve-out retains this principle but deletes the paragraphs that provided guidance as to how this concept can be applied. The deletion of this guidance will allow any entity to claim hedge accounting for a portion of cash flow, even if the hedging instrument generates cash flows that will far exceed the cash flows that are generated from the hedged item. The need still to measure hedge effectiveness is not enough to prevent entities designating cash flows that are not evident in the hedged item, and in addition claiming that the hedge relationship is perfect.

The removal of the last sentence of IAS 39:AG122 which stated that it cannot be assumed that changes in the fair value of the hedged item equal changes in the value of the hedging instrument adds further support to the idea that through ‘innovative’ hedge designation, no hedge ineffectiveness will ever be recognised. This is a fundamental change in hedge accounting that will impact the hedge accounting of all entities, not just banks who wish to macro-hedge interest rate risk.

More broadly, the deletion of many of the hedge accounting paragraphs will impact any corporate or financial institution that wishes to apply hedge accounting. We are concerned that the paragraphs that have been deleted are not separable, distinct and autonomous, and are in fact pervasive to all hedge relationships. The impact of the deletions result in the carve-out ‘over-shooting’ its original objective (i.e., to provide a solution for hedge accounting of demand deposits). The amendments to IAS 39:AG107A, AG99A & B as discussed above are only two examples of this. As the carve-out reduces the number of restrictions on the application of hedge accounting, this increases the risk that the hedge accounting guidance will be abused by entities that are not hedging demand deposits. The Commission must look further at the ability to restrict the carve-out to only those banks that need to apply hedge accounting for demand deposits.

The Commission will be aware that whilst they do not regard IAS 39 as perfect by any means, many banks would prefer full adoption rather than a carve-out solution. In finding a way to restrict the carve-out option to banks that need to apply hedge accounting to demand deposits, we strongly recommend that this is not made the only option available to banks as we believe such a conclusion would create as many problems for the EU banking industry as a whole as the Commission is endeavouring to solve with its carve-out proposals.

## *Other IASs/IFRSs*

The Commission has already endorsed IAS 1 and IFRS 1. An entity that would apply the carve-out will face problems of compliance with both of those endorsed Standards. How could an entity that adopts the carve-out cannot make an “explicit and unreserved statement” of compliance with IFRS, as required by IAS 1.14? Similarly, how could an entity also claim to be a first-time adopter under IFRS 1 if it cannot issue an “explicit and unreserved statement of compliance with IFRSs”? There is a clear conflict between the Commission’s endorsement of IAS 1 and IFRS 1 on the one hand, and the Commission’s proposed carve-outs for IAS 39. In addition, the ability to switch between endorsed IFRS or full IFRS would provide entities the opportunity to use the exemptions in IFRS 1 on numerous occasions resulting in a lack of comparability and provide an opportunity for entities to arbitrage between the two.

IAS 8.11 requires - in the absence of specific guidance - consideration of the requirements of IFRS dealing with similar and related issues, the framework, or recent pronouncements of other standard-setting bodies that use a similar conceptual framework in descending order. It is unclear whether the intention of endorsing IAS 8 is to require full application of IAS 39 or to require entities to look to alternative GAAP or the framework to determine their accounting policy for items affected by the carve-out. Given this uncertainty, we request clarification of whether the carve-out is meant to be an option available to entities, which would seem to put it in the orbit of IAS 8.11, or whether it is meant to force entities not to follow the carve-out sections, which we understand is contrary to the wishes of many entities.

Whilst finding a way of restricting the carve-out only to those banks that need to apply hedge accounting for demand deposits as noted above, the Commission also needs to find a way of reconciling these contrary positions.

## *Drafting*

### *Hedge accounting for demand deposits*

Should the Commission continue to believe that the current carve-out would allow a portfolio of demand deposits to be valued differently from the sum of their parts, IAS 39.83 would need to be deleted in whole to be consistent with this argument. The crux of the Commission’s argument would seem to be that portfolios are valued differently from individual items, and therefore IAS 39.83 would contradict this as it states that similar liabilities can be hedged as a group only if the individual liabilities in the group share the same risk exposure that is being hedged.

If the Commission considers that the Introductions to IAS form part of the EU endorsed standard, then the deletions in IAS 39:AG124(a) on hedge ineffectiveness due to prepayment risk are inconsistent with the second and third sentences in IAS 39:IN24A(c).

### *Fair value option of financial liabilities*

If the limitation of the fair value option is approved, then other deletions in other IASs will be required:

- Reference to “financial liabilities” in IAS 32.94(e)(ii) would need to be deleted.

- IAS 32.94(f) would need to be deleted in whole.
- IAS 32:AG40 would need to be deleted in whole.

Should the Commission consider that the Introductions to IAS form part of the EU endorsed standard, then IAS 32:IN17(c) and IAS 39:IN16 would need to be amended to remove reference to “financial liabilities”.

Also, the first sentence of IAS 39.4 on loan commitments is in conflict with the prohibition on fair valuing liabilities, and therefore would need to be deleted. Under the carve-out, loan commitments written by an entity could no longer be allowed to be designated at fair value through profit or loss.