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17 December 2007

Mrs Rachel Knubley
Project Manager
International Accounting Standards Board
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**Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments:
Recognition and Measurement – Exposures Qualifying for Hedge Accounting**

Dear Mrs Knubley

We are pleased to comment on the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement – Exposures Qualifying for Hedge Accounting* (herein referred to as ‘the ED’). Our responses to the questions raised in the ED are set out in an Appendix to this letter.

We support the Board’s intention to clarify IAS 39 *Financial Instruments: Recognition and Measurement* in the areas of what risks are eligible for hedge accounting and what portion can be designated as a hedged item. As the amendments’ objective is to provide clarity in what is a qualifying hedge accounting relationship it is important that the finalisation of the amendments on risks and portions is very clear. We currently have concerns that some of the drafting is not clear enough and also that the amendments may have unintended consequences for other hedge accounting designations beyond the intended scope of the amendments. We draw this to your attention as well as our proposals to make the amendments clearer and other drafting comments in the answers to the questions in the Appendix to this comment letter.

We acknowledge like you do in your basis for conclusions that the amendments are more rule-driven than principle-based but see this as necessary given the intention of the Board to provide clarifying guidance on hedge accounting qualification which is largely rule-based itself.

If you have any questions concerning our comments, please contact Ken Wild in London on +44 (0) 207 007 0907.

Yours sincerely

A handwritten signature in black ink, appearing to read "Ken Wild", written over a single horizontal line.

Ken Wild
Global IFRS Leader

Appendix

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?

Yes, we agree with the proposal to restrict qualifying risks when hedge accounting for other than all risks when hedging financial instruments. We believe a list of qualifying risks will help to clarify the standard's requirements and the Board's original intentions. However, we believe the list should be amended to include equity price risk in the instance where the denomination of the hedged equity security differs from the functional currency of the entity. This is of particular relevance if entities hedge available-for-sale equity securities that are traded only in foreign currencies (as described in IAS 39 IG F.2.19) and the entity has exposure to the fair value of the equity in the denomination of the equity security and the fair value in the functional currency of the entity. Without amending paragraph 80Y it would appear an entity can hedge all risks in their entirety, foreign currency risk, but not equity price in the denomination of the security. We do not believe this was the Board's intention and suspect the list in paragraph 80Y was compiled with debt instruments in mind and inadvertently excluded equity price risk. Therefore we suggest adding equity price risk to the list of risks eligible to be hedged by amending paragraph 80Y of the ED as follows:

[...]

- (f) equity price risk resulting from a financial asset that is denominated in a currency other than the functional currency of the holder subject to the restrictions set out in the Implementation Guidance to this IFRS under question F.2.19.

Additionally, we suggest in the application guidance that there is clarity as to whether a market interest rate as described in paragraph 80Y(a) can only be an interbank rate, as included in the example in that paragraph, or whether it is wider than interbank rates as BC7 of the ED could be read as suggesting when it states that “the Board decided to permit the designation of **any market interest rate** as a hedged risk [emphasis added]”. Consideration should be given as to whether interest rate indexes that are not interbank rates qualify as a hedged risk, for example, the Bond Market Association Municipal Swap Index (now the SIFMA index) or auction rates.

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?

Yes, we agree in principle with the intention. However, we wonder if some of the wording used in the ED appropriately reflects the Board's intention.

Firstly, we think the use of the word 'portion' in the first sentence of paragraph 80Z might lead to unintended consequences with regard to hedging one-sided risks and percentages for *non-financial* items (which are outside the scope of the ED). Paragraph 80Z(b) and 80Z(c) in combination with the introductory sentence might imply that one-sided risks and percentages are always considered portions. IAS 39.82 restricts non-financial items to be designated for foreign currency risks or all risks in their entirety. This paragraph also states the reason for this limitation is "the difficulty of isolating and measuring the appropriate **portion of cash flows** or fair value changes attributable to specific risks other than foreign currency risks [emphasis added]". We believe paragraph 80Z as currently drafted could be interpreted as effectively prohibiting designating one-sided risks and percentages arising from non-financial items which we do not believe was ever the Board's intention.

We also note that paragraph 80Z only refers to components of cash flows which could imply that hedge accounting is limited solely to cash flow hedge accounting, not fair value hedge accounting. Once again, we do not believe this was the Board's intention. We would therefore suggest the following changes to be made to paragraph 80Z:

An entity may designate as a hedged item one or more of the following ~~portions~~ components of the cash flows *or fair value* of a financial instrument:

- (a) the *contractually specified* cash flows of a financial instrument for part of its time period to maturity (a 'partial term hedge').
- (b) a percentage of the cash flows *or fair value* of a financial instrument (a 'proportion').
- (c) the cash flows *or fair value* of a financial instrument associated with a one-sided risk of that instrument (for example, the cash flows resulting from a foreign exchange rate falling below a specified level).
- (d) any contractually specified cash flows of a financial instrument that are independent from the other cash flows of that instrument (for example, the first four interest payments on a floating rate financial liability).
- (e) the portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a risk-free rate.
- (f) the portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a quoted fixed or variable inter-bank rate (for example, LIBOR).

Secondly, we believe it would be helpful to include a clarification on the interaction of paragraph 80Z(d) and the existence of (non-separable) put or call options within debt instruments. Paragraph 80Z(d) states that "any contractually specified cash flows that are **independent** from the other cash flows of that instrument (for example, the first four interest rate payments on a floating rate financial liability) [emphasis added]" can be designated as a hedged item. It could be argued that interest and

principal cash flows occurring after the first exercise date of such an option are not independent. Our understanding is that although put or call options could have an impact on meeting the other designation criteria set out in IAS 39 paragraph 88, for example whether cash flows are highly probable of occurring, and impact hedge effectiveness, we do not think that it is the Board's intention in principle to prohibit a designation when put or call options exist. We therefore suggest adding a paragraph within the application guidance to clarify this:

AG99BC Paragraph 80Z(d) states that any contractually specified cash flows of a financial instrument that are independent from the other cash flows of that instrument can be a hedged item. In the instance when a financial instrument has call or put options that are closely related to the debt host contract the entity does not treat the call or put option as separate cash flows from the interest and principal cash flows. However, the existence of such call or put option would influence other qualifying criteria in paragraph 88 of this standard such as whether the hedged cash flows are highly probable or the extent of hedge effectiveness.

Thirdly, we welcome the clarification on hedging with options as stated in paragraphs AG99E and BC15 of the ED. However, we believe that the guidance in this area could be made clearer by dealing directly with hedging with options which is the issue IFRIC dealt with which led to its inclusion in this ED. We would propose changing paragraph AG99E as follows:

AG99E When a highly probable forecast transaction is being hedged the entity cannot include the probability of occurrence as a hedged risk. For example, if an entity purchases an interest rate option, an interest rate cap at 8%, to hedge the portion of its issued variable rate debt due to changes in LIBOR above a certain percent, say LIBOR greater than 8%, the entity cannot defer the entire fair value of the option in a fully effective hedge relationship as the fair value of the option includes time value which is not evident in the hedged item. Such an approach would be inferring the time value, being the probability that cash flows may or may not occur, in a non-derivative financial liability.

The proposed wording above would also have the benefit of not being confused with partial-term hedging which is clearly permitted as stated in paragraph 80Z(a) of the ED and in IAS 39 IG.F.2.17. As described in IG.F.2.17 an entity "may be fully effective in hedging interest rate risk for 5 years on a 10 year bond if the swap is designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 **and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap** [Emphasis added]". Paragraph AG99E as currently drafted could be read as prohibiting partial term hedging in this case because of the need to

calculate the change in fair value of the 10 year principal cash flow due to changes in the 5 year interest rate curve, even though the principal is not settled in year 5.

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 expect no significant changes in practice on the exposures qualifying for hedge accounting. With regard to the eligible portions for hedge accounting we expect a material impact only for those entities that inferred the time value of the option in the hedged item as described in our answer to question 2 above.

Question 4 – Transition

Is the requirement to apply the proposed changes retrospectively appropriate?

If not, what do you propose and why?

Yes, we agree from a conceptual point of view. However, we recognise that full retrospective treatment for those entities that previously deferred time value of options in the cash flow hedge reserve, as described in our response to questions 2 and 3 above, would result in full restatement of amounts deferred in the cash flow hedge reserve to retained earnings. We believe there would be no ability to restate to the position had they designated intrinsic value only, ie deferring only intrinsic value in the cash flow hedge reserve, because the very nature of hedge accounting is that it can only be applied prospectively and clearly hedge documentation was not in place that supported that alternative designation. Those entities would therefore only be able to defer intrinsic value on purchased options prospectively if new hedge documentation was put in place and all cumulative fair value changes recognised in the cash flow hedge reserve would have to be restated to retained earnings. As IFRIC recognised that there was diversity in practice with respect to designation of time value we ask the Board to consider an alternative transition requirement that will enhance comparability by aligning entities that had designated both time and intrinsic value to restate their cash flow hedge reserve to include changes in intrinsic value only. This transition approach is similar to concessions that the Board made when it amended IAS 39 for *Cash flow hedge accounting of forecast intragroup transactions*. The transition arrangements could be as follows:

- (1) Full retrospective application of the ED for all hedging relationships that designated both intrinsic and time value as they do not qualify for hedge accounting and hence, restate the opening retained earnings for the earliest prior period presented for amounts retained in the cash flow hedge reserve.
- (2) Retrospective application only for the time value element where both intrinsic and time value were designated (assuming all other elements of this ED and the hedge accounting criteria are met). The opening retained earnings for the earliest prior period presented will be restated only for changes in the fair

value of the hedging instrument resulting from changes in the time value and amounts previously included in the cash flow hedge reserve with respect to the intrinsic value only are retained in equity.