BNP PARIBAS

29 June 2007

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IFRIC Tentative Agenda Decision: Hedging future cash flows with purchased options

The IFRIC received submissions regarding a situation in which a purchased option in its entirety was designated as a hedging instrument to hedge variability in future cash flows in a cash flow hedge.
The IFRIC has analyzed the two following questions in order to address the issue:

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.

We understand that the IFRIC considers that IAS 39 and its Implementation Guidance are sufficiently clear to conclude that the approach suggested by the submission is not allowed. It is why the IFRIC, as reported in the May 2007 edition of the IFRIC update, decided 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.

We consider that this issue is highly complicated and should be considered in light of the reasons detailed below regarding the two questions considered by the IFRIC.

a - Hedged item used for assessing and measuring hedge effectiveness: one-sided risk hedged

IAS 39 (§88 b) requires the measurement of fair value changes in the cash flows attributable to the hedged risk in determining the effectiveness of a hedge.
IAS 39 (§86b) indicates that a cash flow hedge can be a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated to a highly probable forecast transaction.
A one-sided risk, for example the hedge of future cash flows in case of a decrease in rates, should be considered as a particular risk which can be hedged. This approach is confirmed by the implementation guidance F.1.10 and the discussions on the identification of exposures qualifying for hedge accounting (Cf. May 2007 IFRIC Agenda Paper 11 ii §42).

As the hedged risk is a one-sided risk in a future period of time, the best way and common practice to measure the fair value of that risk is by using an option pricing methodology, which represents the expected future cash flows considering the probability of possible outcomes on the hedged item. Because the risk is a one-sided risk in a future period of time, it includes an element of time value and thus there is no creation of a time value that doesn't exist in the hedged item.

What is hedged is a risk not booked in the financial statements the value of which shall be represented in order to identify the variations and to measure the effectiveness. And the best representation of this risk is to model it as an option.

IAS 39 (§74a) permits to separate intrinsic value and the time value of an option contract but does not require to do so.
Based on the above points about the representation of the hedged risk, the time value has to be considered in both the hedging derivative and the hedged item, in case the hedged risk is defined as a future one-sided risk.

In order for the hedge to be highly effective, the hedging option must be one which matures on the date the forecasted cash flow is expected to occur and which has the same notional amount as the hedged item.

b – Eligible hedged items: the hedged risk is modelled as an option without being a derivative

The IFRIC's decision considers that the submission's proposal designates a derivative as the hedged item. Based on the IG F.2.1 of IAS 39, the IFRIC considers that IAS 39 does not allow for the designation of a written option as a hedged item.

Nevertheless, regarding prepayment risk, we understand that this risk is eligible for designation as a hedged risk. This point is developed in IAS 39 § 79 which states that « unlike loans and receivables, a held to maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk … ». This approach is confirmed in Agenda Paper 4 of the Financial Instrument Working Group (April 2007), in its paragraph 29 which specifies that risks eligible for designation as hedged risks should be restricted among others to prepayment risks, and in the IFRIC agenda paper 11ii of May 2007 (paragraph 41).
In this case, IAS 39 does not consider prepayment risk to be a derivative (which would be a written option) otherwise it would not state that this risk can be hedged. Prepayment risk can be hedged according to IAS 39 as the hedged risk is the representation of customers' behaviours, which seems not to be a derivative in IAS 39 doctrine.

We apply the same reasoning for one-sided risk. As explained in point a, the proposed approach of the Submission doesn't designate a derivative as a hedged item. The hedged risk is modelled as an option without being a derivative.

As demonstrated above, this subject raises lot of key relevant issues, which need to be fully reconsidered. Also, we would request that the IFRIC takes this issue on its agenda and allows the normal due process of inviting comments on a published draft to take place.

Should you have any questions regarding our comments, please do not hesitate to contact us.

Sincerely yours

Gérard Gil
Chief Accounting Officer