LIBA

LONDON INVESTMENT BANKING ASSOCIATION
6 Frederick's Place, London, EC2R 8BT
Tel: 020-7796 3606 Fax: 020-7796 4345
Direct: 020-7367 5507 E-mail: ian.harrison@liba.org.uk

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Liz Hickey, IFRIC Coordinator
International Financial Reporting Interpretations Committee
First Floor
30 Cannon Street
London EC4M 6XH

By email to: ifric@iasb.org

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 <u>is</u> 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

Ian Harrison
Director

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 <u>does</u> 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.

LIBA
29 June 07

LONDON INVESTMENT BANKING ASSOCIATION

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Ambrian Partners Limited
Arbuthnot Latham & Co., Limited
Arbuthnot Securities Limited
Arden Partners plc
Banc of America Securities Limited
Barclays Capital
Bayerische Hypo- und Vereinsbank AG
Bear, Stearns International Limited
BNP Paribas
Brewin Dolphin Securities
Bridgewell Group plc
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CIBC World Markets
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