

**Comment letter on tentative decision on IAS 39 Financial Instruments: Recognition and Measurement-Hedging future cash flows with purchased options (May 2007)**

We respond to your invitation to comment on the above mentioned tentative agenda decision, published in the May 2007 edition of the IFRIC Update.

The IFRIC was asked how the effectiveness should be assessed when an option, in its entirety, is designated as a hedging instrument to hedge variability in future cash flows in a cash flow hedge. Specifically, a methodology was considered which involved a comparison of all changes in the fair value of the purchased option with changes in the fair value of a hypothetical written option that has the same maturity date and notional amount as the hedged item. The IFRIC proposes to not take the item on the agenda as IAS 39 prohibits the approach. Further, the IFRIC notes that the suggested hypothetical derivative approach would effectively result in considering the time value component of an option in determining changes in the fair value of the hedged item for the assessing and measuring hedge effectiveness. In addition, IFRIC concludes that derivatives cannot be designated as hedged items, except in specific fair value hedging situations.

In our view, the rejection of the agenda item by stating that IAS 39 prohibits the approach and outlining the above mentioned reasons should be further discussed considering the following arguments which we base on the experience from our industry.

In general, life insurance companies are exposed to long-term interest rate risk, i.e. they face a significant reinvestment risk related to future investments in fixed-income securities, stemming from an ALM (Asset & Liability Management) mismatch. In this respect, an insurance company needs protection against a decreasing long-term interest rate, which would lead to lower investment income from future investments in fixed income securities. Therefore, a frequently applied hedging strategy is to buy interest rate options to ensure that a certain amount of capital can be reinvested at a defined future point in time (the reinvestment date) at a minimum yield (the strike). The risk hedged is one-sided, i.e. only the risk of interest rates below strike level is hedged.

The insurance company seeks to designate the entire interest rate option (including the time value component) as the hedging instrument. IAS 39 explicitly allows to designate only the intrinsic value of an option as the hedging instrument and leave the time value of the option undesignated (with gains/losses of the time value component recorded in the income statement). However, because of the long-term nature of the hedged interest rate risk (the hedged period may sometimes comprise 20 years and more) the time value of the options and related time value fluctuations are very significant for insurance companies. Therefore, the insurance company would need to designate the entire interest rate option as the hedging instrument.

Under IFRS, in order to assess the effectiveness of the hedges, the insurance company can choose a 'hypothetical derivative method' in analogy to 'Method B - Compute change in fair value of cash flows' as described in the IAS 39 Implementation Guidance F.5.5. According to this approach, the insurance company measures the effectiveness of the hedge by comparing the changes of the hedging instrument's fair value (purchased option) to changes in value of a hypothetical option with the same features as the hedged forecasted transaction.

We believe the above approach would be the only possible alternative for analysing hedge effectiveness in such a situation. Ignoring the time value component inherent in the hedged item would lead to effectiveness outside the acceptable 80-125% range in most of the cases. We further strongly believe that this method should qualify under IAS 39 for following reasons:

- We do not believe that IAS 39 prohibits an entity to model a hedged item as a hypothetical derivative for effectiveness testing purposes. In the IAS 39 Implementation Guidance F.5.5,

the hedged item (a forecasted debt instrument to be issued) is modelled as a hypothetical forward starting swap.

- We further understand that the hypothetical derivative approach is a common approach, applied by many companies for various hedging strategies.
- The IFRIC noted that the approach mentioned is not allowed under IAS 39 because it "*would effectively result in considering the time value component of an option (that does not exist in the hedged item) in determining changes in the fair value of the hedged item for assessing and measuring hedge effectiveness*". We disagree with this conclusion because we believe that a time value component is actually inherent in an item hedged against a one-sided risk. This option time value is the probability weighted value reflecting the possibility that the hedged interest rate could get back or further into the protected area (i.e. below the strike rate). Thus, when hedging one-sided risks, a company should be able to choose to consider the "full" value of the hedged item including the time value (i.e. measuring the hedged item using an option pricing model).
- Our understanding is that a hypothetical derivative test is allowed under US GAAP (DIG G20) for assessing and measuring the effectiveness of a purchased option used in a cash flow hedge. Thus, it would be possible under US GAAP to consider the time value of the option in the effectiveness test. For insurance companies reporting also under US GAAP, an IFRS to US GAAP difference would be created related to hedge accounting with options. This would reduce the consistency between IFRS and US GAAP results. In addition, it would increase the administrative burden for preparing the financial statements.

According to the reasons outlined above, we believe the mentioned approach should qualify for IAS 39 hedge accounting. For many life insurance companies it is important to achieve hedge accounting for the full fair value of the hedging options employed in their long-term interest rate risk management. Measuring and managing this risk is embedded in our business model. If hedge accounting is not admitted for this risk management strategy, the underlying economics of the business would not be appropriately reflected.

We ask you to consider the arguments and further discuss the correct accounting treatment. This may need to be addressed by issuing an interpretation.

We remain at your disposal, if you would like to discuss our business model or the specific approach.

Yours sincerely,

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