

Sir David Tweedie, Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Madrid, 9 February 2011

**Re: Exposure Draft ED/2010/13 Hedge Accounting**

Dear Sir David,

SEOPAN appreciates the opportunity to comment on Exposure Draft ED/2010/13 Hedge Accounting (the "ED"). We would also like to thank the Board for its outreach activities in this area, which we were able to take advantage of in our meeting in the first week of March.

Although we acknowledge the efforts the Board has made in order to modify hedge accounting so that it better reflects the risk management model of the entity, however we would appreciate if additional changes are introduced in order to reduce the complexity in reporting of financial instruments and to eliminate the mismatch and distortion that happens in the case of non financial institutions when derivatives linked to debt instruments are measured at fair value, but the assets that this debt is financing are not carried at fair value (e.g. concession contract according IFRIC 12, financed by a debt instrument linked with a derivative)

Following the approach of reducing complexity, our main concern is that an alternative model should be applied for some derivatives where the hedging relationship is straightforward and, in our view, better information will be provided if it is allowed to account the hedged item and the hedging instrument as a single financial instrument at amortised cost.

In those cases where derivatives are contracted simultaneously and are linked to a financing contract with the sole purpose of adjusting the conditions of the financing, like an Interest Rate Swap that is linked to a variable rate loan that turns the loan into a fixed interest loan or index linked swap combined with a fixed rate bond that results in an inflation linked bond, more decision-useful information would be provided for users if they were accounted together with the hedged debt instrument as a single financial instrument at amortised cost, instead of applying fair value.



These derivatives are not held for trading but are held to maturity linked to the loan as requested by the financing entities in order to adjust the interest cash-flows of the loan. In our view, better information will be provided if the underlying debt and the swap could be accounted together as a single instrument at amortised cost. It is important to point out that such request from the lenders is always included as a Condition Precedent for the drawdown of the loan.

The obligation to measure these derivatives at fair value introduces high volatility into equity of the companies concerned, and it does not contribute to represent a true and fair view of the companies as the instruments are not held for trading (in fact it couldn't be sold or renegotiated separately from the loan) and must be held to maturity linked to the loan in order to adjust the interest cash-flows of the loan.

We would like to point out the effects of this decision to measure all derivatives at fair value, in the case of non-financial institutions where there is an accounting mismatch and distortion, as the assets that this debt is financing are not carried at fair value (e.g a concession contract according IFRIC 12 that is financed by a debt instrument linked with a derivative)

In our view, in those cases the financial statements do not provide the best information for users and non-GAAP disclosures and additional information is needed.

Additionally the application of fair value measurement generates quite different treatments for economically equivalent transactions, depending on how the transaction is structured; although the impact on cash is the same. We think this is the sort of inconsistency that makes information about financial instruments difficult for users to understand.

Please see further explanation in our answer to question 20.

Attached you can see our detailed response to the invitation to comment questions and other additional matters.

Kind Regards,

Julián Núñez Sanchez  
Vicepresident



## APPENDIX I

### RESPONSES TO THE SPECIFIC QUESTIONS

#### **OBJETIVE OF HEDGE ACCOUNTING**

**Question 1 -Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?**

We do agree with the proposed objective. We agree that under a principle-based approach this definition is very important.

#### **INSTRUMENTS THAT QUALIFY FOR DESIGNATION AS HEDGING INSTRUMENTS**

**Question 2 - Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?**

We do agree with the proposal. This will allow a closer alignment between hedge accounting and entity's risk management activities.

#### **DERIVATIVES THAT QUALIFY FOR DESIGNATION AS HEDGED ITEMS**

**Question 3 - Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?**

We do agree.

#### **DESIGNATION OF RISK COMPONENTS AS HEDGED ITEMS**

**Question 4 - Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?**

We do agree that risk components should be designated as hedge items, as this will better reflect the economic reality of many transactions which is not the case today under IAS 39. However, we do not agree with the exclusion of inflation as an eligible item.



We recommend deleting paragraph B18 on the final version of the standard. We consider that the exclusion of inflation as an eligible component is a rule and not a principle.

The Exposure Draft considers that the eligibility of a component for designation has to be based in principles. According to paragraph B14: *“When identifying what risk components are eligible for designation as a hedge item, an entity assesses such risk components in the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market”*.

This issue was discussed when preparing the Exposure Draft. According to Agenda Paper 3 of October 27<sup>th</sup>, 2010 IASB meeting:

- P.40: *“In the staff’s view the question of what are appropriate risk components can only be determined in the context of the particular market structure regarding that risk. Hence, the determination of appropriate risk components requires an evaluation of the relevant facts and circumstances, which differ by risk”*. *[In italics in the original]*
- P.41: *“For example, the link of the price of fuel oil products (petroleum products) to the price of crude oil is generally strong, but decreases the more inputs (like additives etc.) and production costs are involved. A step further away from the petroleum products are petrochemicals (ie chemical products derived from petroleum). And products derived from petrochemicals such as plastics products or fertilizer are yet another step further away and hence have a weaker link to crude oil prices. Hence, there is a broad spectrum along which the influence of the crude oil price on the particular risk of a product decreases, which means an crude oil price risk component is less likely to be identifiable”*.
- P.42 *“However, there is no bright-line cut-off that could be set by one for everyone. Instead it requires careful analysis and knowledge of the relevant markets. The examples here are related to petroleum related products (which has one of the most pervasive ripple effects on industry products). There are obviously many other markets, for which similar considerations apply”*.
- P.43: *“The need to consider individual facts and circumstances means that a criteria-based approach is appropriate. The use of criteria allows that entities can perform the evaluation in their specific situations”*.

In some jurisdictions such as the United Kingdom, the Government usually issues bonds linked to inflation and non-linked bonds; as a consequence, real and nominal rates are known and the inflation component can be identified and measured (Level 2 valuation), more reliably than the fertilizer component in crude oil (Level 3 valuation). In this example of a bond of the UK Government (GILT), the inflation is identified as RPI (Retail Price Index) and is reliably measurable.

In our point of view, the inflation component in a corporate bond is also separately identifiable and reliably measurable, following the ‘building-blocks’ methodology for determining the effects of changes in credit risk determined in IFRS 9 (paragraphs



B5.7.16-20). On a principle-based approach, the same 'building-blocks' methodology should be used and since the change in the corporate bond fair value is the sum of the changes in credit risk and changes in benchmark (real, nominal and RPI) the inflation component can be separately identifiable and reliably measurable (as it is possible to determine the change in the benchmark due to changes in real rate and due to changes in inflation).

Please find attached as Appendix II an example of how inflation can be identified and measured in a UK GILT.

#### **DESIGNATION OF A LAYER COMPONENT OF THE NOMINAL AMOUNT**

**Question 5 (a) - Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?**

We do agree with the proposal.

**Question 5 (b) -Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?**

We do agree.

#### **HEDGE EFFECTIVENESS REQUIREMENTS TO QUALIFY FOR HEDGE ACCOUNTING**

**Question 6 - Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?**

We welcome IASB proposal to abolish the 80 to 125 per cent bright line test for effectiveness testing as well as the obligation to quantitatively carry out retrospective hedge effectiveness testing. However, we would appreciate if paragraph B34 explicitly states that when the critical terms remains closely aligned, any quantitative assessment is not needed, and as a consequence, ineffectiveness calculation will be neither needed.

#### **REBALANCING OF A HEDGING RELATIONSHIP**

**Question 7 (a) - Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for**



**a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?**

We do agree.

**Question 7 (b) - Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?**

We do agree.

#### **DISCONTINUING HEDGE ACCOUNTING**

**Question 8 (a) - Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?**

We do agree.

**Question 8 (b) -Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?**

We do agree.

#### **ACCOUNTING FOR FAIR VALUE HEDGES**

**Question 9 (a) - Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?**

We do agree.

**Question 9 (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?**

We do agree.



**Question 9 (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?**

We do not agree. Please, see answer to question 17 below.

#### **ACCOUNTING FOR THE TIME VALUE OF OPTIONS FOR CASH FLOW AND FAIR VALUE HEDGES**

**Question 10 (a) - Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?**

We do agree.

**Question 10 (b) -Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?**

We do agree.

**Question 10 (c) - Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?**

We do agree

#### **HEDGES OF A GROUP OF ITEMS**

**Question 11 - Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?**

We would like to review the open portfolio proposal, before answering this question.

#### **PRESENTATION**

**Question 12 - Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be**



**presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?**

We do agree.

## **DISCLOSURES**

**Question 13 (a) - Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?**

We do agree.

**Question 13 (b) - What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?**

Please, see our answer to question 14 below.

## **ACCOUNTING ALTERNATIVES TO HEDGE ACCOUNTING**

**Question 14 - Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?**

At the moment, after the discussions maintained so far, it is far from clear to what extent derivative accounting will have to be applied to commodity contracts that used to meet the "own use" exception. It is unclear whether this application of fair value to own use contracts will be mandatory or optional, because it will all depend on whether the application of derivative accounting will be in accordance with the entity's underlying business model and how the contracts are managed. For the time being, we believe that this requisite established by the ED needs further clarification.

## **ACCOUNTING FOR CREDIT RISK USING CREDIT DERIVATIVES**

**Question 15 (a) - Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?**

We consider that if any alternative is adopted for the final standard, the model will be more rules based than principles based.





We do not understand why some components that according to the Board can not be separately identifiable and reliably measurable could have a different accounting treatment that will allow the application of hedge accounting.

**Question 15 (b) - If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?**

Please, see our answer above.

## **EFFECTIVE DATE AND TRANSITION**

**Question 16 - Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?**

We do agree.

## **ADDITIONAL MATTERS**

**Question 17 - Step-up swap as a Hypothetical derivative**

Step-up swap is an interest rate swap agreement with an increase in the fixed rate on one or more dates over the life of the swap.

The Agenda Paper 19B (September 13<sup>th</sup>, 2010), included an example of how the hypothetical derivative should be used. This example and the example F.5.5 of the IAS 39 Guidance on Implementing are the only examples published by the IASB to date about hypothetical derivatives.

In these two examples, the pay leg (fixed rate) of the hypothetical derivative is calculated as the embedded fixed rate in the forward curve at inception.

The trouble is that even though it is well known that IFRS is principle-based, is that someone could contemplate these examples as a rule and conclude that the pay leg of the hypothetical derivative should always be obtained from the forward curve at inception as a single fixed rate, no matter the risk management approach considered in the transaction.

In our view, entity risk management approach should be considered when using a hypothetical derivative. For instance, if the approach is to cover the interest rate risk using a step-up that converts contingent outflows into fixed outflows in absolute value. The approach is not to cover the interest rate risk converting a floating rate in % into a fixed rate in %. In this case the hypothetical derivative to be considered should be a step-up swap.



With the example below, we will explain why using the embedded fixed rate in the forward curve setting up the hypothetical derivative generates problems in the effectiveness test and why a step-up fixed rate in the pay leg is 100% effective eliminating the interest rate risk.

Example: Entity A issued a GBP100.000 debt instrument that pays 6-month Libor semi-annually. The maturity of the instrument is 2 years. Entity A is exposed to interest rate decreases, and would like to eliminate the risk of changes in the cash flows by entering into an interest rate swap whereby it receives the Libor cash flows that has pay on the bond and pays a fixed rate. The term structure of interest rates at inception and relevant data on the hedged item are as follows:

|     | Days | t0         |           |
|-----|------|------------|-----------|
|     |      | Spot rates | Fwd rates |
| 0   |      |            |           |
| 6m  | 180  | 5,25%      |           |
| 1Y  | 360  | 5,50%      | 5,75%     |
| 18m | 540  | 5,50%      | 6,25%     |
| 2Y  | 720  | 5,50%      | 6,35%     |

The fixed rate embedded in the forward rates is 5,89%.

Entity A enters into a step-up swap that pays a fixed rate of 2% in the first 3 periods and 18,28% in the last period.

Entity A decides to use a hypothetical derivative (in order to calculate the changes in the fair value of the hedged item) in the effectiveness test. As explained above there are at least two ways to obtain the hypothetical derivative, a single fixed rate in the pay leg (hereinafter 'Hypothetical plain-vanilla swap') and considering an increase in the fixed rate at one or more dates (hereinafter 'Hypothetical step-up swap').

– 'Hypothetical Plain vanilla swap' fair value at inception:

|               |                | t0 values |        |        |        |                  |
|---------------|----------------|-----------|--------|--------|--------|------------------|
|               |                | 0         | 6m     | 1Y     | 18m    | 2Y               |
| Swap          | Days           |           | 180    | 360    | 540    | 720              |
|               | Pay leg        | -2.943    | -2.943 | -2.943 | -2.943 | -2.943           |
|               | Receive leg    | 2.625     | 2.875  | 3.125  | 3.175  |                  |
|               | Net outflow    | -318      | -68    | 182    | 232    |                  |
|               | Discount rates | 0,974     | 0,947  | 0,918  | 0,890  |                  |
| Present Value |                | -1        | -310   | -64    | 167    | 206 <sup>1</sup> |

<sup>1</sup> The fair value at inception is -1 and is not 0, as the fixed rate considered in the AP 19B has not been obtained considering continuous compounding. In any case, as the 'hypothetical step-up swap' has been calculated considering the same fair value at inception than the 'hypothetical plain vanilla swap' the fair value at inception of -1 is not an issue.



- 'Hypothetical Step-up swap' fair value at inception:

|      |                | t0 values |        |        |        |        |
|------|----------------|-----------|--------|--------|--------|--------|
|      |                | 0         | 6m     | 1Y     | 18m    | 2Y     |
| Days |                |           | 180    | 360    | 540    | 720    |
| Swap | Pay leg        |           | 2,00%  | 2,00%  | 2,00%  | 18,28% |
|      | Receive leg    |           | -1.000 | -1.000 | -1.000 | -9.142 |
|      | Net outflow    |           | 2.625  | 2.875  | 3.125  | 3.175  |
|      | Discount rates |           | 1.625  | 1.875  | 2.125  | -5.967 |
|      | Present Value  |           | 0,974  | 0,947  | 0,918  | 0,890  |
|      |                | -1        | 1.583  | 1.776  | 1.952  | -5.312 |

For simplicity in this example, we are going to assume that the 'real step-up swap' is equally to the 'hypothetical step-up swap' calculated above.

In order to demonstrate that the 'Hypothetical step-up swap' is expected to be highly effective, the following prospective analysis is done.

- Considering an increase of 100p.b in the interest rates:
- 'Hypothetical Plain vanilla swap' fair value:

| 1,00% |                | Sensitivity +100b.p |        |        |        |        |
|-------|----------------|---------------------|--------|--------|--------|--------|
|       |                | 0                   | 6m     | 1Y     | 18m    | 2Y     |
| Days  |                |                     | 180    | 360    | 540    | 720    |
| Swap  | Pay leg        |                     | -1.000 | -1.000 | -1.000 | -9.142 |
|       | Receive leg    |                     | 3.125  | 3.375  | 3.625  | 3.675  |
|       | Net outflow    |                     | 2.125  | 2.375  | 2.625  | -5.467 |
|       | Discount rates |                     | 0,970  | 0,938  | 0,905  | 0,873  |
|       | Present Value  | 1.891               | 2.061  | 2.228  | 2.376  | -4.774 |

- 'Hypothetical Step-up swap' fair value at inception:

| 1,00% |                | Sensitivity +100b.p |        |        |        |        |
|-------|----------------|---------------------|--------|--------|--------|--------|
|       |                | 0                   | 6m     | 1Y     | 18m    | 2Y     |
| Days  |                |                     | 180    | 360    | 540    | 720    |
| Swap  | Pay leg        |                     | -2.943 | -2.943 | -2.943 | -2.943 |
|       | Receive leg    |                     | 3.125  | 3.375  | 3.625  | 3.675  |
|       | Net outflow    |                     | 182    | 432    | 682    | 732    |
|       | Discount rates |                     | 0,970  | 0,938  | 0,905  | 0,873  |
|       | Present Value  | 1.838               | 176    | 405    | 617    | 639    |



The change in the fair value is different for the 'hypothetical plain vanilla swap', than for the 'hypothetical step-up swap'.

|                     |                      |         |
|---------------------|----------------------|---------|
| <b>Change in PV</b> | <b>Plain-vanilla</b> | -1.892  |
|                     | <b>Step-up</b>       | -1.839  |
|                     | Effectiveness        | 102,89% |

If the hypothetical step-up to be considered in the effectiveness test has to be the 'plain-vanilla' in that case some ineffectiveness will be recognised. If the 'hypothetical derivative' can be obtained considering the fixed rate structure of the real swap, no ineffectiveness will be recorded.

In this example, ineffectiveness is very low as we are considering a 2 years swap; in the case of long dated derivatives, as a 15 years swap, greater ineffectiveness could arise (higher than 80-125%).

In our view, no ineffectiveness should be recorded as the step-up swap is 100% effective in eliminating the interest rate risk. Entity A is exposed to interest rate risk prior entering the step-up swap as it does not know what will be their outflow of cash for its debt instrument as pays Libor (the outflows of cash are contingent) and this risk disappears when entering the step-up swap (the outflows of cash are fixed).

The inflows and outflows of cash of the hedged item and hedging instrument (considering no changes in the spot and forward rates) in the life of the instruments are as follows:

|              | <b>Swap</b>    |                    | <b>Bond</b>    | <b>Discount</b> | <b>PV</b>      |                    |
|--------------|----------------|--------------------|----------------|-----------------|----------------|--------------------|
|              | <b>Pay leg</b> | <b>Receive leg</b> | <b>Pay leg</b> | <b>Factor</b>   | <b>Pay leg</b> | <b>Receive leg</b> |
| 0            |                |                    |                |                 |                |                    |
| 6m           | -986           | 2.589              | -2.589         | 0,974           | -961           | 2.523              |
| 1Y           | -986           | 2.836              | -2.836         | 0,946           | -933           | 2.681              |
| 18m          | -986           | 3.082              | -3.082         | 0,917           | -904           | 2.826              |
| 2Y           | -9.016         | 3.132              | -3.132         | 0,889           | -8.017         | 2.784              |
| <b>Total</b> | <b>-11.975</b> | <b>11.638</b>      | <b>-11.638</b> |                 | <b>-10.815</b> | <b>10.815</b>      |

The swap will perfectly match the outflows of the bond and the hedging instrument is fully successful eliminating the risk of changes in the cash flows as it is known that the net outflow of cash will be GBP11.975.

In our point of view the swap is 100% effective. On the other hand, the step-up should not be considered in the expense recognition. In other words the fixed rate embedded in the forward curve should be considered in the expense recognition, in this example that for simplicity we have not included credit spread considerations. In our view, the interest rate method should be used in the expense recognition when credit spread has to be considered.



The following table summarizes the outflow of cash and expense recognition.

|              | Swap           |               | Interest<br>Expense        | Discount | PV             |               |
|--------------|----------------|---------------|----------------------------|----------|----------------|---------------|
|              | Pay leg        | Receive leg   | Fixed rate<br>in Fwd Curve | Factor   | Pay leg        | Fixed rate    |
| 0            |                |               |                            |          |                |               |
| 6m           | -986           | 2.589         | -2.902                     | 0,974    | -961           | 2.523         |
| 1Y           | -986           | 2.836         | -2.902                     | 0,946    | -933           | 2.681         |
| 18m          | -986           | 3.082         | -2.902                     | 0,917    | -904           | 2.826         |
| 2Y           | -9.016         | 3.132         | -2.902                     | 0,889    | -8.017         | 2.784         |
| <b>Total</b> | <b>-11.975</b> | <b>11.638</b> | <b>-11.610</b>             |          | <b>-10.815</b> | <b>10.815</b> |

A net interest expense of GBP2.902 (receive leg + bong pay leg =0) should be accounted in every period.

We would appreciate it if an example could be included in the final standard explaining how a step-up swap should be treated for effectiveness requirements.

If it is considered that it should be explicitly explained in the standard how to account for the interest expense in those cases, we suggest including it in paragraph 29 of the ED.

#### Question 18– Credit spread to be considered in the Hypothetical derivative

This issue arose in the due process but finally has not been considered in the Exposure Draft. In the Agenda Paper 19B for the September 13<sup>th</sup>, 2010 meeting, the Staff prepared an example of the hypothetical derivative.

- Paragraph 28 of Agenda Paper 19B states that: *“The FASB’s proposed ASU would allow, as a practical expedient, the credit risk for the ‘proxy’ derivative to be assumed to be the same as the actual derivative designated as the hedging instrument (despite the fact that this may not be the case) when measuring ineffectiveness in a cash flow hedge.” [In italics in the original]*
- p29: *“The IASB Staff believes that this practical expedient is inconsistent with the objective of the hypothetical derivative which is to establish a notional derivative that will be used to indirectly to calculate the changes in fair value of the hedged item attributable to the hedged risk. To calculate such changes the hypothetical derivative should reflect the credit risk of the hedge item and not the hedging instrument”. [In italics in the original]*
- p30: *“In addition, by presuming the same credit risk for the ‘proxy’ derivative and hedging derivative, ineffectiveness due to changes in the credit quality of the hedging instrument (eg changes in the creditworthiness of the counterparty to the hedging derivative) as well as the hedged item will not be recognised in profit or loss. This would represent an exception to the principle that all ineffectiveness should be recognised (if the Board wishes to consider such an exception, it should be considered in the context of all measurements of ineffectiveness)”*



- p31: *“As a result, the IASB staff believe that presuming the same credit risk both for the ‘proxy’ derivative and hedging derivative is inappropriate and should not be permitted”.*

We are worried that someone could contemplate this agenda paper as the IASB conclusion about credit spread in the hypothetical derivative and we found some difficulties in the case of cash flow hedges if the practical expedient of the FASB could not be applied.

If there is a perfect critical terms match between the hedge item and the hedging instrument, the interest rate risk is eliminated and as a consequence changes in the credit risk should not be a source of ineffectiveness.

For example, if an entity has entered in a swap to eliminate the interest rate risk of a floating debt, the receive leg of the swap will be exactly to the outflows of cash of the hedged item and the pay leg of the swap will be a fixed amount. Whatever the credit risk varies, the net outflow of cash will be the same (the fixed rate of the pay leg), as receive leg will match the outflow of the debt.

Changes in the creditworthiness of the entity will not change the outflow of the debt or cash flows of the swap, after inception. Changes in the creditworthiness will affect the terms of a new swap or new debt and the fair value of existing financial instruments but will not affect the forecast cash flows of existing financial instruments. In our view, the only the way that creditworthiness could affect the effectiveness of the swap, is due to a default of the counterparty and the corresponding unwinding of the swap.

As a consequence, it does not make sense to recognise any kind of ineffectiveness due to credit risk, as in our view there are only 2 scenarios:

- or the creditworthiness does not affect
- or hedge accounting should be discontinued due to the termination of the swap (if the counterparty defaults).

The example below illustrates our point of view of the credit spread in the ‘hypothetical derivative’.

Entity A issued a GBP100.000 debt instrument that pays 6-month Libor semi-annually. The maturity of the instrument is 2 years. Entity A is exposed to interest rate decreases, and would like to eliminate the risk of changes in the cash flows by entering into a interest rate swap whereby it receives the Libor cash flows that has pay on the bond and pays a fixed rate. The term structure of interest rates at inception and relevant data on the hedged item are as follows:



|     |      | t0         |           |
|-----|------|------------|-----------|
|     | Days | Spot rates | Fwd rates |
| 0   |      |            |           |
| 6m  | 180  | 5,25%      |           |
| 1Y  | 360  | 5,50%      | 5,75%     |
| 18m | 540  | 5,50%      | 6,25%     |
| 2Y  | 720  | 5,50%      | 6,35%     |

The fixed rate embedded in the forward rates is 5,89%. The swap entered by Entity A pays a fixed rate of 6,19% (5,89%+0,3% of spread).

The inflows and outflows of cash of the hedged item and hedging instrument (considering no changes in the spot and forward rates) will be as follows:

|   | Swap           |   | Bond           | (a)-(b)           |
|---|----------------|---|----------------|-------------------|
|   | Pay leg        | Receive leg (a)                         | Pay leg (b)    | 'Ineffectiveness' |
| 0   |                |   |                | 0                 |
| 6m  | -3.060         | 2.589                                   | -2.589         | 0                 |
| 1Y  | -3.060         | 2.836                                   | -2.836         | 0                 |
| 18m   | -3.060         | 3.082                                   | -3.082         | 0                 |
| 2Y  | -3.060         | 3.132                                   | -3.132         | 0                 |
| <b>Total</b>                                  | <b>-12.238</b> | <b>11.638</b>                           | <b>-11.638</b> | <b>0</b>          |
| <b>Difference between pay and receive leg</b> |                | <b>-600</b>                             |                |                   |
|   |                | <b>(0,30%spread x 100.00 x 2 years)</b> |                |                   |

The swap will perfectly match the outflows of the bond and the hedging instrument is fully successful eliminating the risk of changes in the cash flows (it is always a net outflow of GBP3.060). Whatever the credit spread is at any point of time, the net outflow of cash will always be the same (GBP3.060). Even if the credit quality of the hedging instrument deteriorates the net outflow (swap + bond) will always be the same.

Why changes in the credit quality of the hedging instrument should be a source of ineffectiveness?

We consider that the practical expedient established by the FASB is the best way to consider the credit spread in the 'hypothetical derivative'.

In our view, credit risk should be considered in the valuation of the hedge instrument and if the derivative is 100% effective, the change in the valuation due to change in credit risk should be accounted against OCI.

### Question 19 – Highly probable requirement in hedge accounting of a forecast transaction

The highly probable threshold prevents hedge accounting from being achieved when exposures are long dated. For example, in the case of financing a concession of 30 years it is quite common that banks will only provide financing for the first 15 years



and after this period will roll-forward the financing for the remaining 15 years. However, the same bank that provides the financing obliges the entity to get into a swap to eliminate the interest risk of the project. In this case the roll-forward is not explicitly stated in the contract and as it is a forecast transaction it requires to accomplish with the requirements of the 'highly probable' threshold, which is near the highest level of probability in IFRS literature (second level, after "virtually certain"). The entity did not get into the swap for trading purposes it did it because it was a requirement of the bank to provide the first 15 years of financing. Furthermore, if the roll-forward of the financing is questioned, the trouble will not be limited to do not apply hedge accounting, it should be considered the going concern of the concession what it make no sense.

We would appreciate "probable" or "more likely than not" thresholds to be used better than "highly probable".

#### **Question 20 – Accounting model for derivatives linked to loan agreements for the purpose to adjust financing cost**

External financing is a key issue in infrastructure projects. Predictable cash flows mean high volume of non recourse debt (more than 70% of total investment). It is very difficult to raise fixed financing with banks, it is most commonly offered floating or index linked financing and an interest rate swap in addition to convert it in fixed financing.

As a consequence of this source of financing, a mismatch appears as one part of the balance shall be accounted at fair value. There is a fair value option that can be elected but this option does not resolve the mismatch problem for non-financial institutions due to the following reasons:

- Financial instruments are exposed to the same variables of their market (interest rates, inflation, credit risk, liquidity, etc.) no matter if they are assets or liabilities. Instead tangible assets are exposed to additional variables (demand, obsolesce, etc.) as they are used in other markets. As a consequence the matching in the change of the fair value of assets and liabilities will not be as aligned as it is in the case of financial institutions
- In the case of infrastructure projects within the scope of IFRIC 12, in the case of the intangible asset model, the fair value option is not available.

Due to these circumstances, mismatch is broadly present in the financial statements of these entities that are involved in infrastructure projects. In our view, in those cases, the financial statements do not provide the best information for users and non-GAAP disclosures and additional information is needed.

For those cases, where the hedging relationship is straightforward, derivatives should not be accounted at fair value.





These derivatives are not held for trading but are held to maturity linked to the loan in order to adjust the interest cash-flows of the loan. In our view, more decision-useful information will be provided if the underlying debt and the swap could be accounted together as a single instrument at amortised cost.

This is the case for example, where a variable-to-fixed interest rate swap combined with a variable-rate borrowing results in the same cash flows as a plain-vanilla fixed-rate loan, or of an index linked swap combined with a fixed rate bond that results in a inflation linked bond.

The obligation to measure these derivatives at fair value introduces high volatility into equity of the companies concerned, and it does not contribute to represent a true and fair view of the companies as the instruments are not held for trading but are held to maturity linked to the loan in order to adjust the interest cash-flows of the loan.

Additionally the application of fair value measurement generates quite different treatments for economically equivalent transactions, depending on how the transaction is structured; although the impact on cash is the same:

- If the transaction is structured as a sum of a principal transaction with a derivative (e.g variable loan + IRS) produces volatility on equity.
- If the transaction is a single transaction (e.g fixed rate loan) does not produce volatility

We think this is the sort of inconsistency that makes information about financial instruments difficult for users to understand.

According with the arguments exposed, we propose that certain types of derivatives will not be measured separately at fair value, but together with the underlying debt, as a single instrument, at amortized cost, when complying with the following conditions:

- Have been contracted in order to adjust the financing terms of a loan, being the final result, from the point of view of the cash flows, the same as a loan measured at amortized cost.
- The company has a clear intention and a real possibility to maintain the derivative until maturity.
- Have not been contracted for speculative purpose. Extensive disclosures regarding the fair value of the derivatives should be provided in the financial statements.



## Appendix II

UK inflation, Source: Bloomberg



**UKGGBE10 13-166 --.006 3.167/3.165 Index DES**

At 19:23 Op 3.166 Hi 3.196 Lo 3.137

## UK Breakeven 10 Year

| Tipo              |                                      | Información Index |  | Gráfico |  |
|-------------------|--------------------------------------|-------------------|--|---------|--|
| Ticker            | UKGGBE10 Index                       |                   |  |         |  |
| Cotizada          | Rend /Bid /Ask                       |                   |  |         |  |
| Frec              | Intradía                             |                   |  |         |  |
| Datos disponibles | Últimos datos provistos disponibles. |                   |  |         |  |
| País              | GB                                   |                   |  |         |  |
| Actualizado       | 19:23                                |                   |  |         |  |
| Día bursátil      | 03:00 to 13:45 NY TIME               |                   |  |         |  |
| Fuente            | Bloomberg                            |                   |  |         |  |
| Historia          | TODO(Apert/Máx/Min/Cierre)           |                   |  |         |  |
| Desde             | 07/17/92 Daily                       |                   |  |         |  |

Notes

The rates are comprised of United Kingdom Generic breakeven rates. They are calculated using the closest nominal government bond to the inflation-linked bonds {YCGT0098 <Index> DES<GO>} for more information: nominal minus the inflation-linked bond equals the breakeven. You can locate the rates under {ILBE<GO>}. To view all terms/security type {ALLX UKGG<GO>}.

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2011 Bloomberg Finance L.P. SN 791180 6907-329-1 17-Jan-2011 19:31:09