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Le Président
JFL/MPC

n° 12

PARIS, 8TH JANUARY 2008

Project Manager on Amendments to IAS 39

IASB

30 Cannon Street

London EC4M 6XH

United Kingdom

Re : Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments : Recognition and Measurement - Exposures Qualifying for Hedge Accounting

Dear Sir or Madam,

I am writing on behalf of the Conseil National de la Comptabilité (CNC) to express our views on the above-mentioned Exposure Draft.

The CNC does not agree with the proposed amendments. In particular, the CNC believes that the timing of this Exposure Draft is not appropriate. In effect, the proposed amendments do not resolve certain issues related to hedging of portions, e.g. covering sub-Libor instruments, despite the fact that this topic has already been identified by the Board as an issue to be dealt with. Even more, we consider that the proposals will add to the difficulties of resolving this question since they only help to reinforce and confirm pre-existing IAS 39 rules and may be seen as pre-empting the conclusion of future discussions.

The CNC has also reservations on the proposed Exposure Draft for the following reasons:

1. The CNC considers that clarifying certain aspects of hedge accounting is indeed useful for preparers of financial statements. However, we do not agree with the means implemented to reach this objective since the proposed amendments contribute to impose new rules and will restrict in practice the opportunity for documenting hedging relationships. We believe it would have been better to establish general principles which could be applied and transposed to all hedging relationships.

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2. The proposed amendments add to the complexity and uncertainty for setting up hedging relationships, and do not conform to the needs for simplifications expressed in paragraph BC13a) of the Exposure Draft. In particular, we think that the Exposure Draft makes hedging of one-sided risks more complex and does not take into account the particular nature of this kind of hedge relationships. We equally believe that hedging with options is not equal to hedging portions of cash flows and should be dealt with separately. In addition, the drafting of some paragraphs is unclear and therefore introduces fresh uncertainty on existing application guidance. Our conclusion is that as a consequence there is a risk that the initial target of the IASB may not be attained.

3. We observe that the IASB considers that the scope of this Exposure Draft is only that of hedging financial instruments. However, certain amendments of this Exposure Draft introduce uncertainty as to the treatment of non financial hedging since these amendments could modify the interpretation of existing paragraphs relating to hedging of non financial instruments. In this way, we wonder if the proposed amendments could be extended to non financial instruments, as for example, those contained in paragraph AG99E concerning hedging with options.

   It could also be considered that hedging non financial instruments by using options would be forbidden from now on because hedging portions is forbidden according to IAS 39 for non financial instruments and the Exposure Draft indicates that hedging with options is equivalent to hedging portions.

   Concerning this last point, the CNC would ask the IASB to please clarify that none of the new rules introduced in the Exposure Draft apply to the hedge of non financial instruments. We consider this clarification necessary as we reserve the right to modify and comment further on the Exposure Draft in the case of non clarification. The CNC also believes that in the near future the IASB should examine separately whether all or part of these rules can or should be extended to the hedge of non financial instruments.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

Jean-François Lepetit

Responses to the invitation to comment

Question 1 – Specifying the qualifying risks

The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y. 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?

The CNC does not agree with the proposed amendments that restrict and define the risks qualifying for designation as hedged items as identified in paragraph 80Y.

In principle, any risk that is embedded in a financial instrument should be eligible for hedge accounting as long as the criteria set out in IAS 39-88 are met (documentation, hedge effectiveness…) and the CNC believes that it is not appropriate to limit arbitrarily the risks that can be hedged. Paragraph 80Y should instead be considered as application guidance and a mere illustration of a principle that is clearly stated in the standard. The CNC believes that the IASB should identify and articulate this principle.

Also the CNC believes that by restricting eligible risks the IASB runs the risk that the list becomes obsolete sooner or later.

If the IASB were to maintain paragraph 80Y and although the CNC acknowledges that the risks mentioned in paragraphs 80Ya), b), c) and d) are effectively hedgeable items, the CNC has the following remarks:

- The CNC wishes to emphasize that some risks are not defined such as credit risk and prepayment risk unlike other risks. The CNC questions whether some risks should be defined in the ED and others not.
- The CNC notes that interest rate risk is the only risk for which there is detailed guidance on how to document a hedge relationship. The CNC questions first whether this is necessary to limit in practice designations of interest rate risk as a hedged item and if this is considered necessary why this has not been achieved for other types of risks. Accordingly, the CNC suggests either to delete paragraph 80Ze) and f) or to extend this type of guidance for other types of risks mentioned in paragraph 80Y. The CNC also questions why only risk-free rate and inter-bank rate can be hedged items according to paragraphs 80Ze) and f) although paragraph 80Ya) and BC7 indicate that changes in **market interest rates** can be hedged. Consideration should be given as to whether interest rate indexes that are not inter-bank rates qualify as a hedged risk.
- The CNC wishes to mention that equity risk is missing in the list proposed by paragraph 80Y. For equity instrument denominated in a foreign currency this would imply that only changes in price risk **and** foreign currency risk can be hedged. The CNC therefore suggests adding this risk to the list of risk components that can be hedged in case a limitative list of risks is published by the IASB.
- The CNC understands that paragraph 80Ye) is meant for risks other than those mentioned in paragraphs 80Ya), b), c) and d). The CNC would like the IASB first to confirm this point and if the IASB does not confirm the CNC wishes that the Board explains more fully the consequences of such a limitation on hedges of interest rate risk, foreign currency risk, credit risk and prepayment risk. The IASB indicates that paragraph 80Ye) is meant in particular to limit hedges of risk components that are not present in the hedged instrument (such as inflation risk in a fixed rate financial asset). However, the CNC questions the underlying principle described in paragraph 80Ye) as it is currently drafted ("risks associated with contractually specified cash flows") since

the CNC notes that it does not always apply to or is not always consistent with the principles applying for other types of risks mentioned in paragraphs 80Ya), b), c) or d). For example, the CNC does not believe that the credit risk component is systematically a contractually specified cash flow and therefore in those instances is not a remaining component as defined in 80Ye). The CNC would welcome any clarification on this topic since it believes that this new rule is likely to introduce further complexity and lack of clarity in the standard.

Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item

The proposed amendments specify 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? Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item? If so, which situations and why?

The CNC does not agree with all the proposed amendments.

Similarly to its response to question 1, the CNC would prefer that the Board defines a principle that allows identifying what is a portion instead of creating a limitative list of hedgeable portions. Paragraph 80Z should instead be considered as application guidance and a mere illustration of a principle that is clearly stated in the standard. The CNC notes that this is already the case in the standard for another complex issue which is the separation of embedded derivatives. The CNC believes that the IASB should identify and articulate this principle and then detail and illustrate further this principle in the appendices of the standard.

Additionally, the CNC notes that paragraph 80Z and related paragraphs in the application guidance create the following problems:

1/ First, the CNC considers that the ED does not deal with an important issue which relates to the principle underlying the definition of portions, i.e. can the designated portion be equal or greater than the total cash flows of the hedged financial instrument?

As drafted, the CNC believes that the ED mixes the notions of risk and portion of cash flows (the hedged item) without clearly articulating them. However, the CNC notes that in practice, entities explicitly hedge risks, not portions of cash flows.

Implicitly, in the reasoning followed by the IASB, the CNC believes that there is a bijective relationship between a particular identified risk and a specific portion of the financial instrument's cash flows. Each portion results from the pricing of a risk an investor will require for holding such instrument, and the yield of any instrument is the sum of the portions of cash flows representative of the different risks a market participant will consider when pricing this instrument.

- Under such an approach, the return of a bond, for example, is the sum of the yield's portion representative of the free risk rate - the interest rate risk - and of another portion representative of the credit risk: there is no margin over the risks prices components. In the bond market, the bid-ask spread is the substitute for explicit margin and for testing hedges effectiveness, the bid-ask spread is neglected. But, in retail markets, such margin is the most important part of revenues.
- Therefore, hedging the risks inherent to any financial instrument is equivalent to hedging all or part of the portions of cash flows, and as the risks are additive, the portions of cash flows must also have this characteristic. This leads to the conclusion that the sum of all (or any) designated hedged portions of cash flows cannot be greater then the effective cash flows of a financial

instrument, because the market price asked for issuing or holding an instrument covers, at least, the cost of handling the different risks.

Though intuitively this rule may appear sound, and even obvious, the CNC believes that it is nevertheless wrong. In effect, what an entity requires to bear risks is not the sum of the cash flows' portions representative of the price of the risk, but revenue that is greater or equal to this risk's price and the risk premium associated. Such revenue includes a margin[1], which for assets is added to the sum of the other price components, but for liabilities is subtracted from this sum. A diminution of expenses (on funding for example) is revenue for an entity. Assuming that the benchmark index for interest rate risk is Libor, a bank which has access to the interbank market will pay to borrow Libor in the worst case, if it cannot get commercial deposits which are issued at sub-Libor prices, including a commercial margin which is additional revenue. The level of this margin is an idiosyncratic risk, specific to each family of similar transactions, which the market does not deal with since these transactions are not standardized. This explains why no hedging instrument exists for the whole price of commercial liabilities.

So, an entity eager to hedge a forward liability in a cash flow hedge relationship will use a derivative, based on a benchmark interest representative of a standardized transaction, the Libor interbank benchmark. The commercial margin will be excluded from the hedge designation. In the total revenue the bank will generate finally if it takes a deposit from a commercial transaction, such margin will be included, minimizing the total cost of funding, by borrowing at a below Libor rate. This rate will be lower than the corresponding Libor rate; nevertheless, the hedge will be effective to achieve the designated objective: securing the level of revenue corresponding to the price of bearing interest rate risk.

As drafted, the CNC believes that the ED reinforces the exclusion[2] of many of the hedging relationships built for banking liabilities and is inconsistent with the operational practice for interest risk management based on benchmark rates, regardless of whether these rates are over or under the commercial rate of the hedged item.

To summarise, the CNC does not understand such an approach as reinforced by the current ED and sees at least three objective arguments in favour of removing this restriction:

- it would allow for a symmetric treatment for assets and liabilities
- it would allow to acknowledge market practice, hedging interest rate risk on the benchmark rate, regardless of whether the rate inherent to a specific transaction is above or below the benchmark rate
- Once again a generic risk (the benchmark interest risk) well understood by the market is the only risk that can be hedged as it is the one that is transferable to other market's participants – as opposed to the margin's level risk, which is specific to a particular transaction and cannot be transferred to a third party.

2/ The CNC disagrees with paragraph 80Zc) (and related guidance, in particular AG99E) as it currently stands.

First the CNC believes that there is a confusion between hedges of portions of cash flows, for example when hedging only a percentage of the cash flows of a financial instrument, and hedges of one-sided risks where the cash flows that are considered to be hedged can be the entire future cash flows of the hedged item (for example the future cash flows of a variable rate debt instrument) but where the entity

[1] Why such margin exists on markets is outside the scope of this discussion.
[2] Yet, existing with 39.AG 99c.

only wishes to hedge certain risks (downside/upside risk). The CNC believes that this paragraph creates a lack of clarity for hedges of one-sided risks and does not allow fully acknowledging the specificities of these types of hedges.

Similarly the CNC believes that the guidance provided in AG99E is unclear since it does not deal specifically with hedging with options which is however the issue IFRIC dealt with which led to its inclusion in this ED.

The CNC would instead prefer that the IASB examines and deals separately with the issue of hedging with options rather than mixing it with the issue of hedging portions of cash flows. In particular, the CNC wishes that the IASB takes into consideration and specifies how to compute the changes in fair value of the cash flows of the hedged item when hedged with options, i.e. what about the distribution of probabilities of the hedged cash flows…?

The CNC also notes that paragraph AG99E, as it currently stands, potentially introduces confusion as to whether partial-term hedging is allowed. Paragraph AG99E as currently drafted could be read as prohibiting partial term hedging because of the need to calculate the change in fair value of a 10 year principal cash flows due to changes in the 5 year interest rate curve, even though the principal is not settled in year 5.

The CNC has a similar comment regarding using hypothetical derivatives for retrospective hedge effectiveness tests. This method is explicitly permitted in IAS 39-IGF5.5 for interest rate swaps and IAS 39-IGF5.6 for forward contracts for effects comparable to the time value of an option. However, the CNC believes that AG99E might be read as not allowing any more to apply the hypothetical derivative method in order to assess retrospective hedge effectiveness. The CNC would like the IASB to explain more fully how the rationale underlying paragraph AG99E is made consistent with this existing guidance if this is the case.

Finally, the CNC has also identified potential unintended consequences of paragraphs 80Zc) and AG99E dealing with hedges of one sided risks. When read in conjunction with IAS 39-82, it might be concluded that hedges of one-sided risks are not allowed when hedging **non financial instruments** because hedges of portions are deemed to be hedges of portions and IAS 39-82 does not allow hedges of portions for non financial items. The CNC kindly asks the Board to clarify this point to the extent that it does not believe that the intention of the Board was to forbid this existing practice.

Other additional comments:

In order to clarify the ED in the case the IASB wishes to maintain paragraph 80Z as it is, the CNC suggests that:

(i) paragraph 80Zb) and c) are modified as follows:

- paragraph 80Z (b) : « a percentage of the cash flows **or fair value** of a financial instrument » ;
- paragraph 80Z (c) : « the cash flows **or fair value** of a financial instrument associated with a one-sided risk of that instrument… ».

(ii) paragraph 80Za) and d) are rationalised since the CNC notes that the requirements mentioned in paragraph 80Zd) seem to be covered already by paragraph 80Za).

Question 3 – Effect of the proposed amendments on existing practice

The aim of the proposed amendments is to clarify the Board's original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in practice from arising. Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

The CNC anticipates that the ED will have consequences for entities that did not apply the requirements of paragraph AG99E and for cash flow hedges relationships did defer in equity the changes in time value of the hedging instrument.

The CNC also notes that the proposed amendments do not allow solving the issue of hedging sub Libor instruments although this is a sensitive issue, in particular for financial institutions and this topic was identified by the IASB as an urgent one.

Question 4 – Transition

The proposed changes would be required to be applied retrospectively. Is the requirement to apply the proposed changes retrospectively appropriate? If not, what do you propose and why?

The CNC considers that a retrospective application of the proposed amendments in the ED would result in significant impacts for entities, in particular for those that did not apply the rule stated in AG99E, since they would need to stop the hedge relationships and reclassify entirely the changes in fair value of the hedging options out of the cash flow hedge reserve and not only the changes in time value.

The CNC understands that certain constituents would propose instead that the IASB considers a limited retrospective application of the ED, i.e. with the consequence of only reclassifying the time value element where both intrinsic and time value were designated (assuming all other elements of the ED and hedge accounting criteria are met). The CNC acknowledges that if the IASB followed this route, the opening retained earnings for the earliest period presented would 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 would be retained.

However, due to practical reasons, the CNC would favour transition provisions similar to the ones proposed in IFRS 1-29 for hedges of net positions. In effect, the CNC foresees two major advantages: this would first enable the preparers to keep the benefit of previous designated hedge relationships for the past and it would allow them not entering into complex retrospective calculations when separating time and intrinsic values if a limited retrospective application were finally the choice made by the IASB.