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Mouvement des Entreprises de France
MEDEF

A F E P
Association Française des Entreprises Privées

IASB
30 Cannon Street
London EC4M 6XH
UK

Paris, March 9, 2011

Re: ***Exposure draft "Hedge Accounting"***

It is with great pleasure that we welcome the opportunity to comment on the above-mentioned exposure draft as we believe it represents a significant step towards a high-quality standard. We have always been convinced that hedge accounting should be based on a strong and independent principle and not be treated as an exception to general accounting requirements. Initially the IAS 39 provisions were driven by anti-abuse concerns. They were not intended to reflect the entity's risk management strategies and thus impaired financial information provided to users.

In general, in this comment letter, you will find strong support for all proposals consistent with the general objective, which is to represent the effect of an entity's risk management activities in the financial statements. Conversely, we do have some reservations about proposals that are more akin to anti-abuse rules.

In particular, we believe that the decisions which exclude the eligibility of hedge accounting for exposures which would affect areas of the financial statements other than profit or loss, sub-libor interest-rate components, non-contractually specified inflation, some written options or credit risk pre-judge issues which should, in our view, be left to the judgement of the entity's management in the context of its risk-management strategy.

We also welcome the continuation of the IASB's discussions with regard to open portfolios and macro hedges in a later phase of the project. We think that the present exposure draft is an important step in improving the presentation of the business models and risk management strategies in the financial statements of the entities and therefore we strongly support the IASB's intent to issue the new requirements for hedge accounting, although we cannot give our unreserved support to this first phase without having studied the aspect of hedge accounting which is the most important for financial institutions.

Finally, we wonder to what extent benefits arising from these new proposals will be affected by a too-restrictive use of the Business model in the first phase of IFRS 9 “classification and evaluation” (please refer to our comments in the “other comments” section).

Should you require further comment or explanation, please do not hesitate to contact us.

ACTEO	AFEP	MEDEF
Patrice MARTEAU	**Alexandre TESSIER**	**Agnès LEPINAY**
Chairman	Director General	Director of economic and financial affairs

Appendix – Response to questions in the Exposure Draft

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?

As already mentioned in our response to the discussion paper “Reducing complexity”, we believe that hedging strategies play an important role in the day-to-day business of a wide range of entities, and their impact on entities’ financial statements should be made clearer and more understandable to users of financial statements.

In order to achieve this objective, hedge accounting should be designed so that all the hedging activities of an entity can be reflected in its financial statements, without generating too heavy an administrative burden and unnecessary constraints. Presentation should be straightforward so that users are able to understand the extent of the entity’s hedging strategies.

For all the above reasons, we fully agree with the first part of the overall objective as stated in paragraph 1 “ The objective of hedge accounting is to represent the effect of an entity’s risk management activities in the financial statements”.

Nevertheless, we cannot agree with the second part of the sentence which introduces a rule that only risks affecting profit or loss could be subject to hedge accounting. In fact, entities use hedging not only to protect their net result but also to protect all areas of the financial statements, including the statement of financial position and equity, and it is therefore inconsistent to preclude hedge accounting in this way.

Previously in our different outreach sessions with the Board, we have stated that we strongly support fair value hedge accounting because it allows for the protecting of both net income and equity. We therefore believe that the hedge accounting objective should be extended to the whole of the financial statements, in order to reflect all the different strategies implemented by entities. The only limitation should be the ability of accounting to represent faithfully the economics of the strategy while remaining consistent with the conceptual framework.

Regarding the specific case of equity instruments designated as a fair value through OCI, we do not share the conclusions presented from § BC 24 to BC26. First of all, we would like to remind you that ACTEO is totally opposed to the prohibition of recycling change in fair value from OCI to net income, and we still urge the Board to reconsider its position. If prohibiting reclassification into net income prevents entities from faithfully depicting their hedge strategy in financial statements, this could be a good indication that is not a valid decision for the Board to have made.

Having said that, we believe that since hedge accounting is currently being revised, it is a good opportunity to reconsider its objective and expand it so it can reflect the effect of all of the entity’s risk management activities in all the financial statements.

Finally, we would like to draw your attention to the fact that hedges of the net investment in a foreign operation are also frequently used to protect the whole of the financial statements from different kinds of risk exposures. Concerning this issue, please refer to our comments in the “other comments” section.

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?

Even though we welcome the broadening of the category of eligible items, we are not sure we fully understand the rationale behind it, as we do not see a clear principle in the exposure draft that may help one to understand which instruments can be designated as hedged items.

The only principle we see is the general objective of hedge accounting. In this context, we believe that all instruments used by entities to manage their exposure to risks, should be eligible whatever their classification and measurement, as long as all the criteria for hedge accounting are filled (§ 19 b & c). Any other provision would appear to be anti-abuse rules and will detrimentally affect the significant improvements reached by the Board.

In the same way, we do not understand why the Board is so restrictive regarding written options as eligible hedging instruments, as this may prevent some entities from faithfully depicting their risk management strategy.

For example, in the energy industry some written options may be used to hedge call options embedded in non-financial assets like gas-fired plants. We believe that such written options can be eligible as hedging instruments in order to avoid undue mismatches in financial reporting, provided that they are considered to be economic hedges in the risk management strategy and duly documented. More detailed information about such hedging strategies can be found in appendix A. . Given the importance of these types of hedging transactions, we believe that the IASB should reconsider this issue.

Furthermore, our understanding of paragraph 11 is that a combination of a written option and a purchase option (such as an interest-rate collar) taken out with the same counterparty can qualify as a hedging instrument whereas the same combination taken out with two different counterparties can never qualify as a hedging instrument. We believe that accounting treatment should be the same if the economic purpose is the same.

Finally, we would also like to remind the Board that we still disagree with its previous decision in phase 1, whereby it prohibits bifurcation for derivatives embedded in financial assets. Such a decision leads firstly to more financial instruments measured at fair value, and in many cases this does not faithfully reflect the Business model, and secondly it prevents the entity from designating only the derivative as a hedging instrument.

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 believe that this is consistent with the principle-based approach driving this exposure draft. When the objective of hedge accounting is to reflect, in financial statements, the effects of the way that entities manage their risks, it makes sense that such synthetic positions can be designated as hedged items. We fully share the observations and the conclusions as stated in paragraph BC50, resulting from the extensive outreach activities conducted by the Board during its deliberations. We were pleased that the Board gave us the opportunity to be fully involved in this project and we have noted that many of our comments have been taken into account.

In order to confirm the correctness of our interpretation of the Board's proposals, we have provided some illustrative examples in appendix B that we would like to submit to the Board.

Finally, we would appreciate some further clarification about the accounting treatment in the case of embedded derivatives in non-financial items. The current IFRS 9 phase 1 has retained the IAS 39 guidance for such embedded derivatives that could thus be either bifurcated or accounted for together with the host contract, at fair value. When the derivative is bifurcated, IAS 39 does not allow it to be designated as a hedged item. However this is not currently an issue as there is a nil effect in net income if a derivative is then out to hedge this exposure, since both derivatives are fair valued through net income (the bifurcated embedded derivative and the hedge).

With the new proposals, we understand that the combination of a highly probable transaction plus the embedded derivative (even if it is bifurcated), will be eligible for hedge accounting. We therefore wonder what will be the accounting treatment for such a situation, and we are not sure that the net income will be any more nil, except if the entity choose not to apply hedge accounting.

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 (i.e. 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?

This proposal is one of the most important benefits of this exposure draft for a large majority of corporates, and more specifically for those exposed to variability in commodity prices.

Managing the commodity price risk exposure can be a very strategic issue for manufacturing industries in which raw materials represent a significant part of the cost of sales. However industrial companies are currently limited in their hedging strategies mainly because of the constraint imposed by IAS 39 for non-financial instruments.

Again, we would like to thank the Board for having given us the opportunity to comment on this fundamental issue, at an early stage in the process of drafting the exposure draft.

We believe that the criteria for designating a risk component are strong and clear enough. There is no need for further guidance as there is a risk that this may then be considered to be a rule instead of guidance helping entities to understand how to apply the core principle. For this reason we do not agree with the conclusion in paragraph B18 where the IASB makes the assumption that inflation risk could never be a separate risk component unless it is contractually specified. A high-quality standard should not introduce predetermined conclusions that may contradict with the core principle.

We do not refute the two criteria for being eligible as a separate risk component, and we agree that such assessment requires an evaluation of the relevant facts and circumstances. A non-contractually specified inflation risk may, or may not, be separately identifiable and reliably measurable; but it is up to the entities, and not the Board, to make an assessment and to reach their own conclusions in view of the facts and circumstances.

We also believe that is not consistent with a principle-based approach to maintain the prohibition (that is currently carved-out from the European endorsement of IAS 39) from designating a sub-libor interest rate as a hedged risk component, as this will prevent entities from reflecting this aspect of their interest risk management activities in their financial statements. We believe that such a restriction is not consistent with the component approach retained in the exposure draft. We understand that the Board fears some counterintuitive results in certain circumstances and thus has chosen to prohibit the designation of this as a hedging relationship. On the contrary, we believe that such a management strategy should be permitted to be reflected in the accounting, and should lead to the recognition of ineffectiveness when the entity has greater cash-flows when Euribor, for example, is below the absolute value of the margin.

Please also note that this is an issue not only for Financial Institutions and macro hedging but also for individual hedges and non-financial Corporates. We therefore urge the Board to reconsider its preliminary conclusions.

An effective hedge strategy should not be disqualified from being reflected in the financial statements when this can be achieved in accordance with the principles of the ED.

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 welcome the proposal that allows the designation of a layer component as a hedged item for both anticipated and existing transactions. We believe that such a provision will make hedge accounting easier and closer to the way that entities manage their risk exposure.

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?

While we can understand the rationale behind this decision in the context of a single instrument, we are quite concerned by the fact that this decision may affect the forthcoming model for macro-hedging. In fact, one of the main Bank hedging activities is to hedge interest rate risk on prepayable debt instruments. If the current exclusion was to be replicated in the last phase of the hedge accounting project, it would certainly disconnect hedge accounting from risk management, and this would obviously be in contradiction of the main objective expressed in this exposure draft.

We believe that a different approach is justified in the case of portfolios (closed or opened), as financial institutions can predict the behaviour of this kind of risk more easily at the portfolio level because of the "law of large numbers". Such analysis is already a key component of a bank's risk management strategy.

We therefore welcome the preliminary decisions taken by the Board in November 2010, related to portfolio hedge accounting, which further consider the concept of defining the hedged items as a bottom layer of the overall portfolio of prepayable debt instruments.

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 really welcome these proposals as they are likely to make hedge accounting reflect economic hedges and this facilitates communication between management of the entity and users.

One of the main concerns expressed today about hedge accounting is that it has been rendered either impracticable or too costly up to now. Leading entities reported as if they were engaged in trading activities although they were not, while the economic hedge strategy was described only in the note section of their financial reports.

We believe that the core objective of hedge accounting coupled with a principle-based approach for effectiveness requirements will benefit both preparers and users, as it will re-establish the appropriate link between economic hedge strategies and financial reporting.

Moreover, we believe that the information then provided will be much more transparent and relevant. The real ineffectiveness of the management hedging strategy will be appropriately reflected in the financial statements. In contrast, with the current requirements, the entire relationship is disqualified and users lose the information about the effectiveness of risk management.

We therefore welcome the removal of the 80 to 125 per cent test and the mandatory quantitative tests. We strongly support the objective-based assessment that enhances the link between hedge accounting and the entity's risk management. We welcome also the elimination of retrospective hedge-effectiveness testing

However, we do not feel very comfortable with the objective of hedge effectiveness as described in paragraph B29. In fact, in our opinion, it should focus on risk reduction rather than on minimising the hedge ineffectiveness. Actually, hedging instruments chosen by the management are not necessarily the most effective solution but are often used as the alternative instrument which offers the best cost/benefit balance, for example, or is traded in a more liquid market than the "perfect" hedging instrument.

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?

While we fully agree with this proposal, which is the logical consequence of the core objective for hedge accounting and the way that effectiveness is assessed, we feel that the current drafting is not clear enough and should be tested and improved before finalisation.

We expect that the issue of rebalancing will become the most crucial and challenging aspect of hedge accounting and it is likely that it will receive great attention from preparers and auditors.

We understand that, as long as the risk management has not changed, if a hedging relationship ceases to meet the effectiveness requirements it must be rebalanced by adjusting its relative hedge ratio. However we need further explanations to ensure that this proposal can be implemented:

- The notion of "unchanged risk management objective/ policy" is defined nowhere in the exposure draft and we wonder how it might be interpreted by both preparers and auditors..

- From paragraph B38 of the ED we understand that entities will have to use their judgment to assess whether the risk management objective does or does not remain the same, relying on internal control and documentation. Perhaps it would be helpful if the Board were to confirm this reference to judgment and better explain what could be considered as a continuing relationship or not. In our view, only a significant change in the risk management structure or strategy should be assessed to be a change in management objective, whereas a slight change due to operational considerations should not.

- In respect of the hedge ratio, the exposure draft proposes that only an adjustment of the volume of the hedged or hedging instrument can be seen to be a rebalancing. Paragraph B66(a) implies that if an entity changes the nature of the hedging instruments, it could no longer satisfy the criteria for rebalancing? We believe that an entity can change the hedging instrument without discontinuing the hedge relationship, as long as the first objective remains the same, i.e. it reduces its exposure to the same risk on the same component.

- Finally, it will also be helpful if the Board were to add in paragraph B64, that a relationship could be allowed to be effectively discontinued when, instead of terminating the hedging instrument, entities take out a "mirror position" that cancels all the effects of the first hedging instrument.

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 agree that this provision is consistent with the way that entities manage their hedging strategy.

Question 8

c) 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?

Consistent with the principle that hedge accounting should reflect the way that entities manage their risk, we agree that the hedging relationship ought to be discontinued once it ceases to meet the qualifying criteria.

d) 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 believe that is also consistent with the overall objective that the decision to apply hedge accounting should be irrevocable.

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?

First of all, we would like to express our great satisfaction concerning the Board's decision to maintain the fair value hedge mechanism, despite the fact that it has been subject to a few presentational amendments.

The fair value hedge mechanism allows for the stability of net income and equity.

However, we do not understand the rationale behind the decision to recognise, the gains or losses on the hedging instrument and the hedged item firstly through OCI. Additionally, we are certain that implementing such a mechanism will induce high costs, and therefore we wonder whether the benefits it will generate will outweigh the costs.

Today the majority of reporting systems are built to apply IAS 21 in the first instance, i.e. all foreign currency monetary items are translated using the closing rate and the exchange differences arising from this translation are recognized in profit or loss, whether the monetary items are hedged or not.

The Board's proposals will lead to the extension this exception to "traditional" accounting to a large number of monetary items hedged for foreign exchange risk and the consequent increase in intervention in the systems to achieve the necessary accounting may discourage some entities from adopting hedge accounting. Furthermore, it will extend the use of OCI and recycling even though the conceptual debate about these two items still has not occurred.

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 understand that the Board is concerned by the "hybrid valuation" resulting from the current accounting mechanism (resulting in an item valued neither at amortised cost nor at fair value) that some could find confusing and quite far from transparent. We therefore understand the proposal to present, in a separate line in the statement of financial position, the gain or loss on the hedged item attributable to the hedge risk. Nonetheless, too many separate lines may finally impair transparency and undermine the usefulness of the information provided. It may be more relevant to permit some aggregation in the face of the Statement of Financial Position, and require disaggregation in the notes.

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 agree that linked presentation should not be allowed for fair value hedges and we agree that the information will be better placed in notes.

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 (e.g. 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

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

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 (i.e. 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***

Once again, we would like to thank the Board for having considered the concern expressed by many entities which use options in their risk management strategy.

We concur with the idea that time value should be treated as a cost of the hedging strategy akin to an insurance premium paid for hedging the underlying risk. We therefore welcome the proposed treatment that will avoid undue volatility in net income when the objective of hedge policy is aimed at securing net income. We also believe that the interest elements in forward contracts have a similar function and they should be accounted consistently.

However, we believe that current proposals are quite complex and can surely be simplified without significantly diminishing their effectiveness.

In fact, we believe that providing two different mechanisms, depending on the nature of the hedged items, will add a lot of complexity, both for preparers and users, with little benefit. A single and simpler method will have the advantage of being easily understood and therefore more likely to be correctly applied. We therefore suggest that the Board explores another alternative, such as the following: to account for changes in time value in the same way that one accounts for changes in intrinsic value for all hedged items. This process will make the follow-up of time value easier and the "insurance cost" will be recognised in net income over the same period than the item subject to this insurance.

Finally, concerning the new notion of "aligned time value", we also believe that it will add more complexity to the new standard, with no significant benefit, even though we understand and agree with the rationale that all ineffectiveness should be recognized in net income.

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?

In principle we agree with the proposed criteria as long as they are consistent with risk management strategy, and we welcome the relaxation of the current, somewhat arbitrary, rules. For example, the current criterion "similar items with similar risk characteristics" results in forced, artificial hedge relationships, was and this is far from the risk management objective.

However, we would like to express some concerns about the "same reporting period" restriction imposed on the cash-flow hedge. We think that such a restriction will significantly limit the improvements made in the general hedging model, as it will prevent many entities from applying hedge accounting to very common hedging strategies.

Moreover, this decision highlights the fact that the Board is still thinking on the basis of individual transactions, despite its intent to allow hedges for net positions to be aligned better with risk management and hedge accounting. This trend is even more apparent when one considers that the Board requires that the gross amount is to be identified too.

Finally, focusing only on the period when net income will be affected by the different flows composing the net position is not always consistent with some management strategies which design the net position taking account of cash-impacts and not profit or loss impact.

We therefore urge the Board to reconsider its preliminary decision and conduct some additional outreach sessions to find a more reasonable alternative that will be both in line with the core principle for hedge accounting and more consistent with management strategies.

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 (e.g. 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 believe that a standard whose general objective is to foster the link between management strategy and accounting should not be so prescriptive in terms of presentation. We therefore call for more flexibility in the presentation of financial statements in order to align them with management reporting.

We agree that users should be informed about the way gains and losses on hedging instruments have been presented in the income statement, but such information could satisfactorily be provided in the notes.

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 fully support requirements that provide information about the risk management strategy and its effects on financial statements. It seems consistent with the new hedge accounting objective to improve the usefulness of information provided, by re-establishing the link between hedge accounting and the economic hedge strategy and thus improve the understanding of users.

However, the requirements for quantitative information about the amounts, timing and uncertainty of future cash flows go too far and should not be required as disclosures in financial reporting. The requirement to provide such burdensome and potentially sensitive information may discourage some entities from applying hedge accounting.

Finally, we believe that more room should be left for judgment in selecting information that is really useful to disclose. In our view, disclosing all the existing information directly or indirectly linked to hedge accounting will “swamp” the users of financial statements, especially in a situation when the entity deals with a significant number of complex relationships.

Using judgment will also enable the entity to make a the most efficient use of existing disclosures already required in its reference document (that includes consolidated financial statements and also – due to regulatory requirements – disclosures on risk management in management commentaries) so that some information does not become redundant because of a rule-based approach on disclosures. A judgmental approach will also ensure that a balanced approach is taken for confidentiality purposes.

In addition, we would prefer to include paragraphs 44-52 in the application guidance (and not in the standard itself). This would avoid interpretation of the requirements as rules (avoiding these paragraphs being understood as a checklist to be fully filled in by each entity) and it would rather enable the entity to provide users with the relevant information.

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 response to a) above.

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?

While we welcome the efforts made by the Board to resolve this issue and solve potential accounting mismatches, we have to express some reservations concerning the proposals.

Firstly, we do not believe that the derivative accounting should be mandatory, but instead it should be left as an optional treatment, like hedge accounting. This “free choice” does not deny the purpose for which contracts are entered but provides a practical expedient to solve the accounting mismatch, just as the fair value option does in IFRS9 phase 1. Moreover, a mandatory derivative accounting may also lead to a mismatch in net income when contracts are managed together with assets scoped out from IAS 39 and thus not measured at fair value (e.g. power plants accounted for under IAS 16). For illustrative examples, please refer to appendix C.

Our second main concern relates to the composite contracts issue. Commodity contracts often contain volume flexibilities, and in some circumstances[1] it would be more appropriate to consider them separately from the rest of the contract. For long term commodity purchase or sales contracts, it could also be appropriate to consider different blocks of volumes within one single contract.

The separate treatment can be adequate because of different business purposes (so that accrual accounting for one part and fair value accounting for another part is possible), or because of a different hedging strategy that will be applied to the different components of a contract. We provide some illustrative examples in appendix C.

We note that the IFRIC has received in January 2010 a similar request to add an item to its agenda on providing guidance on whether a contract can be seen as two separate contracts for the purpose of applying paragraphs 5-7 of IAS 39. At that time, the IFRIC decided not to add this issue to its agenda, arguing that the IASB would deal with this request when presenting its project to replace IAS 39. This request has not been adequately taken into account in the IFRS 9 proposal. We therefore urge the Board to resolve this issue before finalising the amendments.

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

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

As already expressed in our cover letter, we really welcome the principle-based approach developed for hedge accounting but we strongly regret all the additional rules and pre-formed conclusions included in this exposure draft, which deal with specific components which we have raised earlier in this letter.

In our view, the practical difficulties anticipated by the Board should not be allowed to preclude entities from applying the general principal of hedge accounting provided that they meet all the qualifying criteria.

Having said that, we believe that credit-risk hedge is such a significant issue for most financial entities (Bank and Insurance activities) that the Board cannot not avoid dealing with it.

[1] This separation should be analysed on case-by-case basis since volume flexibilities can comply with different management intentions, i.e. one being made for “own use” purposes and others being concluded for optimization purposes (and therefore managed based on its fair value).

We believe that the most efficient way to deal with this issue is for the Board to admit, the same way as regulators do, that credit risk hedged by credit derivatives may meet the criteria for hedge accounting as long as it reflects management strategy and ineffectiveness is recognized in net income. Please note that it will not be the first time that entities will be required to identify the credit-risk element in a fair value measurement.

Finally, we would like to remind the Board that the Fair Value Option cannot validly be considered as an alternative to hedge accounting as it is not based on the same objective. It would lead to recognising the fair value of the whole instrument, not just the fair value of the hedge component.

Question 16

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

We agree with the Board that a prospective application is appropriate for hedge accounting. However, we believe that the Board should develop more detailed guidance to help entities in adopting new requirements prospectively.

For instance, take a cash-flow hedge that is newly eligible for hedge accounting: we think that all future changes in the hedging instrument fair value will be recognised in the separate component of equity and later reclassified in the period when the hedged item will affect net income. Nonetheless, we are less confident of our interpretation concerning the treatment of the previous changes in fair value that have occurred while the hedge relationship was not eligible : will the entities have to track them to recognise them once again in net income or will they have to integrate them in the accounting base in the case of non-financial items ? Will these previous changes never be taken in account?

We also wonder how to deal with previous eligible hedging that may no longer be qualified for hedge accounting. We acknowledge that such situation should be quite unusual but we believe that the future transition provisions should cover all possible cases.

OTHER COMMENTS

- **Hedge of net investment in a foreign operation**

We acknowledge that the Board has decided “not to address the hedge of investments in a foreign operation as part of this third phase of the project”. However, we would like to have confirmation that all the amendments proposed in this exposure draft, relating to eligible hedged items (components, net position, layer etc.), eligible hedging instruments and effectiveness requirements, also apply to hedge of net investments. Currently in IAS 39, all these general requirements are common to all three types of hedging relationships and we assume it will be the same in the forthcoming new standard.

- **Consistency between all phases of the revision of IAS 39 :**

  We fully appreciate all the improvements provided in this exposure draft as they are likely to make hedge accounting more accessible and understandable. We believe that the main improvement in this project is this obvious link between accounting and management strategy. We therefore regret that the Board was so cautious in the first phase of IFRS 9 “classification and evaluation” and did not go further in developing an approach based on the Business model.

  In fact, if assets and liabilities are not initially measured in such a way that reflects the way they are managed by entities, it will be much more difficult to benefit from the improvements made to hedge accounting which is fully based on a Business model approach. We therefore respectfully call upon the Board to reconsider the first phase and we hope that the Business model of the entity will become a more prominent criterion in “classification and evaluation”.

Appendix A1 – use of written options as hedging instruments in the energy industry

We believe that written options should also qualify as hedging instrument if it is designated as an offset to a purchased option or to an owned asset that has similar characteristics.

Power generating assets, such as gas-fired power plants represent a real option for the owner of the plant because of the flexibility to let it run or not based on the prevailing market prices. The embedded option in a gas fired-power plant can be referred to as a Clean Spark Spread Option[2]. Therefore, the revenues generated from a gas fired power plant can be characterized as a portfolio of clean spark spread call options.

It is customary to identify different economic hedging strategies that will achieve a risk-reward level consistent with the owner's risk aversion:

1. Fixed-price electricity and natural gas contracts such as forward contracts and swaps.

   These hedging strategies will usually meet the criteria to be accounted for as hedging instruments in a cash flow hedge relationship.

2. Tolling agreements[3]

   These tolling agreements are often favoured by risk-averse entities that prefer to lock-in the capacity revenues. These are usually options with characteristics very similar to that of the power plant and are best described as "**synthetic power plant**". This economic hedging instrument is rarely in the scope of IAS 39 and is therefore accounted for on an accrual basis.

3. Financial spark spread options, call/put options on electricity and on natural gas

   The entity may have the market view that the electricity and natural gas prices will diverge, resulting in high natural gas prices and low electricity prices. <u>That means an increase in the spark spread risk for the power plant</u>. In this case, the entity will choose to sell electricity call options that pay out to the buyer when prices rise above the contracted strike power price. The entity can then use a portion of the sales proceeds to purchase natural gas call options to protect against a rise in fuel costs.

   This sale of options may not achieve hedge accounting in all circumstances, neither in IAS 39 nor in IFRS 9.

   Since all strategies are entered into to reduce entity's risk (even if using different ways) and are considered as economic hedges by risk management, we believe that all should be eligible to hedge accounting.

[2] The annotation 'Clean' refers to the inclusion of costs for CO2 into the plants economic value calculation.

[3] A tolling contract is essentially an option, whereby Party A sells to Party B the right to 'call' power from Party A in exchange of cash and gas and EUAs delivered by Party B to Party A on the expiry date.

Appendix A2 – use of written options as hedging instruments in other hedge strategies

The following examples have been provided by certain of our members in order to illustrate how written options may be used in pursuit of the objectives of a risk management strategy. Although we recognise that these techniques are not eligible for hedge accounting under the proposals of the ED, they illustrate approaches to risk accounting which are considered by the management of the entities concerned to be a valid risk management strategy. If the Board were to wish to take this matter further, we would be pleased to arrange contact with those entities."

Selling options is an instrumental part of some overall hedging strategies. Not all options, but only those directly linked to the entity's exposure are considered to be hedging instruments. For example, if the entity's natural position is long in USD, it would only be selling USD Call / Put Euros that would constitute, if exercised' new forward selling positions that would hedge future USD flows. If not exercised at maturity, the premium received would be allocated to the portfolio, improving mechanically the overall hedging rate.

For example, the entity sells \$100m USD Call / Put Euro strike 1.00 maturity June 2014. If on June 2014, spot is below 1.00, then the option is exercised and the entity would have a USD sell position at 1.00 for \$100m. If spot is above 1.00, the option dies, but the premium of course remains improving 2014 hedging rate.

Selling options can also be used in options' strategies, like leverage forwards. A leverage forward is a combination of:

- The purchase USD Put / Call Euro option for x amount, maturity y, strike k
- And the sale of USD Call / Put Euro option for n times x amount, with the same maturity and the same strike

Basically, an entity may finance an expensive USD Put option by selling a Call option.

A concrete example would be:

- Purchase \$100m USD Put option maturity December 2014 strike 1.30
- Sell \$200m USD Call option maturity December 2014 strike 1.30

At maturity, if the spot is above 1.30, then the Put option would be exercised and the entity would sell \$100m at 1.30. If on the contrary, the spot is below 1.30, then the Call option would be exercised and the entity would sell \$200m at 1.30. Such strategies allow companies to beat the forward. Furthermore, at any time before maturity, entities can restructure the combination of options, by either rolling USD Call further (it is called a Put spread…), purchasing back the Call option sold…"

Appendix B – Question 3: illustrative examples

Example 1

An entity has concluded a fixed-rate debt of 10 years in foreign currency. The risk management policy of the entity is:

- To conclude a 3-months cross-currency interest rate swap in order to transform this fixed-rate debt in foreign currency into a floating-rate debt in local currency. The entity intends to roll over this ccirs each three months;
- To conclude a 10-years interest rate swap to transform a floating-rate debt in local currency into a fixed-rate debt in local currency;

The exposure is then composed of:

- a 10-years floating debt in foreign currency; and
- a 3-months CCIRS rolled over each three months (i.e. they are forecast transactions).

We understand from the ED that these future CCIRS are forecast transactions that can be designated as hedged items as far as they meet IFRS 9 criteria (i.e. highly probable criterion).

Appendix C – Question 14: illustrative examples

Derivative accounting option

Example 1

In order to maintain a sufficient level of flexibility in terms of gas customers' demand and power generation, it is customary for utilities to lease or own storage assets or purchase gas storage capacity contracts. Such storage facilities are mostly for the entity's own usage and will be primarily allocated to the actual gas storage needs of the entity. However, the capacities that exceed the expected usage requirements can be optimized or re-sold to another party, for instance, by buying physical summer gas and selling physical winter gas, or under the form of a written option for the usage of storage capacity.

Not all storage capacities fall under the scope of IAS 39 and are rather accounted for in accordance with IAS 16. While these physical assets are managed based on their fair value together with optimization transactions (transactions linked to the excess capacity), compulsory fair value accounting of these optimization transaction may in some circumstances create a P&L mismatch if "all legs" are not accounted for on the same measurement basis.

Example 2

In the energy industry, it is common practice to manage power plants and related electricity sales on a fair value basis. In this case, the fair valuation of the sales contracts would lead to an accounting mismatch and therefore "artificial" volatility in profit or loss, as the power plants are still subject to accrual accounting according to IAS 16.

Composed contract issue

Example 1

An energy sales contract with a volume of 100, of which a minimum quantity of 75 and a flexibility of 25, can be considered as a combination of two separate contracts: a forward sale of 75 and a written option that allows the customer to purchase a quantity of 25.

Example 2

An energy sales contract with a volume x and a price y, with a term of 2 years and an option to prolong 1 year at the same conditions, can be considered as a combination of two separate contracts: an energy sales contract with a volume x, a price y and a 2 year term, and a written option that allows the customer to buy at the same conditions (volume x, price y) during year 3.

Example 3

A long term gas purchase contract with an annual volume of 1000 take or pay, a price indexed on fuel and a term of 10 years, can be considered as a combination of two separate contracts: one with a volume of 800, and one with a volume of 200. The business intention of both contracts may be different. For example: 800 in accordance with the entity's expected purchase, sale or usage requirements, and 200 for trading activities.

Example 4

In the course of their activities, it is customary for energy companies to enter into gas storage contracts that allow for the needed flexibility in terms of gas customers demand and power generation.

Storage contracts can fall in the scope of IAS 39 and be fair valued if it can be demonstrated that they meet the following criteria:

- The contracts respond to the definition of a derivative (their value change in response to an underlying; little or no initial investment; they settle at a future date),
- They can be net settled (which comes down to the existence of an active market), and
- The contract is not designated for 'own use'.

Storage capacity contracts are generally concluded over several years, for pre-determined fixed maximum quantities and are subject to strict operational constraints (e.g. in terms of injections and withdrawals). Though such contracts are mostly for the entity's own use and will be used to meet the actual gas storage needs of the entity, the contractual volumes that exceed the expected usage requirements can be optimized or re-sold to another party.

Split designation of such contracts, based on volumes, should be possible at the inception of the contracts and provided that the entity can ensure that the volumes sold to the market do not exceed the volumes designated a financial instruments.