

**ABI position paper on exposure draft
of amendments to IAS 39**

***“Exposures Qualifying for Hedge
Accounting”***

January 2007

IAS 39	Issues	ABI comments
<p>Question 1 – Specifying the qualifying risks</p>	<p>The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y.</p> <p>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?</p>	<p>On a more specific level, we question why price risk isn't listed as hedgeable risk in paragraph 80Y.</p> <p>Usually price risk is the only risk associated with equity instruments and accordingly it should be hedgeable according to the first part of par. 80Y.</p> <p>However, let's consider an equity denominated in a foreign currency. In this case, risks associated with equity instruments are both price and fx risk.</p> <p>According to par. 80Y, the entity would be entitled to hedge:</p> <ul style="list-style-type: none"> - both price and fx risk - fx risk only <p>However, according to the same paragraph, the entity wouldn't be entitled to hedge equity risk only, leaving fx risk unhedged.</p> <p>An issue that needs clarification is that par 80Ye forbids the designation as hedged item any changes in the fair value of a fixed rate financial instrument, even when inflation is a contractually specified cash flow, because "the remaining component would be a residual".</p> <p>We support the rule as, even if inflation is a contractual specified component of the cash flows of a fixed rate instrument, changes in fair value of such instrument would depend on changes in interest rates. However it's not clear what IASB means by stating that "the remaining component is a residual".</p>

		<p>It's been argued that the inflation component and "remaining" component are dependent upon each other and, accordingly inflation would not be separately measurable.</p> <p>For instance, it's widely recognized that loans can be hedged against changes in fair value due to interest rate risk and/or credit risk. Interest rate risk and credit risk are contractually specified components of the loan cash flows.</p> <p>However, in a fixed rate loan, the total rate isn't simply composed of an interest rate component and a credit risk component; there is also a residual component.</p> <p>If the rules dictated by par. 80Yd are to be applied to a fixed rate loan, doubts would arise regarding the possibility to hedge interest rates and/or credit risks because also such components and residual component could be considered dependent upon each other.</p> <p>These difficulties are, in our opinion, due to the fact that the Exposure Draft is rule based rather than principle based and, in addition, it doesn't discuss the principles that underlie such rules.</p>
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<p>Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item</p>	<p>The proposed amendments specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item.</p> <p>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?</p> <p>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?</p> <p>If so, which situations and why?</p>	<p>Which portions can be designated as hedged items is strictly related to the hedgeable risks. Accordingly, the hedgeable portions should include price risk.</p> <p>In addition we ask if the example reported in par. 80Z(d) is a correct example.</p> <p>Such paragraph allows the designation, as hedged portion, “any contractually specified cash flows of a financial instrument that are independent from other cash flows of that instrument” while the example refers to the first four payments on a floating rate financial liability.</p> <p>In our opinion, the reported example is an example of a partial term hedge and not of the portion referred in paragraph 80Zd. In our opinion, a better example would be the “inflation component of a floating rate liability contractually indexed to inflation”.</p> <p>We also question if some paragraphs of the ED are consistent with the carved-out version of IAS 39.</p> <p>In particular, we refer to par. AG99E that forbids the designation as hedged item a cash flow that doesn’t exist in the financial instrument as a whole.</p> <p>Paragraph AG99C requires the designation as hedged item of a portion of cash flows of a financial asset or financial liability that are less than the total cash flows of the asset/liability. This part of the paragraph, however, has been carved out in order to allow the hedging of core deposit with zero or below market interest rate.</p> <p>We think that the same is true for par AG99E that, forbidding the designation as hedged item a cash flow that doesn’t exist in the financial instrument as a whole, would make it impossible to hedge core deposits in a macro fair value hedge relationship.</p>
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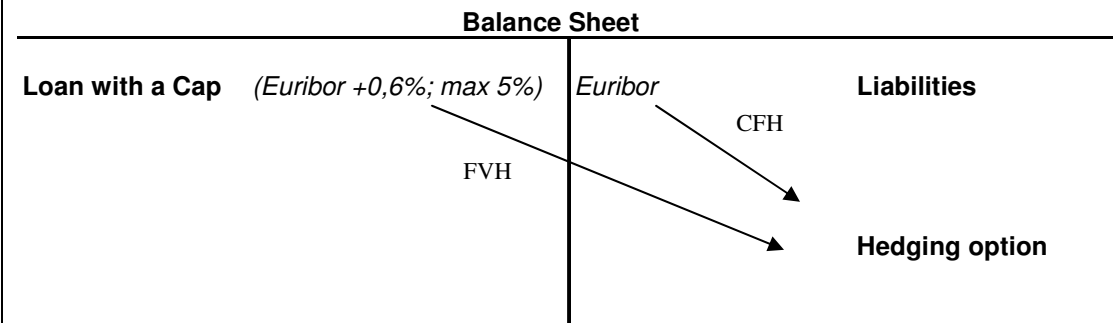
		<p>Finally we would like a clarification of the application of par AG 99E to the cash flow hedge of plain vanilla floating rates financial liabilities through a purchased options (see appendix).</p> <p>Appendix</p> <p>Paragraph AG99E of the exposure draft states the following: <i>"In designating as a hedged item a portion of a financial instrument, an entity cannot specify as the hedged item a cash flow that does not exist in the financial instrument as a whole. For example, in designating a one-sided risk (such as the decrease in the fair value of a financial asset) as a hedged portion, an entity may not include any cash flows that are imputed or inferred in the designated hedged portion (for example, inferring the cash flows arising from the time value of a hypothetical written option in a non-derivative financial asset)"</i></p> <p>BC14 that cites such paragraph refers to the IFRIC's tentative agenda decision of May 2007.</p> <p>In that meeting, the Committee analyzed a situation in which an entity hedges, through a purchased option, the cash flow variability arising from a <u>highly probable future sale</u> denominated in foreign currency. In particular, the entity hedges the risk that fx rate will depreciate below a certain level when the forecast sale occurs.</p> <p>The Committee clarified that it's not possible to designate as hedged portion a hypothetical written option in order to offset both the intrinsic and the time value of the purchased option and to achieve a 100% effectiveness.</p> <p>In fact, the hedged item doesn't include any optionality features.</p>
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We question if such rule must be applied only to cash flow hedges of a forecast transaction or also to cash flow hedges of floating rate assets or liabilities.

Consider the following situation:

- Entity A sells to customers a floating rate loan Euribor + 0.6% with a cap at 5%. Under the terms of contract:
 - The entity will receive Euribor + 0.6% if the total rate is below 5%
 - The entity will receive 5 % if the total rate is above 5% (i.e. if Euribor exceeds 4.4%)
- Entity A pays Euribor on its funding.

In order to hedge the position and to fix the interest rate margin, Entity A may want to enter into an option on Euribor with a strike rate fixed at 4.4%



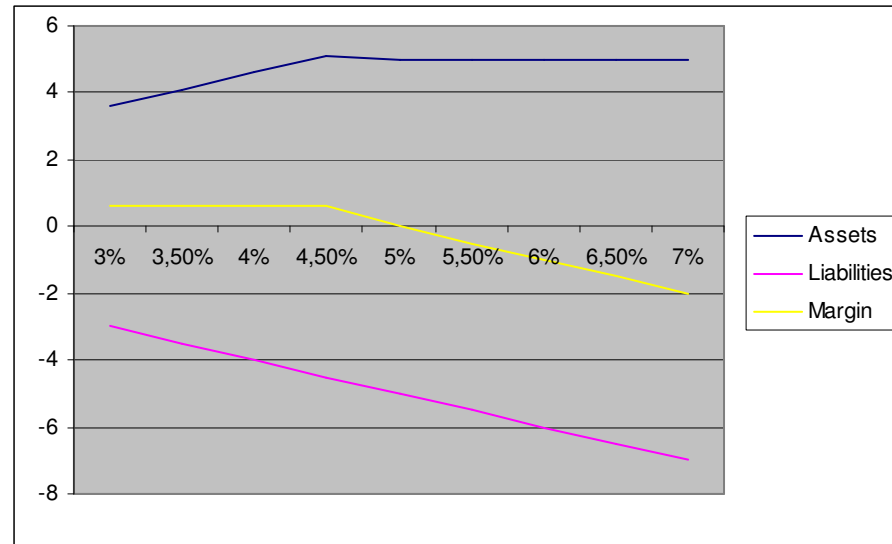
This economic hedge could be represented as fair value hedge of assets or cash flow hedge of liabilities.

If fair value hedge of assets accounting is applied there wouldn't be, in

		<p>our opinion, any issue in designating as “hedged portion” a written option that considers both time and intrinsic value. In fact, the hedged assets themselves contain an option as the interest rate is capped. If the terms (notional, exercise date etc.) of the “theoretical option” and of the actual hedging option are the same, no ineffectiveness should arise. Accordingly:</p> <ul style="list-style-type: none"> - Change in full fair value of the hedging purchased option are recognized to income statement - Change in fair value of the hedged portion (both time value and intrinsic value) are recognized to income statement - Any premium paid on the hedging option is amortized in income statement throughout the life of the hedge. <p>If cash flow hedge accounting of liabilities is applied, possible problems may arise if par. AG99E has to be <i>applied not only to cash flow hedges of forecast transaction but also to cash flow hedges of floating rate liabilities</i> by forbidding the designation of a “hedged portion” that mirrors the hedging purchased option because the liabilities haven’t any optionality features.</p> <p>In order to achieve a 100% effectiveness, in such circumstance, the entity would be forced to designate as hedging instruments only the intrinsic value of the purchased option. Accordingly, the entity will have to:</p> <ul style="list-style-type: none"> - recognize in equity changes in intrinsic value of the option - recognize in P&L changes in time value of the purchased option <p>thereby recognizing volatility in P&L.</p> <p>In our opinion, the application of par. AG99E to cash flow hedge of floating rate liabilities isn’t correct because the reported hedge would achieve exactly its objective, namely to convert floating rate liabilities into fixed ones if Euribor exceeds 4.4%. Accordingly, no P&L effect should</p>
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arise.

Additionally, the proposed hedge is sound, from an economic point of view both as hedge of assets and as hedges of liabilities; in fact, if Entity A doesn't apply any hedging, its interest margin will decrease if Euribor exceeds 4.4%. In such situation, it will have to pay Euribor while receiving 5%. Accordingly its interest margin could become negative (see the following graph)

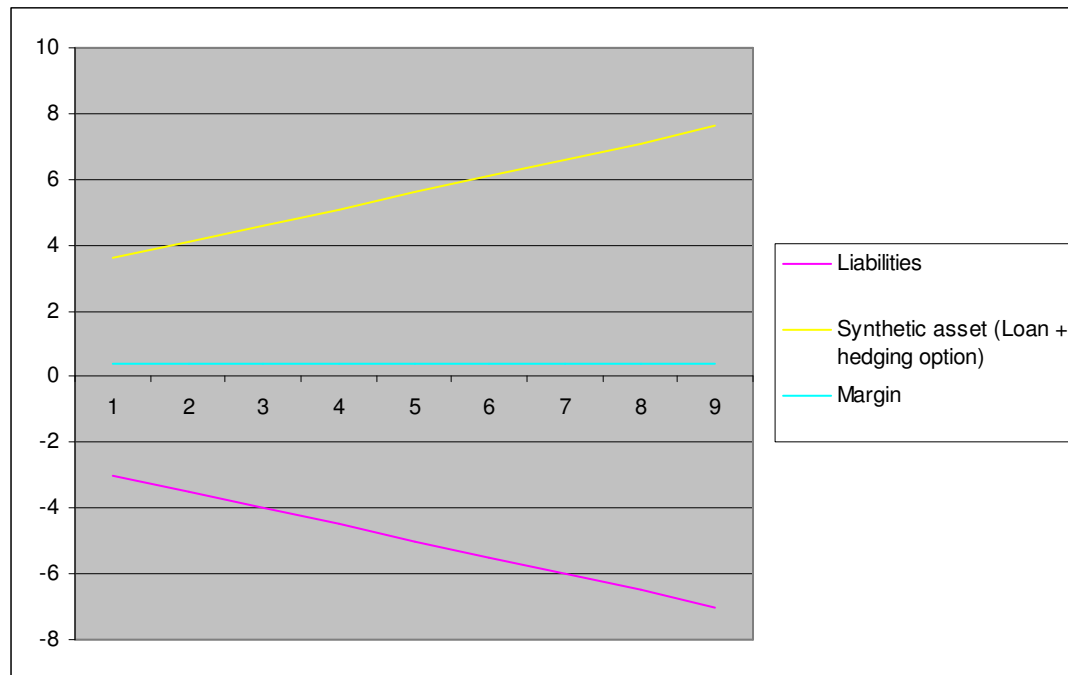


In order to fix its interest margin, Entity A has to enter into an option on Euribor with a strike rate fixed at 4.4% under which it will receive the difference between the actual Euribor rate and 4.4% if the Euribor rate exceeds 4.4%.

This way the entity has fixed its interest margin at the desired level.

Additionally if the entity has paid a premium in order to purchase the option, the premium should be amortized throughout the life of the deal (in order to offset in the income statement the extraspread received on the loan for incorporating a cap).

This economic hedge could be seen as a hedge which converts the assets from fixed to floating if the Euribor Rate exceeds 4.4% (fair value hedge)



Otherwise the hedge could be seen as a hedge which converts the liabilities from floating to fixed if the Euribor Rate exceeds 4.5% (cash flow hedge)

