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Der Standardisierungsrat

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Berlin, 10 January 2008

Dear David,

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

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement: Identification of Exposures Qualifying for Hedge Accounting (herein referred to as 'the ED'). We appreciate the opportunity to comment on the exposure draft.

The ED is based on the opinion that IAS 39, par. 81 in particular, needs clarification in the area of which portions/exposures are eligible for hedge accounting. The need for clarification is evidenced by a number of questions that have been brought before the IFRIC, with only one of those questions mentioned in par. 14 of the Basis for Conclusions. We acknowledge that IAS 39 needs clarification in this respect and that, in order to clarify the principle, introducing more detailed guidance may be unavoidable.

However, we think that effective restrictions can best be placed by introducing a clear and understandable principle, accompanied by guidance and examples that clarify the application of this principle. Thus, we would suggest retaining the principle along the lines of the example currently contained in par. 81 of IAS 39: "To qualify for hedge accounting, a risk or a portion must be identifiable and have a separately measurable effect on the financial instrument's cash flow or fair value".

The application guidance should be amended by a list of risks and portions eligible for hedge accounting consistent with the principle in the standard, similar to the proposed 80Z. Further, the application guidance should explicitly address those situations where the IASB thinks that existing requirements have been applied inappropriately and inconsistently with the IASB' intentions and should explain why, in these situations, hedge accounting is deemed inappropriate. Furthermore, introducing a set of rules into the main text of the standard may expand the scope of the amendment and may have unintended consequences. This may undermine the IASB's intention of not changing existing practice significantly (see par. 7 of the Basis for Conclusions).

While we generally concur with retrospective application, we suggest the proposed amendments be applied prospectively. Given that the IFRIC noted divergence in practice in a particular situation (ref. to our answer to question 2) and given that hedging relationships must not be designated retrospectively, we think that prospective application is appropriate in this circumstance.

We also have concerns as to the clarity and details of the Exposure Draft, which we specify in the appendix to this letter.

Yours sincerely,

Liesel Knorr

Liesel Knorr

President

Appendix

Question 1 – Specifying the qualifying risks 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?

We understand the proposals in pars. 80Y (qualifying risks) and 80Z (qualifying portions) as dealing with two separate issues. We are not convinced that, in order to place effective restrictions on portions qualifying for hedge accounting, defining the qualifying risks (i.e. par. 80Y) is necessary at all, as the current IAS 39.81 does not give any consideration as to the qualifying risks. Furthermore, any list cannot be comprehensive as financial markets develop and new risks are traded. It may be that mortality risk or weather risk may be sought to be hedged in the future.

We note that the proposed list of qualifying risks does not include equity price risk and commodity price risk. Provided the portion can be separated and reliably measured, we do not see, conceptually speaking, any reason why these risks, should no longer qualify for hedge accounting. With regard to equity price risk, one may argue that, as long as equity price risk is substantially the only material risk, the entity may still choose to designate all of the changes in the financial instrument's cash flows or fair value as the hedged risk. However, this would not be possible if the financial instrument (e.g. a share) was traded in a currency other than the functional currency of the reporting entity. In this situation, the reporting entity has two exposures (a currency exposure and an equity price risk exposure, see IG F.2.19), but would be prevented from hedging solely the latter. We suggest the IASB reconsider the list of qualifying risks with regard to the two issues mentioned above.

Par. 80Y contains definitions of interest rate risk and foreign currency risk, but no definitions of credit risk and prepayment risk. The first three of these risks are currently defined in IFRS 7. Thus, repetition of the definitions in the exposure draft is redundant. It just so happens that the only risk currently not defined in IFRS 7 is prepayment risk, and the proposed amendment does not contain a definition, either. We think that *all* risks (including prepayment risk) contained in par. 80Y should be defined. Further, we are of the opinion that no risk should be defined in more than one standard and that the user of the standards is best served if all risk definitions were grouped together in either IFRS 7 or IAS 39.

Since proposed par. 80Y does not contain a definition of credit risk, it is unclear to us whether the definition contained in IFRS 7 is to be applied. The definition in IFRS 7 is a broad definition that comprises both unsystematic and systematic credit risk. We are not sure whether the systematic credit risk (i.e. the risk of changes in the credit spread for a given credit risk in the market place) is eligible for being designated as

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the hedged risk under the proposed amendment and note that, currently, this is an acceptable hedgeable risk (see IAS 39.IG F.4.7).

Par. 80Y refers to the restrictions in par. 79 on hedge accounting to held-to-maturity financial assets. Par. 79 allows designation of credit risk as the hedged risk in a held-to-maturity financial asset, but prohibits designating any other risk (e.g. interest rate risk). We think that par. 79 needs to be amended to reflect the possibility to designate "risks associated with contractually specified cash flows" that is introduced in 80Y(e), as far as those cash flows are not exposed to interest rate risk.

With regard to the „risks associated with contractually specified cash flows" in par. 80Y(e), we are also wondering whether this wording is appropriate, since it could be interpreted differently: Does "associated" mean that the contractually specified cash flows are exposed to a certain risk (and that this risk has a measurable effect on the contractually specified cash flows) or does "associated" mean that the specified cash flows must be *independent* from any other cash flows of the financial instrument? In particular, the example in par. 80Y(e) could be interpreted in this way. If this was the intention, the proposed wording could be clarified in this respect.

We understand, and concur with, the notion behind the example in par. 80Y(e). Splitting a fixed interest rate into an inflation component and a residual does not, economically speaking, have economic substance. This would even be true if inflation was a contractually specified cash flow, since, as the example sets out, "the remaining component would be a residual." However, we are not sure whether this wording is appropriate. After splitting out a specified cash flow or particular risk, any remaining part is a "residual" by definition, and it is in the nature of a residual that it does not necessarily have any particular characteristics. We are concerned that this example might be interpreted as requiring that any exposure of the changes of the cash flows or fair value of a financial instrument can be split up into different risks *completely*, i.e. any residual must be one of the risks in par. 80Y or a combination thereof.

Question 2 – Specifying 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?

As set out in our answer to question 1, the notion behind restricting the risk eligible for hedge accounting in addition to par. 80Z is unclear to us. We think that proposed par. 80Z, if read in conjunction with the existing par. 39.81, should be sufficient.

Par. 80Z(c) is an example of potential unintended consequences. Par. 80Z defines different portions eligible for hedge accounting, with 80Z(c) being a portion of the cash flow associated with a one sided risk of an instrument (for example, the cash flows resulting from a foreign exchange rate falling below a specified level.) An analogy could be drawn to IAS 39.82, dealing with the designation of non-financial items as hedged items. Although IAS 39.82 is outside the scope of the amendment, one may conclude that if one applied the definition of a portion in par. 80Z(c) to a non-financial item, hedging a one-sided risk would no longer be in accordance with IAS 39.82, since that paragraph explicitly prohibits designating portions of non-financial items as hedged items. We note, however, that this is considered an acceptable hedge qualifying for hedge accounting under IAS 39 at the moment. We do not think that a change of current practice in this respect was the IASB's intention.

The wording in par. 80Z refers to cash flows only. This could be interpreted as if the proposed amendments are limited to cash flow hedge accounting. We think that this was not the IASB's intention and, therefore, suggest amending par. 80Z accordingly, since some portions in par. 80Z can clearly be defined in terms of fair values as well, e.g.

- par. 80Z(b): a percentage of the cash flows *or fair values* of a financial instrument,
- par. 80Z(c): the cash flows *or fair values* [...] falling below a specified level.

We note that the example given for a partial term hedge in par. 80Z(d) is not very helpful, as the situation could be subsumed under par. 80Z(a) already. We suggest that a different example be used.

Proposed AG99E states that, in designating a one-sided risk (such as the decrease in the fair value of a financial asset) as a hedged portion, an entity cannot include any cash flows that are imputed or inferred in the designated hedged portion. Including the cash flows arising from the time value of a hypothetical written option in a non-derivative financial asset is given as an example. We welcome this clarification. However, we note diversity in practice, as some entities currently include the time value in order to assess hedge effectiveness under the hypothetical derivative method. The IASB should be aware of the fact that, for these entities, the proposed amendment is most likely to result in a significant change to current practice.

Question 3 – Effect of the proposed amendments on existing practice
Would the proposed amendments result in a significant change to existing practice?
If so, what would those changes be?

With the exception of the entities mentioned in our answer to question 2 above (inferring the time value of an option under the hypothetical derivative method), we generally do not expect significant changes in practice.

Question 4 – Transition
Is the requirement to apply the proposed changes retrospectively appropriate?
If not, what do you propose and why?

We generally support retrospective application of amended standards or interpretations. However, we think that there is an inherent inconsistency between retrospective application and the designation of hedges for accounting purposes, since retrospective designation of hedging relationships is prohibited under IAS 39.

Although the IASB does not intend the proposed amendment to significantly change current practice, there might be situations in which an entity previously designated a hedging relationship that does not qualify under the proposed amended standard. One example would be those entities mentioned in our answer to question 2 (inclusion of the cash flows arising from the time value of a hypothetical written option in a non-derivative financial asset). The IFRIC itself noted divergence in practice in this respect.

In those situations, retrospective application would result in a full restatement as if a hedging relationship qualifying for hedge accounting had never existed. In addition, such an entity would be prohibited from retrospectively designating a hedging relationship that complies with the amended standard. We would, therefore, encourage the IASB to consider allowing prospective application. Furthermore, we do not think that a full restatement is appropriate if an entity applied the current requirements in a manner unintended by the IASB, since both the IASB and the IFRIC deem the current requirements in need of being clarified.

Other issues

Preparers frequently encouraged the IASB to consider amending IAS 39.82 as well, in order to allow, in limited circumstances, portions of non-financial items to be eligible for hedge accounting. We note that the IASB's Financial Instrument Working Group made a similar suggestion.

For example, certain commodities are traded in active markets (e.g. oil, gas in the UK, electric power in Europe). Those commodities could be treated the same as financial instruments. Possible situations where we would think that portions should be eligible for being designated as hedged items include

a) the cash flows of a commodity contract for **part of the time** period to maturity, e.g. only the first year of a five year gas delivery contract if the first year is traded in an active market.

b) a **percentage of the cash flows** of a commodity, e.g. for a 100 MWh electricity contract only 70 MWh could be hedged;

c) the cash flows of a commodity contract **associated with a one-sided risk** of that instrument, e.g. the cash flows resulting from an oil price falling below a specified level;

d) any **contractually specified cash flows** that are **independent** from other cash flows of that instrument, i.e. pricing structures where the price of a commodity is *indexed* to the price of another commodity that is traded in an active market and where the changes in the cash flows can thus be attributed to the changes in a market price observable in an active market;

e) the portion of the cash flows of a commodity contract that is **equivalent to a commodity contract with a quoted fixed or variable price**: this could apply to a long-term own-use power delivery contract at a fixed price; if this contract was hedged with regard to its fair value exposure ineffectiveness might arise if the power market price had changed: the power delivery contract has a fair value (marked-to-model) which is subject to interest exposure and credit exposure whereas the hedging instrument with a fair value of zero at inception of the hedge is not subject to these exposures so that ineffectiveness will arise if the whole contract is designated as the hedged item.

We note that we consider example c) to be a hedging relationship eligible for hedge accounting under the current standard (ref. our answer to question 2). Example c) is only included in the list above for reasons of completeness.

We would encourage the IASB to consider amending par. 82 of IAS 39 as well in the light of the examples given above.