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Exposure Draft IAS-39: Financial Instruments Recognition and Measurement

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Invitation to Comment: An economic risk management perspective on the new Hedge Accounting principles contained in proposed IAS-39;

1. We strongly support the **IAS-39 theme of identifying and documenting the exposures and the hedging instruments** used to cover business financial risks. This approach decreases the opportunity for renegade transactions and or fraud. For example the large financial losses of Orange County in the US during the 1990's serves as a good reminder of what can go wrong when derivative positions are mis-managed.

2. As per (1) it is **best business practice** for companies to have a risk policy integrated into the overall company strategy. The documentation should highlight the risk exposures in the business and how they will be managed. This type of policy paper reduces the opportunity for unexpected outcomes as business risk is rigorously defined and discussed.

3. But the **hedge effectiveness test range** of 80% to 125% seem arbitrary, overly restrictive and not particularly well designed. See pages / paragraphs 210 to 211 / 146 to 151 of the Exposure Draft.

In practice, this means that only a few types of risk management strategy will be consistent with the "Hedge Accounting" classification.

These involve hedge instruments and transactions that provide nearly a complete offset to the underlying current or forecast risk exposure.

Therefore, hedging strategies that attempt to modify the earnings profile rather than fully offset risk exposures will not always be eligible for Hedge Accounting treatment.

Practical Hedging Example – demonstrating the limitations of IAS-39:

In the mid to late 1990's AUD mining companies used bought AUD/USD Forward FX positions to cover Forward US dollar earnings exposures – under proposed IAS-39 these transactions would most likely be considered "effective" and therefore eligible for Hedge Accounting classification.

In practice these strategies were not particularly successful because the AUD/USD depreciated by more than expected and as a result the companies faced a significant opportunity cost - using forwards and related instruments provides more certainty in earnings but removes the company's opportunity to take advantage of *positive moves in key business variables.*

A potential alternative to protect against an appreciating AUD/USD is to use a Call option that gives the company the right but not the obligation to buy AUD against a sold USD position at a predetermined rate. Thus, the company $A earnings can benefit from a falling AUD/USD but the option provides "insurance" against the AUD/USD rising. The key point is that an out-of-the money Call, even after stripping out time value as suggested on Page 203 / Paragraph 126C (option valuation as per the generic Black and Scholes formula is a function of time value, volatility of the underlying, interest rate funding and the strike price), is not going to be initially or potentially ever able to provide an 80% to 125% offset to changes in the fair value of the underlying position.

However, the Call option although a simple and relatively "vanilla" strategy may benefit and maximise shareholder wealth which is the ultimate objective of modern companies.

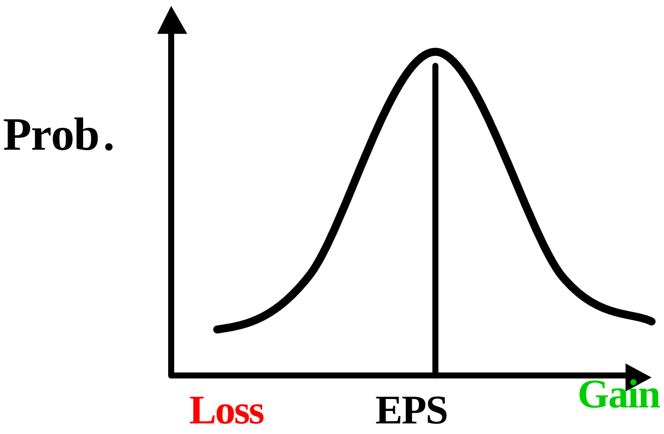
The four diagrams on the following pages provide a basic overview of the type of risk management strategies available to companies – **(i)** leaving exposures unhedged, **(ii)** locking-out exposures with forwards, **(iii)** modifying the downside exposure via a long option position and **(iv)** modifying both the downside and upside exposure by purchasing a collar, made up by a long and a short option position. These diagrams assume the company has only one key financial variable that impacts on earnings per share (EPS) such as a resources company that produces Oil.

The strategies demonstrated in diagrams 2, 3 and 4 should be treated similarly by IAS-39 as valid hedging strategies, and not speculative or trading, even though the Call option and the Collar structure will not necessarily meet the existing hedge effectiveness test. Strategies 3 and 4 are designed to modify the risk profile rather than to remove all risk exposure.

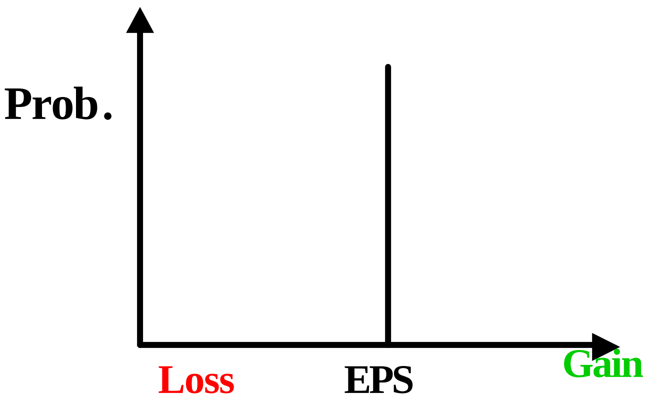
This is consistent with the approach that equates risk not solely with loss but focuses instead on the distribution of all likely outcomes including those associated with positive states of nature. To suggest that a hedging instrument and strategy must always cover close to 100% of the underlying exposure promotes an opportunity cost on companies that seek to manage business risks in a more profitable way.

In summary, **it maybe more appropriate from a hedge effectiveness perspective to demonstrate that the hedge instrument is consistent with the overall business strategy** rather than rewarding one style of exposure management over another.

(i) Unhedged – exposed to earnings "tails"

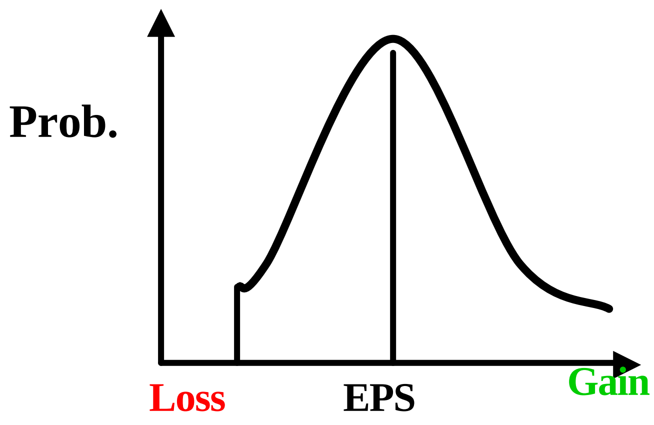


(ii) Forwards – 100% effective but opportunity cost

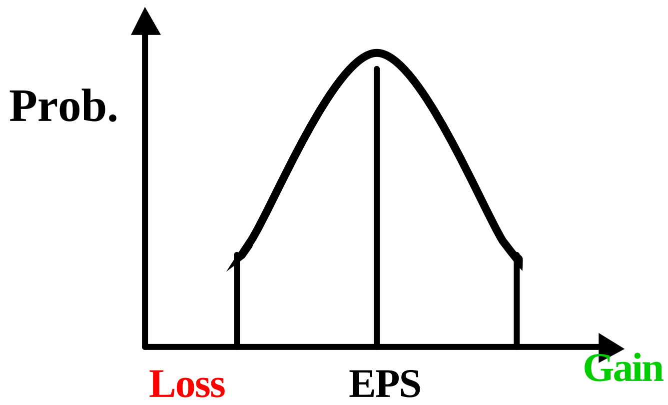


Diagrams 3 and 4 are on the following page.

(iii) Insurance–Options modify the downside potential



(iv) Collar–trade-off downside for less upside opportunity



4. Point 3 leads to the follow up question - **what is the real economic benefit of having Hedge Accounting ?** - while as mentioned in 1. we agree and support the need for identifying what companies are doing with derivatives - it does seem that the Hedge Accounting standard in IAS-39 is too restrictive and not subtle enough for practical use by companies whether they be Australian or not. The increasing focus by all business to look globally for commercial opportunities would seem to argue for more sophisticated risk management and hedging strategies and not less.

Fundamental Questions:

(a) Will the implementation of IAS-39 necessarily be positive if it constrains the ability of business to execute desirable business strategies based on modifying, rather than fully covering, risk exposures?

(b) Will business that does not use transactions that comply with the Hedge Accounting classification be seen as second rate by the marketplace, even though to pursue Hedge Accounting may not be a first best policy that is in the interests of shareholders ? This raises the real prospect that shareholder value maybe damaged if companies are coerced into pursuing this standard out of concerns, over the increasingly important issue, of reputational risk.

(c) Related to (b), how is it envisaged that the Hedge Accounting entries will be presented in performance related documents such as annual reports ? In the same way how will hedging instruments not consistent with this classification be treated in company publications ?

5. Embedded derivatives – again, what is the rationale for excluding these packaged derivatives from individual accounting scrutiny and transparency? If the objective of IAS-39 is to force derivative reporting out into the open it is not clear how this is achieved by the approach outlined on page 152, Paragraph 23. There seems to exist an opportunity here for regulatory arbitrage between "customised" Over The Counter (OTC) embedded derivatives and the standard publicly Exchange Traded derivative contracts. The packaging of risks adds complexity and potentially creates outcomes that have not been fully worked through. In the interests of a level playing field there seems little reason to differentiate between these two types of hedge instruments.

6. Overall business risk vs specific risk exposures. On page 210 / paragraph 149 proposed IAS-39 states –

"To qualify for Hedge Accounting, the hedge must relate to a specific identified and designated risk, and not merely to overall entity business risks..."

The assumed purpose of this, as per the portfolio hedging type issues mentioned on page 206 / paragraph 133, is that it ensures that hedging instruments are matched out directly against a defined hedging item. This is commendable from a reporting perspective but in economic profit terms it may not be the best approach. Modern risk management theory and practice endeavours to measure company wide net financial risks rather than at an individual business unit, project or transaction level. The company wide approach attempts to determine any natural hedges in the business mix that provide offsets for risk. This may still leave a measurable net risk that potentially benefits shareholders if covered completely or partially managed. This suggests that IAS-39 may again encourage risk management practices that are not necessarily business value friendly.

Yours Sincerely,

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If there are any questions or issues arising from this review please contact Ross McInnes Director Research **by Ph: +61-2-9564-3815 , Email research@airs.com.au or visit the www.airs.com.au site for more details.** **This report was prepared on Friday September 27th 2002.**

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