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R.A. van den Berg		344 81 92 344 84 06 (fax)	14 November 2003

CL 40

RE: Exposure draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement: Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk.

Dear Ms. Thompson:

Thank you for the opportunity to comment on the *Exposure draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement: Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk (ED)*. We fully support the Board's effort to include portfolio hedges of the interest rate risk in financial assets and/or financial liabilities in IAS 39. We agree with the proposed changes. However, we do not believe that the changes are substantial enough for many entities to utilize existing systems and hedging methodologies to achieve hedge accounting on portfolios that comply with the underlying principles in IAS 39.

We agree that fair value portfolio hedges of interest rate risk should be designated as hedges of specific assets or liabilities (or a percentage of currency assets and liabilities) and not on a net position. However, in the illustrative example in paragraphs IE1 through IE5, we believe that the requirement to hedge time period buckets individually in order to achieve hedge accounting is too constraining and entities should have the option to hedge multiple time buckets in aggregate with one or more derivatives. We do not believe that hedging individual time buckets is essential to proving an effective portfolio hedge of interest rate exposure. Rather, if specific assets and or specific liabilities (or specific amounts of currency assets or liabilities) can be effectively hedged on a portfolio basis (80-125%) with one or more interest rate swaps then hedge accounting should be allowed.

Our proposed changes would enable companies to create hedges in the most cost-effective structures. Costs increase when entities hedge individual time buckets because derivative counterparties quote higher rates for smaller notional amounts. Additionally, internal legal and tracking costs increase with each individual derivative. Structuring hedges in a portfolio manner is more cost-effective and allows companies to hedge efficiently in the market while still utilizing their existing systems and qualifying for hedge accounting. Our approach would identify specific hedged items within a portfolio, recognize material ineffectiveness from both over and under-hedging, and also adjust the net gain or loss on the hedged item in conjunction with changes in the hedged items.

Consider the following example:

An entity invests in fixed and floating rate assets and also issues fixed and floating rate liabilities. The entity wishes to hedge the interest rate risk associated with the un-hedged fixed rate position by purchasing an interest rate swap. The entity schedules out their un-hedged position into time maturity buckets with the following maturity schedule (CU = Currency Unit):

CU 25 million mature in 2 years
CU 25 million mature in 5 years
CU 25 million mature in 7 years
CU 25 million mature in 10 years

The unhedged position is a net asset position. To hedge the benchmark interest rate exposure, the entity has at least three scenarios for constructing a hedge:

1. Enter into one swap with an amortizing notional balance. The swap would mature in 10 years and have an original notional amount of CU 100 million. The notional amount would be decreased in years 2, 5, and 7 by CU 25 million. Designate this swap as a hedge of the above group of asset position time buckets.

2. Enter into four individual swaps; one CU 100 million notional swap with a two-year maturity, one CU 75 million notional 2 year forward 3 year swap, one CU 50 million notional 5 year forward 2 year swap and one CU 25 million 7 year forward 3 year swap. Designate these swaps together as a hedge of the above group of asset position time buckets.

3. Enter into four individual swaps each with a CU 25 million notional that mature in 2, 5, 7 and 10 years. Designate each swap individually as a hedge of each asset position time bucket that matures in the same year as the swap.

In the three hedging scenarios above, the balances of the assets are exactly matched with the outstanding notional on the interest rates swap(s). Additionally, the timing of the cash flows match because each time a fixed payment is received on the asset, the entity would pay a fixed rate on the swap and receive a floating rate in return. Effectively, the entity has hedged away the risk associated with the change in fair value of the assets by receiving a floating rate. All three scenarios would meet the underlying principles of IAS 39 discussed in paragraph A30 of the ED. Paragraph A30 requires that all of the assets being hedged are 1) items whose fair value changes in response to changes in the interest rate being hedged and 2) items that could have qualified for fair value hedge accounting if they had been hedged individually.

Under the ED, only the third scenario would clearly qualify for hedge accounting because this swap hedges the asset positions in their individual time buckets. This hedging methodology is not as cost effective as the first scenario, due to the execution of multiple smaller swaps. The second scenario may qualify for hedge accounting if an entity designated a percentage of each swap in the various time slots and combined these to hedge the individual asset position time buckets and tested for effectiveness. However, this process also requires the execution of multiple swaps, would most likely require an additional hedging system to assign a percentage of each derivative to each time bucket and will result in more ineffectiveness being recorded in income than what is occurring economically. The first scenario may be the least expensive option from both a swap pricing perspective and internal swap execution costs, but would not qualify for hedge accounting under IAS 39 paragraph 132 because the entity has hedged the time buckets in aggregate with one derivative. Paragraph 132 requires that if similar assets and liabilities are hedged as a group, the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the

hedged risk of the group. Due to the range of maturities of the four liabilities and their sensitivities to various points on the yield curve, all of the liabilities will not change proportionate to the change in the fair value of the entire portfolio. We believe that if all three hedging methodologies could prove to effectively hedge a portfolio (where the change in the value of the derivative is within 80-125% of the change in the value of the hedged item) and all three meet the underlying principles of IAS 39, all three hedging relationships should qualify for hedge accounting.

Question 1 of the ED has three parts:

a*) In your view how should the hedged item be designated and why?* As stated above, we propose that the definition of an allowable hedged item be expanded to include a portfolio of time buckets, but not require that each individual item in the portfolio have the same response to changes in interest rates. Entities can hedge a portfolio of time buckets more cost effectively. Therefore, if an entity can prove an effective hedging relationship (i.e. the change in the hedged item is within 80-125% of the change in the hedging instrument), then the hedge designation should be allowed. For hedge documentation purposes, an entity would indicate at inception which assets (or currency amount of assets) were hedged with which derivatives.

We recommend the following changes to the ED:

1. Paragraph 154 (a) and 154 (b) – delete "for a particular maturity time period"
2. Appendix A, paragraph A26 (e) add "individually or in the aggregate" at the end of the paragraph.

In order to implement our recommended approach we suggest an additional paragraph 132A that would read as follows:

"However, in a fair value hedge of the interest rate exposure of a portfolio of financial assets and/or financial liabilities, the designated hedged items may be aggregated and hedged in total with one or more derivative instruments."

b) Would your approach meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over and under-hedging) should be identified and recognised in profit or loss? Yes, our approach would expand the allowable definition of the hedged item, but the calculation of ineffectiveness would be the same as proposed by the ED. If individual time buckets were hedged as a portfolio, the change in the value of the each individual time bucket would still be calculated. The change in the fair value of each time bucket in the portfolio as calculated per paragraph A36 of the ED would be aggregated and compared to the change in the fair value of the hedging instrument(s).

c) Under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet? An entity would follow the same process as described in paragraphs A38 to A40 in the ED for each individual time bucket identified within a hedged portfolio. Although the time buckets would be aggregated into a portfolio for structuring a hedging derivative and for testing hedge effectiveness, the entity would individually track the time buckets for adjusting the net gain or loss on the balance sheet.

We believe that our proposed changes to IAS 39 are in compliance with the underlying principles of IAS 39, but would allow for more cost efficient execution in the design of hedging instruments. Increased costs of hedging may impede an entity's ability to be competitive in the marketplace. Our approach would allow entities to structure competitive hedging strategies, while still requiring effectiveness tests to qualify for hedge accounting. Additionally, our approach maintains the

requirement to monitor the changes in fair values of the individual items within the portfolio for appropriate adjustment of the net gain or loss associated with these items. Finally, our proposed changes would continue to recognize ineffectiveness in both over and under-hedging situations.

Although not directly related to paragraph 128, we would like to provide additional comments on adding language to the Hedging Section: Assessing Hedge Effectiveness in IAS 139. Our proposal is to allow an assumption of no ineffectiveness in a hedging relationship involving an interest rate swap, if the critical terms of an interest rate swap match the critical terms of the hedged item. Retrospective hedge effectiveness testing for these circumstances is over-burdensome and requires complex computations that will result in similar financial statement results as the assumption of no ineffectiveness. We suggest adding the following wording in a new paragraph 152A (this wording appears in US GAAP Statement of Financial Accounting Standard No. 133, in paragraph 68).

"An entity may assume no ineffectiveness in a hedging relationship involving an interest rate swap if the following criteria are met:

- The notional amount of the swap matches the principal amount of the interest bearing asset or liability
- The fair value of the swap at the inception of the hedging relationship is zero
- The formula for computing net settlements under the interest rate swap is the same for each settlement
- The interest-bearing asset or liability is not prepayable except in circumstances where an embedded call option is a mirror image of an embedded call option in the interest rate swap
- The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship
- For fair value hedges:
- The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
- There is no floor or ceiling on the variable interest rate of the swap
- The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable portion is at a market rate
- For cash flow hedges:
- All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged and no interest payments beyond the term of the swap are designated as hedged
- Floors or caps in the swap match a floor or cap in the asset or liability
- Repricing dates match those of the variable rate asset or liability."

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These changes would still meet the underlying principles of IAS 39, but would greatly reduce the computations necessary to account for certain hedging relationships involving interest rate swaps.

We would also like to comment on the Board's tentative decision at the October 2003 IASB meeting to revert to the proposal in the IAS 39 Exposure Draft regarding prospective effectiveness testing. Paragraph 146 indicates that "a hedge is normally regarded as highly effective if, at inception and throughout the life of the hedge, the entity can expect changes in the fair value or cash flows of the hedged item to be almost fully offset by the changes in the fair value of cash flows of the hedging instrument, and actual results are within a range of 80% to 125%." Paragraph 151 indicates that "If the critical terms of the hedging instrument and the entire hedge asset or liability or hedged forecasted transaction are the same, an entity could conclude that the changes in fair value or cash flows attributable to the risk being hedged are expected to offset each other fully at inception and on an on-going basis."

We agree that for each purchased hedging instrument, the entity should document why the hedge is expected to be effective. The terms “highly effective” and “almost fully offset” are defined in paragraph 146 for retrospective or “actual” tests when changes in cash flows or fair value of the derivatives are within 80-125% of the hedged item. We believe the prospective hedge determination should be based on the same criteria, but that the prospective test may be based upon either a qualitative or quantitative determination, regardless of the planned retrospective test. At inception of a hedging relationship, if an entity can make a reasonable determination on a qualitative basis that the relationship is expected to be effective (i.e. within 80-125%) based upon critical terms of the relationship, then additional mathematical or statistical testing should not be required. The primary purpose of the prospective test at designation of the hedge is to document management’s intent and to document how the hedge will offset variability in fair values or cash flows. Under this assumption, the time consuming process of designing complicated prospective quantitative tests is unnecessary when qualitative tests are sufficient.

Similarly, if an entity chooses to document a prospective test based on a quantitative measure, that entity should not be prohibited from designating a hedging relationship based upon a quantitative prospective test result of 82% when on a retrospective basis, the hedge would have been considered effective. We do not believe that prospective quantitative tests or more restrictive prospective effectiveness rules are necessary to qualify for hedge accounting. We believe that our interpretation of requirements for a prospective test is in compliance with the underlying principles of IAS 39 and is compatible with the language in paragraphs 146 and 151. In order to clarify that prospective and retrospective tests should be based upon the same criteria, we recommend the following underlined change to paragraph to 146: “a hedge is normally regarded as highly effective if, at inception and throughout the life of the hedge, the entity can expect changes in the fair value or cash flows of the hedged item to be almost fully offset <u>(e.g. within 80-125%)</u> by the changes in the fair value or cash flows of the hedging instrument.”

Thank you for the opportunity to comment. We would be happy to discuss our comments with you at your convenience.

Sincerely,

Ruurd van den Berg.