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holding
The Federation of
Swiss Direct Investors

November 14, 2003

Ms. Sandra Thompson
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Dear Ms. Thompson

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

Together with our member companies we have studied the above Exposure Draft and would like to offer the following comments.

We welcome the decision of the Board to address the issues of accounting for macro-hedging. The exposure draft is a step in the right direction of bringing hedge accounting requirements closer into line with entities' actual risk management. This should help to reduce the problem of excessively restrictive anti-abuse rules leading to financial statements which do not offer a true and fair view of an entity's results by excluding many real economic hedges.

However, there is still some way to go in this respect, as you will see in our response below. There are significant unresolved issues, particularly the inability to designate a net position as a hedged item and the arbitrary restriction of hedge accounting to certain types of items, e.g. the fact that the ED addresses only interest hedges whereas entities also use portfolio hedging for currency and other exposures.

Answer to Question 1 – Designation and resulting effect on measuring ineffectiveness

While we support the designation of portfolios of similar transactions for applying hedge accounting, we disagree with the requirements of paragraph 128A that say that an amount designated for hedge accounting is "an amount of assets or an amount of liabilities", and that the "designation of a net amount including assets and liabilities is not permitted".

We consider that, to be transparent and relevant for the users and to produce financial statements which give a true and fair view of an entity's results for a period, the revised IAS 39 should implement requirements that correspond to entities' actual risk management. We are not convinced by the arguments of the basis for conclusion (BC5 (b)) that leave paragraph 133 of IAS 39 unchanged. Since the objective of the current revision of IAS 39 is "to enable fair value hedge accounting to be used more readily for a portfolio of interest rate risk" (background information page 4), we consider that this revision will not meet its objectives if IAS 39 paragraph 133 is not modified to allow the designation of net positions as hedged items.

a) It should be possible for a hedged item to be a net position because enterprises designate net positions as hedged items in their risk management policies. Inasmuch as such positions are – and can be shown to be - homogenous in their critical terms such as risk, duration, types of instruments hedged, currencies and maturities, we do not see why they would be unacceptable for hedge accounting.

b) A net approach would still permit the identification and recognition of all material ineffectiveness where the net positions are homogeneous as under (a) above.

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c) The ED’s proposals for elimination of the corresponding asset or liability would also still be appropriate.

Answer to Question 2 – Demand deposits

Basically, we agree that a specific financial liability the counterparty can redeem on demand does not qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. However, there are cases where such an accounting rule for demand deposits would not reflect economic substance e.g. where a portfolio maintains a very stable level of deposits allowing macro hedge transactions that can be demonstrated on the basis of past experience. We would welcome if IASB would elaborate a set of principles that allows a pragmatic accounting approach to such portfolios.

Other Points

Portfolio hedges of currency and other risks

We consider the draft amendment inadequate since it arbitrarily restricts the acceptability of a portfolio hedge approach to interest rate risks. This effectively excludes from hedge accounting currency hedging that entities widely perform with treasury centres. Typically such treasury centres regroup the currency positions transmitted by their subsidiaries (sales and purchases in foreign currencies) and hedge net amounts by currencies and maturities with financial institutions.

However, under the current requirements of IAS 39 §133, a derivative cannot hedge a net asset or liability position. It should be designated as a partial hedge of several gross asset or liability positions, which either makes the effectiveness criteria almost impossible to meet or involves administrative costs which are not justified by the benefits.

If the prohibition of designating net positions in paragraph 133 were removed, entities could apply hedge accounting to the net currency hedges of their treasury centres and not confuse the users by requiring preparers to recognise risk management operations of their treasury centres as “trading” derivatives, which leads to a false picture of economic results in the income statement and have a highly misleading speculative connotation.

Use of internal contracts in hedging foreign currency transactions

We fully concur with the arguments set out in discussions and letters that you have had with and received from representatives of ERT (European Round Table) and ACT (Association of Corporate Treasurers). We therefore refer to them in this letter without repeating them.

The Board’s decision in its September meeting to limit the applicability of IGC 134 1- b) to separate financial statements was taken without any reference to the above mentioned basic principles. The examples that the Board received from both ERT and ACT show that foreign currency transactions may be hedged through internal contracts with the Corporate Treasury Department, tracked right through to the external hedging instrument that offsets the risk externally, and allow all internal contracts to be eliminated upon consolidation. If IGC 134 1- b) were also applicable to consolidated financial statements, there would be no breach of any fundamental principle involved in hedge accounting. We therefore ask the Board to revert to the existing IGC 134 1-b) when issuing the IAS 39 version applicable from 2005 onwards.

Furthermore the change made by the Board in September is a severe breach of the IASB due process, since it has never been exposed by the Board. It constitutes a huge change in the present practice of companies applying IFRS already and in the planned practice of those preparing to comply with IFRS in 2005. Most companies that we know have already designed the information systems to be set up in order to comply with existing requirements regarding the hedging of foreign currency transactions. Since no change was planned by the Board and the

IGC made sense in taking into account the underlying economic and organisational reality of corporates, those entities were right in planning their future accounting processes in accordance with the existing literature.

Hedging of a portfolio of commercial bids

Our comments here relate to entities that make long-term contracts. These entities generally carry at any point in time portfolios of commercial bids made in foreign currencies. Because not all bids are going to result in firm orders being placed by customers, each portfolio is evaluated on the basis of weighted average probabilities of occurrence. It is on that basis that hedging relationships are documented and managed right through the process for production of the long-term contracts.

Historical evidence of these entities shows that they have reached a sound practice of estimating the probabilities of occurrence of the in- and out-flows of foreign currencies arising from their portfolios of commercial bids. Adequate documentation is essential to the process and is therefore available. Inefficiency can be determined and accounted for adequately. This practice is therefore compatible with the basic principles laid down for hedge accounting.

We therefore request from the Board that a portfolio of commercial bids expressed in a foreign currency, and from which, as a whole, future in- and out-flows of currencies can be reliably estimated and adequately documented, is regarded as a highly probable future transaction.

Initial effectiveness

The present rules on hedge effectiveness are very strict, and we do not believe that the requirement that a hedge should be almost entirely effective at inception reflects the economic substance of many risk management transactions, e.g. in commodity hedging. For practical purposes we would recommend that the current rule of 80 to 125% for the retrospective effectiveness testing should also be applicable at the inception of the hedge. This would lead to a fairer presentation of the entity's results and mitigate some of the crasser distortions from IAS 39's excessively rule-based approach.

It is appreciated that the incorporation of the above suggestions into IAS 39 would probably necessitate a re-exposure on hedge accounting. We nevertheless believe that the standard would remain excessively arbitrary and continue to give users a distorted picture of entities' results in many important situations if they are not incorporated.

Yours sincerely

Federation of Swiss Industrial Holding Companies

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