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CL 44

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International Accounting Standards Board
30 Cannon Street
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14th November 2003

Dear Madam,

Re Exposure Draft of Proposed Amendments to IAS39 Financial Instruments: Recognition and Measurement Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

The Association

1. The Association of Corporate Treasurers was formed in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field. Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally. A professional body and not a trade association, it has over 3,000 Fellows, Members and Associate Members. With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education. Members of the Association work in many fields. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions.

2. The ACT usually comments from the corporate and not the financial services sector standpoint

Introduction

3. The ACT supports the main principles behind IAS39 that derivatives should be measured at fair value, but that subject to effectiveness testing and designation hedge accounting may be applied, with any ineffectiveness recognized in earnings. Our concerns, which we have been making since the early days of IAS39, centre round the objective that normal commercial hedging carried out as standard treasury best practice should not be caught out by the rules and fail to qualify as hedges. We do not wish the accounts to give a misleading picture of routine treasury activity, nor do we wish to see the accounting process introduce excessive administration or costs. Worst of all we would not wish to find that Corporates are actually changing their hedging

policies to their commercial detriment simply on account of the accounting presentation.

4. We believe that convergence of IAS with USGAAP should be a general objective where this can be achieved without compromising the fundamentals behind IAS. Thus if there are opportunities to bring the two sets of standards together in some of the specific detail this will be welcomed. The more differences there are the more effort and costs need to be expended by companies subject to both regimes. For those with European standards applicable for their prime reporting there may even be the risk that the accounting will drive their commercial actions which could put them at a competitive disadvantage. Where differences remain this could lead to a lack of transparency if companies engage in convoluted work arounds to achieve what they regard as a fair accounting treatment.

5. We welcome the Exposure Draft on Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk. We very much support the move to a basis which is closer to how large organizations actually manage their risk portfolios. Nonetheless we advocate that this portfolio approach should go further and allow the net of the portfolio of assets and liabilities to be the hedged item instead of an amount of the asset or of the liability equal to the net amount.

Summary of Principal Points

6. In response to Question 1 we support the change to allow a designation of an amount of asset or liability however we believe that it should be possible to designate this amount against the **net** of the assets and the liabilities. The group of assets and liabilities being netted will have to have sufficiently similar characteristics such that taken individually they would have met the effectiveness tests to qualify for hedge accounting.

7. We appreciate the recognition by the Board that organizations often manage their interest rate risk positions on a portfolio basis. It is equally true that this happens in respect of financial price risks in general, and accordingly we consider that the Exposure Draft should extend a similar approach to such portfolios of foreign currencies.

8. We have three essential points we wish to make to the IASB covering this and two related areas. In each case they represent convergence with FASB on matters where IAS39 is currently proposing to diverge. All three of these points are easy and brief (even the odd-word change) to incorporate in IAS 39 or the IGC and would not need further exposure if dealt with in response to the existing exposure. The consequences for companies of not adopting them are significant, and that burden would be one which US GAAP companies do not face.

9. The three points are;

Treasury centre netting
Prospective effectiveness testing bands
Short cut method for interest rate swaps

Comments

Treasury centre netting

10. It is a well established practice in most larger companies that FX exposures are identified at the subsidiary level and that these subsidiaries then hedge using fully documented internal deals with the centre. Within the subsidiary effectiveness testing can be done and hedge treatment will be available. At the centre the internal deals with the subsidiaries are combined and the net position is hedged with external parties.

11. As things currently stand where a central treasury does internal deals with its subsidiaries and then lays off the net position in the external market the group will run into significant administrative problems. It will not be allowed to designate the net of its internal contracts as the hedged item. It would need to identify sufficient exposures in each of its various subsidiaries and designate, on a potentially arbitrary basis, some of those exposures on a one to one basis with its external contract.

12. It is best practice to net deals for control and operational risk reduction as well as avoiding the costs with banks and the administration costs. The alternative would be to deal gross in each subsidiary, which is not attractive. There are work-arounds to the alternative of gross hedging for corporates, but these involve special deals with banks or with non-consolidated special purpose vehicles - and one objective of IASB was to do away with the use of such devices and go for transparency.

13. Paragraph 134 of the current version of IAS 39 (126B in the exposure draft) explicitly prevents internal contracts from qualifying as hedges in consolidated statements. As a result, companies hedging currency exposures on a net basis through a treasury centre will be unable to obtain hedge accounting for this common strategy, meaning that in this area the standard is fundamentally misaligned with healthy treasury practices. We believe that a limited exception to paragraph 134 (now 126B) should be included in the standard to permit that under IAS, internal hedges may qualify as hedges of risk in consolidated financial statements to the extent that these have been appropriately and fully laid off externally via a treasury centre, on an aggregate or net basis.

14. Not only would such an exception clarify the current situation and ease the burden of implementation, it would also achieve the objective of alignment with the principle behind FAS 138, whereby treasury centre hedging for foreign currency risk is allowed based on specific rules. In line with the principles-based approach of IAS we would not recommend adopting the precise rules in FAS 138 on this point, but would suggest that the strong underlying principle be reflected in the amendment to IAS 39.

15. A simple wording to amend IAS 39 was provided to the IASB by Nokia's letter of October 2002 which is among the comments on the IASB's website (ref CL90). We support their suggested drafting and reproduce the relevant section from their letter as follows.

Extract from letter of Nokia dated 9th October 2002:

Our suggested wording for paragraph 12GB and for this limited exception would be as follows:
"126B. For hedge accounting purposes, ***except as stated under 126B(1) below,*** only derivatives that involve a party external to the entity can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any gains and losses on such transactions are eliminated on consolidation. Therefore, such intra— group or intra—entity hedging transactions do not qualify for hedge accounting in consolidation.

126B(1). Foreign currency derivative contracts that have been entered into with another member of a consolidated group (such as a treasury centre) can be hedging instruments in a foreign currency hedge in the consolidated financial statements if such internal contracts fulfil the requirements for hedge accounting at the individual entity level and are aggregated or netted against each other and the foreign currency exposure is fully offset externally with unrelated third parties."

Prospective effectiveness testing bands

16. When testing effectiveness on a prospective basis IAS39 (para 146) requires the outcome to be "highly effective" without specifying the bands, although the words "almost fully offset" are used. On a retrospective basis it applies the 80% to 125% bands familiar from FAS133. FAS133.20b and 28b provides for 80% to 125% bands for both prospective and retrospective tests. At the IAS Board meeting in July 2003 it was agreed to use the 80% to 125% test prospectively and retrospectively. Subsequently at the October Board it was decided to revert back to the basis of "almost fully offset". Given the use of the words "almost fully offset" the worry is that interpretation of highly effective will be set nearer 95% to 105% which for some hedges will be impossible to meet.

17. An example in commodities would be airlines hedging jet fuel. The liquid market for hedges beyond the relatively short-term is crude oil and then the gas-oil premium which is approximately 90% correlated with jet fuel. It is possible to get a bank to write a hedge over-the-counter for jet fuel itself, but the market is narrow and expensive. So airlines would face never being able to get hedge treatment. Other commodities and financial contracts could suffer similarly.

18. We fail to see the basis for applying a narrower range for prospective as opposed to retrospective testing and suggest that the IAS wording be aligned with that used under US GAAP (FAS 133 20b and 28b). Failure to make this change will put companies reporting under IAS at a significant and unreasonable disadvantage compared to their US GAAP counterparts, by making hedge accounting virtually impossible to achieve in practice for many risk classes, both financial and non-financial.

Short cut method for interest rate swaps

19. The final point was to seek an extension of the short cut method to hedging with interest rate swaps. For a company with, for example, a simple swap of a fixed rate borrowing to floating, the short-cut test avoids unnecessary extensive work. The concept is allowed under US GAAP and means that no periodic effectiveness testing is required where the hedge and the hedged item meet certain conditions designed to demonstrate that they are perfectly matched and that there is no chance of any ineffectiveness. The approach taken by US GAAP in this area is pragmatic and simple to apply in practice.

20. In the interests of easing the implementation burden for companies using only basic hedging strategies we believe that the short cut method should be allowed under IAS. The well known weaknesses of the traditional "dollar offset" effectiveness test, whereby perfectly matching Fair Value hedges with interest rate swaps may on occasion fail the test due to reliance on a single data point, make this change a necessity for corporate hedgers. The IAS approach, which is based on "portions" of cash flows, does not resolve this issue for Fair Value hedges due to volatility caused by the floating leg of an interest rate swap.

21. We suggest that the short cut method should be allowed under IAS 39 via an amendment which incorporates similar guidance to that in FAS 133. A copy of this is appended below for ease of reference

22. The ACT is pleased to be able to contribute to your consultations on the Exposure Draft and hope that our concerns and suggestions will be fully taken into account. If further clarification is required we will be pleased to help.

Yours faithfully

Richard Raeburn
Chief Executive

Appendix:

Extract from FAS 133 guidance notes re the so-called "Short Cut Method"

Assuming No Ineffectiveness in a Hedge with an Interest Rate Swap

68. An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met:

Conditions applicable to both fair value hedges and cash flow hedges

a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability.

b. The fair value of the swap at the inception of the hedging relationship is zero.

c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.) [E12]

d. The interest-bearing asset or liability is not prepayable (that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option provided that the hedging interest rate swap contains an embedded mirror-image call option. The call option embedded in the swap is considered a mirror image of the call option embedded in the hedged item if (1) the terms of the two call options match (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called) and (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, this criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded put option provided that the hedging interest rate swap contains an embedded mirror-image put option. [E6, E20]

dd. 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.*

e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only

f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.

g. There is no floor or ceiling on the variable interest rate of the swap.

h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

i. 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.

j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)

k. The repricing dates match those of the variable-rate