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Sir David Tweedie
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International Accounting Standards Board
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Thursday 20th November, 2003

Hedge accounting effectiveness testing

Dear Sir

We are writing to comment on the recent decision made by the IASB in Toronto with respect to IAS 39 and the hedge accounting effectiveness test, and in particular the decision to return to the more restrictive “almost fully offset” language in the criteria for the prospective hedge effectiveness test. This decision represents a significant diversion from US GAAP, and will introduce substantial profit and loss volatility in financial statements.

It is our experience that many common hedging strategies which have been proven as highly effective in reducing risk, both from an economic perspective, and under US GAAP, will fail the prospective test as proposed, and will therefore be required to be treated as speculative trading positions under IFRS. ISDA believes that this will only serve to mislead the market and misrepresent the business of our members.

In the appendix attached to this letter we clarify the current application of hedge accounting under US GAAP and outline some of the key technical arguments that we feel may not have been fully considered by the IASB. We also highlight some of the practical implications that will arise as a result of applying the prospective effectiveness test as proposed.

We strongly recommend that the IASB reconsider their October decision and amend IAS 39 to incorporate a prospective effectiveness test that is (i) consistent with the retrospective test and (ii) converges with US GAAP. Refusal to do so will, in our view, significantly restrict the number of hedges which qualify for hedge accounting

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under IFRS and lead to results in practice which were not necessarily those intended by the IASB.

We would be pleased to discuss our comments with the Board or staff. Please contact either Ed Duncan, Assistant Director of European Policy for ISDA, at 7330 3574.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Melissa Allen', with a stylized, flowing script.

Melissa Allen
Chair of the ISDA European Accounting Committee
Global Risk Solutions
BNPParibas

A handwritten signature in dark ink, appearing to read 'Ed Duncan', with a stylized, flowing script and a long horizontal flourish underneath.

Ed Duncan
Assistant Director of European Policy at ISDA

cc. Sandra Thompson
Senior Project Manager
IASB Staff

Appendix

Introduction

We understand that for a hedge to qualify for hedge accounting under both IFRS and US GAAP the requirements include that throughout the life of the hedge two effectiveness tests are passed. The hedge must pass a retrospective test, that shows the actual hedge results to have been effective in the past, and a prospective test that shows that the hedge is expected to be effective looking forward.

IAS 39 currently states that to pass the prospective effectiveness test, changes in fair value or cash flows of the hedging instrument must “almost fully offset” changes in the fair value or cash flows of the hedged item. However, the retrospective effectiveness test requires changes in fair value or cash flows of the hedge to be within a range of 80% and 125% of the change in value of the hedged item.

In July the IASB made a tentative decision to amend IAS 39 and bring the prospective and retrospective tests into line with each other and with US GAAP. Hedges must be expected to be “highly effective” both prospectively and retrospectively and actual results must be within the range of 80% to 125%. Whilst the Board did not go so far as to define the prospective test as being within this range, this was the implication of the decision. However in October this decision was reversed and the Board decided to return to the more stringent “almost fully offset” criteria for the prospective test. Whilst “almost fully offset” has not been defined, the Board agreed to include an example in the final standard to illustrate its use. Based upon the discussion at the meeting, it is likely that the Board would anticipate the prospective effectiveness range for hedges that were planned to be narrower than the 80% – 125% test would imply. In fact, our discussions with the accounting firms suggest that the prospective test standard to which companies will be held in practice is, at the outside, a range of approximately 95% to 105%.

This decision marks a significant difference from the application of hedge accounting in the United States under Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, where a single criterion of “highly effective” is used both prospectively and retrospectively (FASB Statement 133 Implementation Issue E-7). Although an effectiveness range is not specifically defined in Statement 133, market practice has consistently interpreted “highly effective” as being within the range of 80% – 125%. This practice, which has been fully embraced by the Big Four accounting firms when advising their clients, is documented in the AICPA’s *Guide for Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, and supported by public positions taken by the SEC in reviews of hedging relationships.

US GAAP has developed in this way for a number of reasons and we believe that these reasons may not have been fully considered by the IASB. We would therefore like to highlight some of the difficulties that will arise in practice as a result of having a prospective effectiveness test that is different from both the retrospective test incorporated in IAS 39 and the criteria applied under US GAAP:

Issues with inconsistency between prospective and retrospective tests

ISDA believes that there is a practical issue arising from the inconsistency between the prospective and retrospective tests that means that in practice the more restrictive prospective test will need to be applied for both. As the prospective test is required to be performed at each assessment date it is not clear how an organisation who tests retrospectively and has actual results that are within the 80% to 125% range but outside a range that would meet the “fully offset” criteria should then deal with its prospective assessment. It is difficult to see how a company in this position would be able to assert that it expects the hedge to “almost fully offset” going forward if its retrospective testing, albeit completely within the criteria of the standard, indicates otherwise.

Furthermore, under US GAAP, Statement 133 Implementation Issue E-7 indicates that prospective effectiveness testing “can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.” For this reason, many US GAAP filers use one regression test as the foundation for both their prospective and retrospective effectiveness tests. It is difficult to see how IAS filers would be able to do this given an “almost fully offset” standard, thereby creating incremental operational burdens under IAS 39.

Hedging interest rate exposure of debt

When a company issues debt to the market, the interest rate payable on the debt will include a market perception of the credit rating of the company as well as the market interest rate for the fixed term of the debt. Therefore, if a company chooses to hedge the interest rate exposure, it is likely that there will be a difference between the interest rate on the debt and that of the hedging swap, if it is executed at market rates. To illustrate, assume the current five year market interest rate is 5% and a company has a credit rating that equates to 200 basis points then its debt will be issued at 7%, and an “at the market swap” will be executed on which the company receives 7% and pays LIBOR plus a margin of 2%. This is equivalent to a swap that receives 5% and pays LIBOR.

IAS 39 illustrates in paragraph 128 that the “benchmark interest rate component” can be designated as a hedge, and the wording of this example is consistent with the allowance in paragraph 21(f)(2) of Statement 133 to hedge exposure to “changes in the designated benchmark interest rate”. As such, some of our members have been advised by the accounting firms that in testing effectiveness of this hedge, they must

follow the requirements in paragraph 21 of Statement 133 to include all of the hedged item's contractual cash flows (for example, they may not exclude "the portion of the interest coupon in excess of the benchmark interest rate"). Therefore, the effectiveness testing will assess a 5% swap against 7% debt. Under most testing methods, even though the economic hedge is clearly in place and the results would fall within the 80% to 125% retrospective range, the "almost fully offset" range of 95% – 105% may be breached.

The "almost fully offset" range may be breached due to the manner in which the credit-spread portion of the bond enters into the effectiveness calculations. If the contractual cash flows of the bond are discounted at the swap curve plus the original credit spread held constant, ineffectiveness is created due to "duration mismatch", meaning that although both the swap and the hedged item are initially at par, this will not be the case for future changes in value. Alternatively, if the contractual cash flows of the bond are discounted at the swap curve flat, the initial valuation of the bond used to compute changes in fair value for effectiveness testing purposes will not be par and will lead to ineffectiveness. Ironically, the treatment of credit spread in fair value calculations will create ineffectiveness in simple interest rate hedge relationships although issuers are not trying to hedge credit spread. This ineffectiveness is non-trivial.

If this was not the IASB's intention, then we would recommend that, at a minimum, the example included in paragraph 128 should be clarified.

ISDA acknowledges that the Board has stated that, the provisions in IAS 39 which allow a portion of the debt to be designated as the hedged item will allow the company to designate a percentage of the debt, somewhat less than 100%, to be the hedged item which will meet the "fully offset" criteria. However, whilst this is theoretically possible the practical implications of following this portions approach are extensive.

Moreover, although a clarification of Paragraph 128 would enhance the ability of companies to meet the "almost fully offset" criteria in this particular interest rate situation, other significant issues would remain. For example, even if a company interpreted paragraph 128 of IAS 39 to allow the portion of the bond coupons excluding credit spreads to be hedged, there would still be some ineffectiveness in the relationship arising from the fixing periods on the floating leg of the swap. To illustrate, assume that the same 7% bond is issued with annual coupons payable on the 15th of March each year. The company then swaps the 5% market interest rate excluding credit for a 6-month LIBOR swap, which resets on the 15th of March and the 15th of September each year. On 31 December, when the company calculates its effectiveness, the present value of the 5% coupon on the bond and the 5% fixed leg of the swap would both be calculated based upon the current 6-month LIBOR swap curve and would net to zero. However, the floating rate on the swap would have been set on the previous 15th of September. Thus, when the present value of the floating

leg payments are discounted using the 31 December curve, the fair value of the swap will show a positive or negative fair value which will not be offset by the fair value of the bond. Our experience is that, while this variance would not be expected to fall outside of the 80% - 125% range, it could very well fail the “almost fully offset” test.

It is our view that unless there are changes to the IAS 39 wording, our members will quite possibly be held to a standard under IAS 39 that will disqualify a simple hedge such as this example from hedge accounting, while the same relationship may qualify for shortcut treatment under US GAAP with no ineffectiveness recorded.

Non-financial exposure

The higher level of effectiveness will present severe problems for hedging of non-financial assets and liabilities, where a component approach is not allowed and the concept of partial hedging is not helpful. For example, an airline that has exposure to the forward price of jet fuel has a limited choice of hedging contracts the best of which may be to use gas oil derivative contracts. Whilst representing a sensible economic hedge of the exposure, proving effectiveness of this arrangement within the very strict “fully offset” criteria will be extremely difficult. The airline may well be in a position where there are no hedges that will meet the highly restrictive test to achieve hedge accounting.

Group treasury functions

A serious issue for the hedging of financial instruments will be situations where a firm uses transactions with an internal treasury desk to hedge assets and liabilities. As internal trades are not eligible for hedge accounting, it is necessary for firms to identify external derivatives that match assets or liabilities and designate these as hedges. In this process it is often not possible to find external derivatives (which are often executed on a net basis) that exactly match the gross asset or liability position in terms of amounts, tenure, interest rates etc., even though the net exposure is exactly offset. The use of an 80% -125% range made such an exercise feasible. Going forward, without this degree of flexibility, it will often be much more difficult to allocate external derivatives against individual assets or liabilities.