UNICE

THE VOICE OF BUSINESS IN EUROPE

18 November2003

Sir David Tweedie
Chairman
IASB
30 Cannon Street
London EC4M 6XH

Dear Sir David,

RE: IAS 39 *Financial Instruments; Recognition and Measurement - Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk and related issues*

UNICE has read attentively the above-mentioned exposure draft and some related discussion points 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 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.

1. Portfolio hedges of currency and other risks

We consider the draft amendment fully 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 tests almost impossible or requires administrative costs which are not justified by the benefits.

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

2. 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 hence refer to them in this letter without repeating them.

The decision to limit the applicability of IGC 134 1- b) to separate financial accounts that the Board took in its September deliberations was taken without any reference to the above-listed 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. In allowing IGC 134 1- b) to apply to consolidated financial statements also, there is 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 goes against the IASB due process since it has next been exposed by the Board. It constitutes a significant 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 that the IGC made sense in taking into account the economic and organisational underlying reality of corporates, those entities were right in planning their future accounting processes in accordance with the existing literature.

3. Hedging of a portfolio of commercial bids

Our comments here relate to entities that deal with 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 develop into 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 practice of these entities show 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 arid is therefore complied with. Inefficiency can be determined and accounted for adequately. This practice is therefore compatible with the basic principles set up 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 cut-flows of currencies can be reliably estimated and adequately documented, is regarded as a highly probable future transaction.

4 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 this '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 IAS39 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 146 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 146 is not modified to allow the designation of net positions as hedged items. In particular, we are of the opinion that:

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. In as much 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.

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

5. Initial effectiveness

The present rules on hedge effectiveness are very strict and we do not believe that the requirement that a hedge is almost entirely effective at inception reflects the economic substance of the 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 much 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.

6. Change made to IFRS 1 regarding the retrospective application of IAS 39 derecognition requirements

Last July, the Board decided to change IFRS 1 so that the exception made regarding retrospective application of IAS 39 derecognition requirements is set as of 1 January 2004.

Some entities however are listed in the US and have therefore planned their conversion to IFRS with a transition date being 1 January 2003. Those entities have planned their conversion effort well in advance, leaving some room for late adjustments arising from the last decisions to be made by the IASB. The conversion effort for these entities is an exceptional challenge since they compete with other entities in the US financial markets that offer consistency throughout periods in the presentation of their financial position and performance.

Those entities need to rely on a consistent IFRS 1 that should authorise a consistent set of standards to be applied from the transition date.

We therefore ask the Board to change its July decision on this account to set out that the exception to retrospective application of IAS 39 derecognition requirements is set as of 1 January 2004, unless retrospective application of IAS 39 derecognition requirements can be made as of the transition date if earlier and in full compliance with IAS 8 revised requirements.

We hope that the above concerns will be taken into account in your discussions and remain at your disposal to discuss them further.

Yours sincerely,

Jerôme P. Chauvin
Director, Company Affairs Department