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Dear Sir

ISDA's comments on FRED 23

The International Swaps and Derivatives Association (ISDA) appreciate the opportunity to comment on FRED 23 Financial instruments: Hedge accounting and we attach our response.

ISDA's members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such we believe ISDA brings a unique and broad perspective to the ASB's work.

As set out in our attached letter "Implementation of International Financial Reporting Standards (IFRS) in the UK" dated Monday 16th September 2002, while ISDA recognizes that the implementation of International Accounting Standards represents a monumental change, we believe that the piecemeal, incremental approach proposed by the ASB represents an onerous and complex method of transition. As a result, we are not supportive of the introduction of a UK standard on hedge accounting as an interim measure. In addition, it is premature to introduce a standard which sets out the conditions when financial instruments including derivatives may be afforded hedge accounting treatment, when there is no standard yet in place which otherwise determines the accounting for these items.

Nevertheless, we welcome the ASB's efforts to develop a standard that sets out general principles for hedge accounting, rather than detailed rules. We are also pleased that the proposal does not (for example) prohibit the application of hedge accounting on a portfolio basis, nor preclude the use of "internal" hedges between different parts of an organisation. We encourage the continued development of this approach as part of the longer-term project to develop a principles-based framework for accounting for financial instruments.

We would be pleased to discuss our comments with the Board or staff. Please contact either Sue Harding, Chair, ISDA European Accounting Committee, at 7888-2664 or Ed Duncan, Assistant Director of European Policy for ISDA, at 7330 3574.

Yours faithfully

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Sue Harding
Chair of the ISDA Accounting Committee
and

A handwritten signature in black ink, appearing to read "Ed Duncan". The signature is bold and blocky, with a long, horizontal underline that extends across the width of the signature.

Ed Duncan
Assistant Director of European Policy at ISDA

Question 1

Do you agree that a UK standard on hedge accounting is needed at this time to improve UK accounting and to prevent a gap appearing in UK accounting literature on hedges of net investments in foreign operations?

No, ISDA does not believe that an interim UK standard on hedge accounting is necessary at this time. We do not believe that the gap in itself presents an issue. The hedge accounting principles currently contained in SSAP 20 are sufficiently well established that it is unlikely that firms would seek to apply, or auditors permit, hedge accounting that would not comply with the principles of SSAP 20 after it has been replaced.

There is also a tax concern with the proposal as drafted:

Whereas SSAP 20 allows (paragraph 46) an item hedged by a forward foreign exchange contract to be recorded at the contract rate, FRED 23, as drafted, does not explicitly permit this treatment. Paragraph 2) in the draft standard imply that the hedged item and the hedging transaction should each be constantly retranslated. While there will be little or no difference in the effect on the profit and loss account, UK tax legislation on hedging transactions assumes that it is the norm to value hedged items at the hedge rate and so there is a risk that companies could experience unfair tax consequences if a new standard is put in place before the tax rules can be amended.

Question 2

The ASB has taken the view that, in order to start the process of bringing UK practice on hedge accounting into line with the practice adopted internationally, the proposed UK standard's restrictions on the use of hedge accounting should be based on the main principle that underlies the hedge accounting restrictions in IAS 39: that hedge accounting should be permitted only if the hedging relationship is pre-designated and meets certain effectiveness criteria.

- a) Do you agree that the UK standard should be based on the principles underlying IAS 39 as set out in the FRED?
- b) Does the principle need to be supplemented by any other principle?

- a) If the ASB believes that it does need to introduce a hedge accounting standard at this time, we agree that the principles should be based on those underlying IAS 39, so as to avoid further change when IAS are implemented in the UK.
- b) No, we support the main hedging principle underlying IAS 39.

Question 3

The ASB has taken the view that the UK standard should contain those detailed restrictions in IAS 39 that appear to it to be necessary to implement the aforementioned principle, but should not at this stage include any other restrictions on the use of hedge accounting.

- a) Do you agree that the FRED's proposed restrictions on the use of hedge accounting (see paragraphs 4, 6 and 8 of the FRED) are all necessary to implement the aforementioned principle?
- b) Do you agree that the FRED should not contain any other restrictions on the use of hedge accounting? If not, what should those other restrictions be?

- a) With the important caveats set out above, yes.
- b) Yes, it should not.

Question 4

Do you agree with the material in the FRED on measuring hedge effectiveness (see paragraphs 9-15 of the FRED)? If you do not, what if any changes would you make to the material (bearing in mind that the material is drawn largely from IAS 39 and that one objective of the FRED is to being about convergence of accounting practice)?

With the caveats set out above, largely yes. However, the proposals would prevent hedge accounting for hedges taken out to protect against fluctuations in the projected value of a portfolio of financial instruments based on the forecast behaviour of the counterparties rather than the contractual terms. Such hedges are an important risk management tool for banks who need to control their interest rate expense on their deposit base.

Question 5

The ASB has taken the view that, in the main, the proposed FRS should not prescribe how hedge accounting should be done. Do you agree with this approach?

As discussed above, we do not believe that an interim UK standard should be issued and it would be inappropriate to prescribe how hedge accounting should be carried out in the absence of a standard on how derivative instruments should otherwise be accounted for.

Question 6

The ASB has nevertheless decided that the FRED should propose some minimum requirements on the hedge accounting techniques to be used. Do you agree with the FRED's proposals on:

- a) the treatment of hedges of net investments in foreign operations (see paragraph 16(a) of the FRED)?
- b) the treatment of the ineffective portion of a gain or loss on a hedge that is not a hedge of a net investment in a foreign operation (see paragraph 16(b) of the FRED)?
- c) the treatment of hedging instruments that cease to qualify for hedge accounting (see paragraphs 17 and 18 of the FRED)?

a) Yes. However paragraph 51 of SSAP 20 explicitly allows a company in its non-consolidated accounts to reflect the hedging of a foreign entity investment by retranslating the investment and the hedge and offsetting, to the extent permitted, the retranslation differences through reserves. It is unclear whether this will be possible under FRED 23, as drafted. It is not clear whether paragraph 16(a) of FRED 23 refers to an investment in the company's individual accounts, given that the term "net investment in a foreign operation" is normally used in the context of consolidated accounts. The concern that FRED 23 only refers to the consolidated treatment is reinforced by the definition of the term in paragraph 6 of FRED 24. Further, paragraph 21 of FRED 24 states clearly that a non-monetary item shall be recorded at its historical rate and not retranslated, with no explicit exemption to this rule comparable to that in SSAP 20. In addition, as FRED 23 is silent on the treatment of effective hedges, there will be no basis in the UK accounting literature for taking the retranslation of a loan hedging an investment in a foreign subsidiary to reserves.

b) and c) As with question 5, it is inappropriate to issue a UK standard on this subject at this time, but we agree with the principles set out in the exposure draft.

Question 7

The ASB is proposing that the standard should come into effect for reporting periods ending on or after a date in early 2003, although it is also proposing certain transitional arrangements (see paragraph 20 of the FRED). Do you agree with this approach?

As set out in our answers to questions 1 and 2 above, ISDA does not believe that a standard on hedge accounting is necessary at this time.

Issues not covered by ASB questions

In two cases, the drafting could be improved:

- a) The accounting treatments set out in the definition of hedge account are stated as “assuming that historical cost is being used”. However, most firms that trade in financial instruments and use fair valuation accounting principles regard themselves as using the historical cost accounting rules set out in the UK Companies Act but with modification. We recommend that rather than “assuming historical cost is being used”, the standard says “assuming that the accounting policy applied does not recognise profits arising from changes in fair value”.
- b) Paragraph 5 as drafted is ambiguous. It says that hedge accounting is available for hedging instruments that are financial instruments but “not for hedged items that are financial instruments”. As worded, this can be read to mean that if the item being hedged is a financial instrument then hedge accounting is not available, even for the hedging instrument. The paragraph would be clearer if it was reworded to read “Under the [draft] FRS, hedge accounting is available for hedging instruments that are financial instruments but not for the hedged items, even if they are financial instruments”.