Developments in IAS 32 and 39 - Financial Instruments (Issue 6)
Introduction
This edition of our Developments in IAS 32 and 39 newsletter covers the discussions relating to financial instruments at the IASB meetings held in January and February 2004, and the IFRIC meeting in January. This includes some welcome news concerning the prospective hedge effectiveness test – bringing the requirement closer to US GAAP – and useful clarification of how portions of risk – such as exposure to risk free interest rates – can be hedged. Also included in this newsletter is a commentary on an article written by the European Central Bank on the impact on the European banking sector of the use of fair value accounting.

IASB developments
The following summarises the conclusions of the Board at their January and February meetings, based on observation of the meetings and the IASB Updates (available on www.iasb.org).

Demand deposits
The Board tentatively decided in January not to reconsider the proposal in the macro hedge Exposure Draft (“ED”) that a core deposit cannot qualify for a fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand repayment.

The Board also tentatively decided not to change paragraph 49 of IAS 39 which states: “The fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.”

When applying the approach proposed in the ED to fair value macro hedge accounting, all the assets or liabilities on which the hedge amount is drawn must be items whose fair value will change in response to changes in the interest rate being hedged, and so would have qualified for fair value hedge accounting if they had been hedged individually.

This raises problems where the hedged items are demand deposits, ie deposits that can be redeemed by the holder on demand. Because IAS 39 specifies that the fair value of a financial liability that can be redeemed on demand can never be less than the amount payable on demand, its fair value will not change in response to changes in the interest rate being hedged. As a result, a demand deposit will not normally qualify for fair value hedge accounting.

Even after considering the strong arguments put forward by various financial institutions, the IASB has decided not to alter its “principles”. Therefore, the treatment of repayment risks on assets remains inconsistent with the treatment of liabilities with similar risk characteristics. In addition, financial institutions will often be unable to use fair value hedge accounting to lock in the interest rate spread on their deposit base. We expect this matter will continue to be a significant source of debate.

Other macro hedging issues
In January, the Board considered a number of points raised by respondents to the macro hedge ED. Its tentative decisions included:

• to retain the proposal in the ED that a net position cannot be designated as the hedged item;
• that when the hedged item is designated as an amount, the final standard will specify a method for designating the hedged item and measuring its effectiveness;
• to require a method of designation, so that changes in the value of a hedged prepayable asset that are attributable to interest rates should include the effect that interest rates have on prepayment rates;
• where an entity can reliably measure the change in fair value of an entire asset or liability that is attributable to changes in interest rates (including the effect that the change in interest rates has on prepayment rates), it should use this method to measure the effectiveness of the hedge. However, in all other cases, the entity should use the percentage method proposed in the ED; and
• to clarify that when prepayment estimates change because of factors other than changes in interest rates, no ineffectiveness arises.

In February further tentative conclusions included:
IAS 39’s effectiveness requirements should apply to a macro hedge. That is, the proposals in the ED are not an alternative to, and do not overrule, IAS 39’s effectiveness tests;

the final standard will clarify that if the entity’s strategy is to ‘rebalance’ a macro hedge periodically, by altering the amount of the hedging derivative to reflect changes in the hedged position, the entity, when assessing whether the hedge is effective on a prospective basis, only need demonstrate an expectation that the hedge will be highly effective over the period to when the hedge is next adjusted. The Board accepted that the guidance provided in the standard was inconsistent and this would need to be amended;

the final standard will clarify that the retrospective macro fair value effectiveness test may be assessed for all time buckets in aggregate and not individually for each time bucket. The entity will be left to determine the most appropriate way to assess hedge effectiveness;

gains and losses arising on macro hedges should be amortised when practicable on the basis of a recalculated effective interest rate and, when not practicable, using a straight line method.

Fair value option

The Board tentatively agreed in February to amend IAS 39 so that the fair value designation will be applied only in specific circumstances to a financial asset or financial liability. The Board tentatively decided to publish these proposals as an ED.

The revised IAS 39 published in December 2003 allows any financial asset or financial liability, on initial recognition, to be designed as a financial asset or financial liability recorded at fair value with gains and losses taken through profit or loss. European financial regulators have since expressed concerns that an entity may seek to apply the fair value option to financial assets and financial liabilities even where, for risk management purposes, the instruments are managed on an amortised cost basis (eg originated loans). The Board considered these views and agreed that they had specific circumstances in mind when developing the option, and tentatively agreed to limit its application to the following circumstances:

1. when the item is a financial asset or a financial liability that contains one or more embedded derivatives;
2. when the item is a financial liability whose amount is contractually linked to the performance of assets that are measured at fair value; and
3. when the exposure to a change in the fair value of the financial asset or financial liability is substantially offset by the change in the fair value of another financial asset or financial liability, including a derivative.

The Board noted that some entities might wish to use the fair value option for financial assets in cases other than the three set out above. Such entities include investment trusts and venture capital entities for which industry practice is to measure all financial assets at fair value through profit or loss and some insurance companies that seek to match, in part, the valuation of their liabilities. To address this issue the Board tentatively agreed to allow the use of the fair value option for any available for sale financial asset, other than a loan or a receivable.

In addition, the Board tentatively agreed that a financial asset or financial liability may be designated at fair value through profit or loss only if its fair value is verifiable and that the application of the fair value is consistent with the entity’s risk management policies and objectives.

The IASB’s Information for Observers suggested that the verifiable criteria will be met only where the fair value estimate is based on:

1. observable current market transactions in the same instrument;
2. a valuation technique that is calibrated regularly to observable current market transactions in the same instrument or to other observable current market data;
3. a valuation technique commonly used by market participants to price the instrument that has been demonstrated to provide
reliable estimates of prices obtained in actual market transactions; or

4. a range of possible outcomes whose probability can be reasonably assessed.

When a financial instrument is classified as held for trading or as available for sale there is a presumption that the asset is reliably measurable and should be held at fair value. In contrast, the verifiable concept has been designed for assets not normally held at fair value and establishes a principle that an entity will not necessarily be able to establish a fair value unless it is verifiable. This is a significant change and will attract a great deal of comment.

The revised IAS 39 published in December 2003 made it easier for entities to achieve the same results as hedge accounting, by fair valuing both the hedged item and the hedging instrument, without the need to meet the hedge account criteria. The proposed change would restrict an entity’s use of the rule.

Examples of possible problems due to the proposed new rules include:

i) firms will not be able to fair value their fixed rate liabilities as natural hedges of the interest rate on fixed rate assets, unless changes in the fair value of the two instruments ‘substantially offset’. Presumably this means that there would have to be limited exposure to credit spread on either the asset or the liability and they will need to have matching interest terms. Not only will this reduce the frequency with which liabilities may be fair valued, but introduces a bureaucratic process similar to that for hedge accounting;

ii) banks may have sought to fair value loans where they have taken out protection through credit derivatives, to avoid the need to use hedge accounting. This might no longer be feasible, if changes in the loans’ fair values do not “substantially offset” changes in the value of the derivatives, or if the fair values are not deemed to be “verifiable”; and

iii) presumably the IASB intends the application of circumstance 3 (ie where exposures to changes in fair value are substantially offset) to be applied on an asset by asset or liability by liability basis, and will provide no mechanism to match assets and liabilities on a portfolio basis.

The Board is encouraged to avoid restricting the application of the fair value option to this extent. Also, care needs to be taken to provide clarity as to what is meant by terms such as “substantially offset”.

**Hedge effectiveness**

The revised IAS 39 states that a hedge qualifies for hedge accounting only if it meets both of the following conditions:

a) the hedge is expected to be highly effective (the “prospective effectiveness test”). This will be the case only if it is expected that the changes in the fair value or cashflows of the hedging instrument will “almost fully offset” those of the hedged item from the hedged risk; and

b) the hedge is determined actually to have been highly effective (the “retrospective effectiveness test”). This will be the case if the actual results of the hedge are within an 80-125% range.

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b) the hedge is determined actually to have been highly effective (the “retrospective effectiveness test”). This will be the case if the actual results of the hedge are within an 80-125% range.

The Board tentatively agreed to amend the wording on prospective hedge effectiveness in the IAS application guidance. The words “almost fully offset” will be deleted and replaced by a requirement that the hedge is expected to be highly effective. The application guidance will also include a statement that if an entity hedges less than 100% of the exposure of an item, such as 85%, it shall designate the hedged item as being 85% of the exposure and shall measure ineffectiveness based on the change in that designated 85% exposure.

This is a welcome change that will make hedge accounting much easier to achieve, especially for hedges of non-financial items.

The Board tentatively agreed to clarify the extent to which it is possible to hedge a “portion” of a financial asset or liability.

The final standard will clarify that when a hedged item is designated as a portion, such as the risk free interest rate, of a financial asset or liability, ineffectiveness in the retrospective test
should be measured by measuring changes in the fair value or cashflows of that designated portion.

However, if an entity designates a portion of the exposure of a financial asset or financial liability, that designated exposure must be less than the total exposure inherent in the asset or liability. For example, for a liability whose interest rate is below LIBOR, an entity cannot identify a LIBOR portion and a negative residual portion, and so hedge just the LIBOR risk without recording ineffectiveness.

In contrast, if a fixed rate financial instrument is not hedged at its origination, and interest rates have changed in the meantime, the entity can designate a portion that is greater than the contractual rate paid on the item. For instance, if the entity originates a financial asset paying a fixed rate of 6% when LIBOR is 4% and begins to hedge the asset when LIBOR is 8%, the entity can designate the asset as containing a LIBOR portion of 8%, that consists partly of a contractual interest flows and partly of the unwinding of the difference between the present fair value and the amount payable on maturity.

The Board also confirmed that an entity can designate any portion that is smaller than the total exposure on the hedged item, regardless of whether that portion is highly correlated for the pricing of the hedged item. For example, an overdraft issued by a bank can be viewed as containing a LIBOR portion even if the overdraft rate is not highly correlated with LIBOR.

The effect of this to clarify that hedge accounting is permitted even where the hedged item pays interest at a higher rate, due to a credit spread. It also confirms that banks can apply hedge accounting to their overdraft assets. But, this clarification will usually prevent a bank from obtaining hedge accounting treatment for its deposit base, even if they are term deposits, rather than demand deposits (see above). This conclusion will not be popular in the banking industry, not least since the logic is not clear – why can’t a component be greater than the whole?

Also, this clarification is, according to the IASB Update, restricted to the retrospective test. Presumably, the same interpretation needs to be extended to the prospective test.

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**Consolidation (including special purpose entities)**

The Board tentatively decided, in principle, that holdings of potential voting rights are relevant to an assessment of power when, as a result, the holder has the ability to dominate policy determination. The Board also tentatively decided that there is a rebuttable presumption that the holdings of certain entities or parties should be assumed to be available to an investor, in assessing its ability to satisfy the power criterion.

The Board continued its discussion of the concept of control as the basis of consolidation. This was debated at the September meeting when the Board tentatively agreed that the concept of control should require satisfaction of three criteria:

- the ability to set strategic direction and to direct financial and operating policy (the “Power criteria”);
- the ability to access benefits (the “benefit criteria”); and
- the ability to use such powers so as to increase, maintain or protect the amount of these benefits.

This is part of a longer term project that will not be completed before 2005 (see our October IAS 32 and IAS 39 Developments newsletter). The Board decided in principle that holdings of potential voting rights (such as unexercised options or convertible instruments) are relevant to an assessment of power when, as a result, the holder has the ability to dominate policy determination. However, the Board did not decide on the particular circumstances in which such holdings should be included.

The Board also discussed how the holdings of “straw men” or de facto agents (entities that act as an agent for another investor) should be treated in assessing an entity’s ability to satisfy the power criterion. It tentatively decided that the following are straw men:

- the investor’s related parties as defined in IAS 24 Related Party Transactions;
- an entity that receives its interest in the investee as a contribution or loan from the investor;
c) an entity that has an agreement that it cannot sell, transfer or encumber its interest in the investee without the prior approval of the investor;

d) an entity that cannot finance its operation without financial support from the investor;

e) employees of the investor (where highly likely to be dominated by the investor);

f) an entity that has a close business relationship with the investor (again where it is highly likely to be dominated by the investor); and

g) an entity with the same board of directors as the investor’s.

IFRIC Developments

IAS 27 – Consolidation of Venture Capital Funds

The revised IAS 27 Consolidated and Separate Financial Statements requires consolidation of any controlled entity, where control is defined as being “the power to govern the financial operating policies of any entity so as to obtain benefits from its activities”. This definition is notably different from that in SIC 12 – dealing with SPEs – in that there is no mention of whether the controller obtains the majority of the benefits from the entity’s activities. There is a concern whether managers of venture capital investment funds need to consolidate the funds they manage: they often have the power to govern the financial and operating policies of the investments, and benefit from doing so, but will not normally hold a majority interest in those investments.

This issue was discussed by the International Financial Reporting Interpretations Committee (“IFRIC”) at its meeting in January. At the meeting it was only noted that IFRIC needed to understand the issue better and has asked the staff to work with the EFRAG to develop the issue.

Members’ shares in co-operative banks

At their January meeting the IFRIC also discussed the treatment of members’ shares in co-operative bank and whether they should be classified as debt or equity under IAS 32. This issue has arisen because IAS 32 (revised) seems to argue that all shares in co-operatives need to be regarded as debt instruments, since they are redeemable.

At the meeting, the IFRIC took advice from representatives of co-operative organisations in Europe. It concluded that, except for the redemption feature, none of the specific characteristics of co-operative shares indicate that they are liabilities rather than equity. It also noted that the redemption rights are often constrained in many jurisdictions by regulators and are designed primarily to help make a market in the shares. The IFRIC also wants to look at whether there could be more helpful ways of presenting the balance sheet of entities whose shares do not meet the definition of equity, than the illustrations provided in IAS 32.

Discussions will continue.

The Impact of Fair Value on the European Banking Sector

Introduction

In February, the European Central Bank (“ECB”), in its Monthly Bulletin, prepared an analysis of the impact of fair value accounting (“FVA”) on the European banking sector, concerned about the financial instability that could arise from its application. This can be obtained from the ECB’s website: www.ecb.int. The analysis may be misunderstood, since it implies that most of the implications of FVA will flow from the introduction of IAS 39 when European banks have to comply with International Financial Reporting Standards (“IFRS”) in 2005. However, a full FVA model will not be imposed for a number of years, not least because some of the issues described in the Bulletin.

The only significant change in the application of FVA in the revised version of IAS 39 is an irrevocable option that entities can exercise when they first record an instrument, to measure it at fair value, with gains or losses taken to the profit and loss account. The implication of the ECB analysis is that this will give rise to three significant concerns: that it will increase volatility in banks’ financial statements, impose difficulties in establishing the fair value of such instruments, and, third, raises the possibility that banks could report profits as a result of
deterioration in their own credit risk. Each of these is discussed, in this article, in turn.

**Volatility**

The ECB assumes that the use of the fair value option will be to increase the volatility of banks’ reported profits, whereas we believe that it is more likely to be used to reduce it. This is because it will enable items which are entered into as a natural hedge to be measured on a consistent basis, and so avoid the need to comply with the complex and challenging hedge accounting rules.

For instance, banks may issue bonds that contain embedded derivatives, so that repayment of the principal is linked to equity prices, credit events etc. While the embedded derivative is, rightfully, required to be recorded at fair value, under the previous version of IAS 39 it was not possible to fair value the entire instrument. As a result, where they contained interest rate risk (as many bonds have a fixed rate coupon) it was necessary to establish that there were external interest rate derivatives that could be allocated as a hedge, to get the “correct” accounting treatment. Since most banks do not normally choose to hedge using derivatives with the outside world, but through their own derivative desks, banks have had to go through a complex and time-consuming process to achieve this, (or else accept assets and liabilities being recorded using different measurement rules). Applying the new fair value option in the revised IAS 39, banks can just fair value the bonds and so measure all of the components of risks on a consistent basis.

A second example of where the option to hold at fair value would decrease volatility of earnings is loans, where the bank chooses to hedge the credit risk by entering into credit derivatives. Using the fair value option in the revised IAS 39, it is now possible for banks to fair value the loans as well as the hedging credit derivatives (and, possibly, interest rate derivatives if the loans are at a fixed rate) and so simplify their accounting and reduce profit and loss volatility.

The vast majority of banks will go to considerable lengths to avoid introducing unnecessary volatility into their reported results. Given that trading gains and losses are specifically required to be disclosed, analysts and other users of accounts always tend to regard trading gains as lower quality earnings, with the consequent impact upon the price at which banks’ shares will trade. As a result, the investment banks, such as Morgan Stanley and Merrill Lynch, have sought over the last ten years to move into businesses where their earning stream is far less volatile, with activities such as custody, asset management, credit card issuance etc, to improve the quality of their earnings. If any bank uses the fair value option in IAS 39 in order to deliberately increase its earnings volatility then it is likely to be punished by the equity markets for doing so.

**Difficulty**

The second concern of the ECB is the difficulties in valuing certain instruments. This is indeed one of the reasons why a full FVA model is impractical at this time, but is less of an issue for the fair value option in the revised IAS 39. This is mainly because banks are unlikely to exercise the option to fair value the instrument unless it can be reliably measured and they have the systems to do so. Also, there are restrictions on the recognition of profits on a transaction at the outset, where it is not traded in an active market. However, the ECB does raise a genuine concern with the wording of IAS 39, in that it only precludes instruments from being recorded at fair value if they are equity instruments whose fair value cannot be reliably measured.

At the prompting of the ECB and others, the IASB is preparing to issue a new ED to further amend IAS 39 to limit the use of the fair value option (see IASB Developments, above) – but to such an extent that its utility could be significantly restricted. The IASB would be better served simply to extend the limitation applied to equity instruments to all financial instruments. The limitations currently envisaged would continue to require the use of fair value hedge accounting in many situations, thereby requiring entities to incur additional costs to prevent income statement volatility, the very issue that so concerns the ECB.

**Own debt**

The third concern of the ECB, that banks could record a profit by fair valuing their own debt when their credit rating declines, is a fair concern and one which was raised by many
realise the gain that IAS 39 requires to be reported. Until the standard setters address this fundamental issue, we will continue to suffer from inconsistent and perplexing rules surrounding the application of FVA.

However, we strongly believe that these issues should not prevent the IASB from moving forward with their original proposal on the fair value option, to solve a fundamental problem created by the current mixed-measurement model that requires complicated and costly hedge accounting.

**Loan provisioning**

The ECB is also concerned that if loans are recorded at fair value there will be considerably greater income statement volatility than the current accounting for loans, where provision is only permitted “by regulations in most countries”, when narrowly defined impairment conditions are encountered. This not only implies that accounting in many European countries is currently determined by tax regulation, rather than by prudent accounting concepts, but also suggests that there are many banks whose loans are only provided for if they have demonstratively gone bad.

In contrast, it has long been a tradition in Anglo-Saxon banks to provide not only for loans where impairment can be specifically identified, but also for losses which are believed to be inherent in the portfolio but not yet made manifest. One of the major concerns of the ECB should be to promote consistency of loan provisioning and to ensure that it is not constrained by local tax regulation.

Unfortunately, one of the worst aspects of the new IAS 39 is that the rules on loan impairment are written so vaguely that they are likely to be applied differently in different countries, so as to lead to no great change in existing accounting practice. Consequently, they will not provide for the consistency of reported results across European banks that should be a primary objective of both the capital markets and the European bank regulators.

The analysis in the ECB Bulletin goes on to express a concern that during favourable periods of the economic cycle, use of fair value for the loan portfolio could give rise to considerable gains and hence an increase in own funds,
thereby providing the basis for further lending, and so leading to a spiral of over-extension by the bank. While the concern is valid, it ignores the important regulatory tool of capital requirements in respect of such risks.

In the new Basle credit model, whose introduction has unfortunately been delayed, capital requirements are assessed based upon the expected losses on the loans and to the extent this is not reflected in an accounting provision it forms part of a bank’s required capital. As a result, a bank’s own funds should be significantly less sensitive to changes in the fair value of loans than the Bulletin implies. Further, it should be possible for banking regulators to require that trading book capital requirements are applied whenever banks choose to record items at fair value through profit and loss account, so helping ensure that the risks are always commensurate with a bank’s capital base.

Risk appetite

Interestingly, the ECB then goes on to raise the concern that to reduce volatility in reported income using FVA banks may take on less risk. It introduces the example that banks may “be reluctant to grant fixed rate or long term loans for fear that the interest rate risk will manifest itself in the financial statements”. But why should deposit taking institutions enter into such risks? If they do not choose to hedge themselves, or mis-price the loans so as not to cover the price of hedging, then surely this is an activity that needs to be stamped out by the regulators? If it takes a move to FVA to stop banks taking on inappropriate risks, then the introduction of FVAs is to be applauded rather than a matter of concern.
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