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THE INSTITUTE OF
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IN IRELAND

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14 November 2003

Dear Ms Thompson,

Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

The Accounting Committee of the Institute of Chartered Accountants in Ireland's ("AC") response to the above exposure draft is set out below.

AC supports the Board's aim to develop an approach to fair value hedge accounting for a portfolio hedge of interest rate risk that is workable in practice, allows data captured for risk management to be used in preparing financial statements and would not require major system changes.

Measurement of effectiveness

AC believes that approach D should be the default position for entities with regard to the assessment of effectiveness and the measurement of ineffectiveness. However, if this approach is clearly inconsistent with the actual risk management strategy adopted by the entity, then the entity should be allowed to apply a model which best equates to its risk management strategy providing it provides adequate disclosures in its financial statements. This is consistent with the rest of IAS 39 which requires entities to base their assessment of effectiveness on their risk management objectives and strategies without specifying how an effectiveness assessment should be carried out.

Systems issues
AC would like to point out that the need to track the fair value adjustments arising from the Exposure Draft's hedging approach will require considerable systems support as the tracking of these adjustments will be very complex in practice. The requirements for such systems support is not consistent with the Board's objective of not requiring major systems changes.

Consistency with hedging rules in IAS 39
AC assumes that the requirements of the exposure draft will be included in the hedging section in IAS 39 and that normal hedging rules will apply to these hedges.

Question 1
Draft paragraph 128A proposes that in a fair value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount. For example, it may hedge the change in the fair value of the designated amount attributable to changes in interest rates on the basis of expected, rather than contractual, re-pricing dates (The re-pricing date of an item is the date on which the item will be repaid or re-priced to market rates). However, the Board concluded that ineffectiveness arises if these expected re-pricing dates are revised (e.g. in the light of recent prepayment experience), or actual re-pricing dates differ from those expected. Draft paragraph A36 describes how the amount of such ineffectiveness is calculated. Paragraphs BC16-BC27 of the Basis for Conclusions set out alternative methods of designation that the Board considered, their effect on measuring ineffectiveness and the basis for the Board's decisions including why it rejected these alternative methods.

Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness? If not,

(a) in your view how should the hedged item be designated and why?

(b) would your approach meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit or loss?

(c) under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet?

AC agrees with the board's proposals.

(a) However, as discussed above, where an entity can clearly demonstrate that approach D is inconsistent with its actual risk management strategy and discloses in its financial statements in detail its actual risk management strategy (supported by management actions rather than intent) along with the reasons for the inapplicability of approach D to this strategy, then the entity should be allowed to assess effectiveness using the model that best aligns to its risk management strategy. Again, the model applied should be disclosed in detail in the financial statements. An example of a risk management strategy that would not be consistent with approach D is where an entity purposely under-hedges to avoid ineffectiveness caused by prepayment risk (here approach C may be more appropriate).

(b) AC does not believe that under-hedging should always give rise to ineffectiveness. In cash flow hedging under IAS 39, under-hedging does not cause ineffectiveness. The model in the exposure draft is essentially based on cash flows and, therefore, it is inconsistent to require ineffectiveness to be recorded in this model where an under-hedging strategy is adopted.

(c) AC believes that entities should be given the option to amortise the balance sheet line items over the period to derecognition or to defer and remove at derecognition. Such a choice already exists in IAS 39 for all other fair value adjustments to hedged items. Failure to allow amortisation is not consistent with the rest of IAS 39 and would produce excessive volatility in the profit and loss account at maturity.

Question 2

Draft paragraph A30(b) proposes that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair value hedge accounting if they had been designated individually. It follows that a financial liability that the counterparty can redeem on demand (i.e. demand deposits and some time deposits) cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. Paragraphs BC13-BC15 of the Basis for Conclusions set out the reasons for this proposal.

Do you agree that a financial liability that the counterparty can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment? If not,

(a) do you agree with the Board's decision (which confirms an existing requirement in IAS 32) that the fair value of such a financial liability is not less than the amount payable on demand? If not, why not?

(b) would your view result in such a liability being recognised initially at less than the amount received from the depositor, thus potentially giving rise to a gain on initial recognition? If not, why not?

If you do not agree that the situation outlined in (b) is the result, how would you characterise the change in value of the hedged item?

(a) AC agrees that a financial liability that a counterparty can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. However, AC does not believe it is appropriate for the board to conclude on the fair value of deposits before its comprehensive measurement project has been completed. There are a number of significant issues that need to be explored in this review prior to determining fair value including entry versus exit value, customer behaviour and portfolio versus individual accounts. As this comprehensive measurement project is not yet complete, AC does not believe that it is possible, at this point in time, to determine the fair value of demand deposits with reliability.

(b) As mentioned above there are significant issues that need to be addressed before finalising the determination of the fair value of demand deposits. However, should the board's overall review of fair values indicate that the fair value of a deposit could be less than its cost, then it could give rise to a gain on initial recognition.

Other comments

Since available-for-sale assets are available for fair value hedging under IAS 39, AC assumes that they can be included in the portfolio of assets and liabilities used to determine the amount of the hedged item. However, this gives rise to practical difficulties that are not addressed in the exposure draft. In particular, the entity would need to establish a methodology to determine the proportion of the fair value adjustment that has already been reflected in the carrying amount of available-for-sale securities and the amount that related to assets held at amortised cost. This will have significant systems implications in tracking the subsequent derecognition of the assets.

Yours sincerely

Simon Magennis
Secretary
Accounting Committee
Institute of Chartered Accountants in Ireland