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Sir David Tweedie
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30 Cannon Street
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13 November 2003

Dear Sir David

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

We are responding to your invitation to comment on the above exposure draft on behalf of the worldwide organisation and the Global IFRS Board of PricewaterhouseCoopers. We respond below to the questions posed in the exposure draft. We also include comments on certain detailed aspects of the proposed amendments to IAS 39.

We welcome the Board's willingness to enter into a dialogue with the banks to develop an approach to fair value hedge accounting for a portfolio hedge of interest rate risk that is workable in practice within the confines of a bank's risk management systems without requiring major systems changes.

Whilst we support a principles-based approach to accounting, our response recognises that the IAS 39 requirements relating to hedge accounting are essentially a set of rules designed to permit exceptions to the general measurement principles in IAS 39. The hedge accounting model proposed in the exposure draft is an exception to those rules and therefore it is inappropriate to place too much emphasis on principles in evaluating the proposals. We believe that a number of improvements are needed to make these proposals operational in practice.

We encourage the Board to focus on the practical application of the proposed approach and to ensure that it reflects, as closely as possible, the economics underlying the risk management strategies that have been developed and applied by management within the regulatory environments in which they operate. It follows from this that any designation and assessment of effectiveness should be based on the entity's own risk management objectives and strategies and applied on a consistent basis. The Board should not insist on a single method in an attempt to justify the use of a fair value hedge accounting methodology.

We note that the approach to hedging interest rate risk on a net basis adopted by most banks is neither a cash flow nor a fair value hedging strategy, but rather a hedge of net interest margin. The methodology proposed in the exposure draft is based largely on the approach used in IGC 121-2 and reflects a cash flow hedging strategy since it requires assets and liabilities to be scheduled based on their expected repricing dates. However, the Board is seeking to apply fair value hedge accounting to this strategy. As a result, the measurement of effectiveness required by the proposed standard is contrived.

Nonetheless, we recognise the need for banks to limit exposure to volatility in their capital in light of the various regulatory frameworks that they operate in, as well as the need to minimise systems changes. We would therefore support an approach that reflects as closely as possible the way in which banks actually manage their interest rate risk. We would also encourage the Board to give equal status to the other interpretative guidance on portfolio hedging of interest rate risk (IGCs 121-1 and 121-2).

In addition to ensuring that any proposals are closely related to the reporting entity's risk management strategy, we also support the Board's objective of making them workable in practice. Some of the changes proposed in the exposure draft, such as the ability to schedule assets and liabilities on the basis of expected cash flows for interest rate risk hedging strategies and to designate a portfolio of partially offsetting derivatives as a hedging instrument, represent significant improvements to the current requirements and will help companies to devise strategies for prepayable assets and dynamic hedging that can achieve hedge accounting. We therefore welcome these proposed changes. However, we believe that there are other areas where the proposals are not workable as discussed in more detail elsewhere in this comment letter. The Board should address these concerns to ensure that banks can apply the proposed methodology in practice.

Foreign exchange risk

The primary rationale for this exposure draft is to reflect the realities of the way in which banks manage their interest rate risk. However we believe that the Board should also take the opportunity to address other areas of the hedge accounting rules that do not reflect the risk management strategies adopted in practice by other entities. In particular we are disappointed that the Board chose to limit the proposals in this exposure draft to a particular method of interest rate risk management adopted by banks and did not take the opportunity to address the equally significant practical problems faced by multi-national companies which use a central treasury function to hedge foreign currency exposure, particularly since this would represent a convergence with US GAAP.

We recognise that IGC 134-1-b did not address adequately many of the practical difficulties faced by groups with multiple functional currencies. However, it did represent an attempt to understand the realities of foreign currency risk management within an multinational organization. It was therefore disappointing to note the decision at the September Board meeting to revise this guidance to make it less effective. We urge the Board to extend the scope of its limited amendment to IAS 39 to permit the use of internal derivatives in foreign currency hedge accounting provided that the net exposure is laid off externally in such a way that the net mark to market gain or loss on the external derivative fully offsets the net gain or loss arising on the internal derivatives.

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, repricing dates (The repricing date of an item is the date on which the item will be repaid or repriced to market rates). However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (e.g. in the light of recent prepayment experience), or actual repricing 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?

Answer 1

We agree with the Board's proposal to designate the hedged item in terms of an amount of assets or liabilities in a maturity time period, rather than as individual assets or liabilities. However we do not agree with the Board's proposed approach to the measurement of ineffectiveness. As explained further below, we would expect the method used for effectiveness testing to be based on an entity's risk management strategy.

(a) Paragraph 142(a) of IAS 39 requires an entity to document its risk management objective and strategy for adopting a particular hedge and paragraph 147 requires it to base its assessment of effectiveness on that strategy. Consequently, the standard does not seek to impose requirements for the assessment of effectiveness in particular circumstances, thus appropriately recognising the importance of the entity's own strategy in making that determination. Provided that the strategy is properly documented and consistently applied to all similar hedge relationships, we support this approach and do not consider it appropriate for the standard to specify the method of assessing effectiveness in particular circumstances. We also support the Board's decision not to explicitly state the width or amount of time buckets to be utilised under the proposals as this should also be dependent on the underlying risk management strategies.

We accept the Board's view that a key principle should be to recognise ineffectiveness in the income statement. However, we believe that the Board should not specify a single method for designating the hedging relationship and assessing hedge effectiveness but rather allow the entity to choose the one that most closely reflects the risk management strategy that they currently adopt. We recognise that there are strong arguments for and against each of the proposed approaches as set out in the Basis of Conclusions, but believe that the merits of each can only be assessed in the context of the reporting entity's own circumstances. Linking the risk management strategy with the method of assessing effectiveness in this way will also meet the Board's stated objective of minimising the need for systems changes.

We note that the Board's primary argument against Approaches A to C depends on the inseparability of interest rate risk and prepayment risk. However, in the context of hedging interest rate risk on a portfolio basis, many banks deliberately adopt a policy of underhedging their exposure in order to avoid ineffectiveness arising as a result of prepayments that do not occur in accordance with expectations. This approach is a valid risk management strategy that addresses the practical difficulties of assessing accurately the behavioural risk associated with prepayments of financial assets such as mortgages. Approaches A, B and C all appear to reflect such a risk management strategy whereas Approach D assumes that ineffectiveness will arise from underhedging as well as overhedging, without recognition of the risk management strategy adopted by the entity. We therefore believe that Approaches A to C are more likely to reflect the intention of management and to be consistent with the underlying systems need to rework their hedging processes.

It follows from the above that, if Approach C is adopted in accordance with a bank's risk management strategy, we would not recommend the imposition of an artificial cushion, as discussed in the Basis of Conclusions, since the size of the cushion should be driven by the extent to which the entity chooses to hedge its net risk position. If the entity chooses to hedge the entire net position, any prepayment earlier than expected will automatically lead to ineffectiveness in the hedge.

In paragraph BC 21, the Board argues that interest rate risk and prepayment risk are not separable. This fails to address the strategy adopted by some banks that address interest-rate related and behavioural prepayment risk separately. Such banks hedge the former with options and the latter by scheduling expected cash flows. This process effectively splits the prepayable assets into two components: a prepayment option and a non-interest rate sensitive prepayable asset. We also believe that the separation of prepayment risk and interest rate risk is consistent with the right in IAS 39.128 to hedge any portion of the fair value of an asset.

(b) We note the Board's assertion that one of the principles underlying IAS 39 is that underhedging should give rise to ineffectiveness but we have been unable to determine the source for this statement. It is expressly recognised in the context of cash flow hedging that underhedging does not give rise to ineffectiveness. We consider that the proposed approach addressed in this exposure draft is essentially based on cash flows.

Additionally, the proposals in the exposure draft have recognised the need to depart from the normal fair value hedge accounting approach of identifying specific assets and liabilities as the hedged items, in recognition of the fact that it is not practical to determine which will prepay or settle early. We therefore do not understand why the measurement of effectiveness should not also reflect the reality of the risk management strategy adopted.

Furthermore, we note that overhedging resulting from greater prepayments than expected flows into the profit or loss account naturally when the derivative is fair valued since the notional amount of the derivative exceeds the amount of the underlying hedged asset. Under Approach D, underhedging as a result of lower prepayments than anticipated, gives rise to a fair value adjustment to the hedged assets that is not matched by an equivalent movement in the hedging derivatives. As a result the separate line item on the balance sheet will include an unmatched amount that will not reverse until the disposal of the underlying assets. This is inconsistent with the basic objective of hedge accounting that is to match offsetting amounts on the hedging instrument and the hedged item in the income statement. It is also difficult to understand the resulting adjustment to the hedged portfolio in the balance sheet.

In our view, all approaches meet the principle underlying IAS 39 that all ineffectiveness arising from the hedge designation in accordance with the risk management strategy should be identified and recognised in profit or loss. We agree with the Board's conclusions in paragraph A35 that ineffectiveness will arise from a number of factors and will be reflected under any of these approaches.

(c) We believe that it is inappropriate, under any of the proposed designation approaches, to leave the fair value adjustment to the hedged item in a separate line in the balance sheet until the hedged asset is derecognised. Theoretically, IAS 39 requires amortisation to start as soon as a fair value adjustment exists since the adjustment of the carrying amount affects the calculation of the effective interest of the hedged item. However, an entity may defer amortising the adjustment until the hedged item ceases to be adjusted. This is because it may be administratively burdensome to amortise the adjustment at the same time as the carrying amount is being adjusted for changes in its fair value that are attributable to interest rate risk (the risk being hedged).

In the proposed approach, any reduction in the amount of assets hedged from one time period to the next is effectively a partial cessation of hedging. This should result in the amortisation of the relevant portion of the adjustment through the income statement over the remaining period to the maturity of the underlying assets. Failure to do this will result in volatility in the income statement resulting from the recognition of the balance in the gain or loss on derecognition of the assets maturing in that particular time period. In addition, since a primary objective of the risk management strategy of many banks is to hedge the exposure to volatility in its net interest margin, amortisation is essential to ensure that the effective yield on the assets reflects the results of that strategy.

A number of factors may combine to generate a significant fair value adjustment in any individual time period. In particular, the failure of hedge accounting due to actual ineffectiveness outside the 80% - 125% band or the dedesignation of a portion of the gross assets as the result of a natural hedge created by the inclusion of new liabilities in the portfolio will mean that the existing line item will no longer be subject to adjustment and will, under the current proposals, remain in the balance sheet until the relevant time period expires. If this relates to a relatively long-dated item, the results could be significantly distorted. We therefore recommend that, as a minimum, entities applying the proposed hedging strategy be permitted to amortise the fair value adjustment in accordance with IAS 39.157.

Additionally, although it may seem a concession to allow the fair value adjustment of the hedged item to be included in a separate line in the balance sheet rather than adjust the carrying amount of numerous assets and liabilities comprising the portfolio, there are still significant systems requirements to track the fair value adjustment and its related time period for release. Paragraph A39 discusses what happens if items in the hedged portfolio are derecognised for other reasons, that is, because they are repaid other than as expected, are sold or become impaired. It requires entities to determine the maturity time period into which the derecognised item was scheduled because this determines which time bucket to remove it from and "hence the amount to remove from the separate line item". This will certainly have significant systems implications and is inconsistent with the Board's primary objective of not requiring major system changes.

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?

Answer 2

We recognise that demand deposits do not individually have a fair value exposure to interest rate risk. Therefore we agree with the Board that they should not qualify for fair value hedge accounting for any period beyond the shortest period in which the counterparty can demand repayment. However, we note that many banks currently schedule demand deposits on a behavioural basis for their operational risk management purposes. We are concerned that the Board may have underestimated the impact that this decision may have on many European banks which are likely to be in a net liability position for many individual time buckets due to the significant level of demand deposits in their retail networks. This potentially penalises such entities which have access to long term, stable, low-cost funding whereas other institutions that are required to fund themselves at a more volatile higher cost level would be more likely to be able to achieve hedge accounting for their portfolio hedges of interest rate risk.

We do not believe it is appropriate to draw conclusions on the fair value of demand deposits until the Board's existing comprehensive measurement project has been completed. We encourage the Board to accelerate this project and address the determination of fair values for those liabilities. Only when such a project is complete can an informed conclusion on the measurement of financial liabilities be made.

Such a debate is considerably wider than the inclusion of demand deposits in portfolio hedging, and as such should be carried out independently from this proposed amendment to IAS 39. Any project on fair values needs to address such issues as entrance versus exit value, wholesale versus retail markets, portfolio values versus the aggregation of individual contracts, customer behaviour and whether the fair value of a liability is what would be paid to someone else to assume it or the amount to immediately settle with the holder of the contract. These are not unique to the banking industry and should be addressed on a cross-industry basis in order to ensure a level playing field.

The following comments are in response to your specific questions in 2(a) and (b):

(a) We do not agree that the fair value of a demand deposit should not be less than the amount payable on demand. In view of its dependence on behavioural considerations, its value could be more or less depending on many factors including, but not limited to, interest rate risk. We do not, however, consider that it is yet practical to determine the fair value of such liabilities with sufficient reliability to drive the accounting treatment, nor do we believe that it is yet practical to determine the analysis of the fair value of a portfolio of such liabilities between the fair value of the liabilities themselves and that of the related intangible asset.

(b) Theoretically, we believe that the fair value of a demand deposit might be less than initial cost and therefore could give rise to a gain on initial recognition. However we recognise that there are significant valuation issues related to this and we would accept the premise that the fair value is not less than the amount due on demand as an expedient until the issues are resolved.

Other comments on the exposure draft

Actual results of hedge effectiveness

As this hedging methodology is intended to form part of the whole hedging section in IAS 39, the Board should reaffirm that the normal hedging rules with regards to documentation and effectiveness testing still apply. If, as we assume, the normal parameters for actual effectiveness testing are intended to apply, guidance should be given on the treatment of the fair value adjustment in the event that hedge accounting ceases as a result of ineffectiveness. IAS 39.157 requires the adjustment to be amortised over the remaining life of the asset in such circumstances. It is not clear whether this requirement or the requirement in the proposed paragraph 154 takes precedence.

Offsetting derivatives

The Board should clarify whether the inclusion of paragraph 126F which permits the designation of offsetting derivatives as a hedging instrument gives rise to the need for a consequential amendment to paragraph 126D of the June 2002 Exposure Draft which prohibits designation for only a portion of the time period during which the hedging instrument remains outstanding. This is necessary since the Appendix to IGC 121-2 prohibits the use of offsetting derivatives on the grounds that it would effectively permit the designation of a derivative for a portion of its duration.

Scheduling of assets and liabilities

We understand that the Board's proposals require entities to schedule assets and liabilities into the time buckets in which they reprice or mature. It is not clear how this would permit partial term hedging (i.e. using a 3 year swap to hedge an asset with a maturity of 5 years) which is permitted elsewhere in IAS 39.

Use of the term "similar" for portfolio of assets and liabilities

Paragraph A29 introduces the term "similar" in the context of a group of similar items. It is not clear whether this has the same meaning as the similar items test in paragraph 132 of current IAS 39 that has always been interpreted as prohibiting the inclusion of assets and liabilities in the same portfolio. If not, clarification is needed of this term in this context.

Use of the term "similar" for a portfolio of hedging derivatives

Paragraph A31 also introduces the term "similar" in relation to a portfolio of derivatives. As the full fair value of the hedging instruments are automatically included in the profit and loss under fair value hedge accounting, we do not see the need for the derivatives to be similar. If the term is intended to have some effect, it needs further clarification.

"Material" ineffectiveness

The Board has identified that one of the three principles that are most relevant to fair value hedge accounting is that "all material ineffectiveness should be identified and recognised in profit or loss". The concept of materiality is not applied to other hedging relationships in IAS 39 and does not appear to have any special relevance in the context of portfolio hedging of interest rate risk. The concept of materiality is addressed within the Framework and therefore individual standards should therefore not address materiality.

Impairment

IGC 111-2 discusses assessment of impairment when a specific asset is part of a fair value hedge relationship. We ask the Board to clarify whether this IGC is also applicable to the hedge methodology proposed in the exposure draft, and if so, how it should be applied.

Applicability of this approach only to those financial assets and liabilities carried at amortised cost.

Since available-for-sale assets are available for fair value hedging under IAS 39, we assume that there is no intention to exclude them from the portfolio of assets and liabilities used to determine the amount of the hedged item. However, we believe that 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.

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If you have any questions in relation to this letter please do not hesitate to contact Jochen Pape, Chair of the PwC Global IFRS Board (+49 211 981 2905), or Pauline Wallace (+44 207 804 1293).

Yours faithfully

PricewaterhouseCoopers