The Hundred Group
of Finance Directors

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Our Ref: RPT/ADM.nw

30 October 2003

Paul Ebling
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
London WC1X 8AL
United Kingdom

Dear Mr Ebling,

FRED 30 Supplement 'Financial Instruments: Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk'

I am pleased to submit the response of the Technical Committee of the 100 Group of Finance Directors to the FRED 30 Supplement on Fair Value Hedge Accounting.

Our responses to the specific questions asked in the exposure draft are set out in the attachment to this letter.

Yours sincerely

Rosemary Thorne
Chairman
Technical Committee of the 100 Group of Finance Directors

Cc IASB

FRED 30 Supplement 'Financial Instruments: Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk'

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. However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (eg 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,

We agree that the hedged item may be designated in terms of an amount of assets or liabilities rather than as individual items. For large volumes of small value items, it is impractical to designate individual items in a fair value hedging relationship as the systems requirements to do so would be prohibitive. We consider that the hedged item is actually an overall net position and find it illogical that the standard cannot recognise this for both fair value and cash flow hedges. However, we can accept that the hedged item is deemed to be a portion of a portfolio of assets or liabilities.

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

The designated item should be the net balance in each time bucket. We do not agree that the hedged item should be designated as a percentage of the assets or liabilities in the maturity band. Rather, we support Approach C because this better reflects the way in which institutions manage interest rate risk in practice. We believe that some banks in the UK can and do separate interest rate risk from repayment risk and hedge each separately. The hedging rules should permit this practice to continue.

(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?

All material ineffectiveness would be recorded for the risks designated to be hedged. Where an individual financial asset that is being fair value hedge accounted repays later than the repayment date, no ineffectiveness arises since, presumably, the hedged items still exists but the hedging instrument matured on the date of the expected repayment. Hedge accounting would then cease unless new hedging instruments were purchased. Similarly we do not consider that ineffectiveness arises where some assets in a portfolio of financial assets prepay later than expected.

(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?

In accordance with IGC 157-1, fair value adjustments for a hedged interest bearing financial instrument can either be amortised immediately as part of the adjustment to the effective interest rate or this amortisation can be deferred until the end of the hedging relationship. There seems no reason why this treatment should be different where the fair value adjustment is not made to individual assets, although the mechanics will obviously need to be different to address the portfolio nature of the adjustment. Where the adjustment is not amortised immediately, it would be removed from the balance sheet when the underlying items being hedged were removed, or the time bucket expires. If necessary, use would be made of statistical or other estimation techniques as appropriate.

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 (ie 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?

We accept that it is reasonable to designate the fair value at inception of a demand deposit at its face value, although conceptually, if valued as a portfolio on behavioural basis its fair value may be less than face value.

(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?

For practical reasons we would be happy to accept that demand deposits are recorded initially at face value so no gains arise on initial recognition, but believe that they should be included in risk management models which may lead to net demand deposits being hedged for those time buckets which are long liabilities. To do otherwise would result in the very odd position that time periods which are long assets are hedged using fair value hedging and those long liabilities are hedged using cash flow hedging. This would be impossible to administer and would produce very strange results. We believe that once the decision is taken to consider hedging on a behavioural basis the rules should apply equally to assets and liabilities where they together form a common risk class, which is hedged within a unified strategy. It should be recognised that no individual item is itself being adjusted, but an adjustment is being made to the hedged item (a sum of money), for the purposes of achieving hedge accounting. This practical simplification is not the same as recognising a liability at an amount other than that received from the depositor.