CL 11

FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF INTEREST RATE RISK ('MACRO-HEDGING')

Memorandum of comment submitted to the International Accounting Standards Board in November 2003 concerning the 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*, published by the International Accounting Standards Board in August 2003.*

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the 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*, published by the International Accounting Standards Board in August 2003.

2. We have reviewed the exposure draft and set out below a number of comments. We deal first with significant matters, before commenting on the specific questions raised in the exposure draft and a number of points of detail.

SIGNIFICANT MATTERS

Support for the proposals

3. We welcome publication of the exposure draft, which marks a positive move by the Board to allow fair value hedge accounting for a portfolio hedge of interest rate risk.

4. We welcome the proposals to allow assets and liabilities to be scheduled on the basis of expected, rather than contractual, repricing dates for interest rate risk hedging strategies, and to allow a portfolio of partially offsetting derivatives to be designated as a hedging instrument. Under the proposals, hedge accounting can be achieved by designating the hedged item in terms of the amount of assets or liabilities in a maturity time period ('time bucket') rather than as individual assets or liabilities. This flexibility will widen the circumstances in which hedge accounting can be achieved, to the benefit of corporates as well as banks.

5. We agree that the size of the time buckets should not be specified in the standard, either in terms of period or amount. The size of the time bucket is a function of the risk management strategy, having due regard to the requirements of paragraph 132 of IAS 39 in relation to the aggregation of assets and liabilities. The frequency of effectiveness testing is then also a function of the length of the time periods, but at a minimum testing should be performed at the time the entity prepares its annual or interim financial statements, as specified in paragraph 151 of IAS 39.

6. We agree that ineffectiveness, as identified in accordance with the risk management strategy adopted, should be recognised in the income statement.

Designation: reflecting the economics

7. We welcome the approach of using the entity's asset and liability risk management strategies for designation purposes. However, when finalising the standard the Board should seek further consistency with the risk management strategies adopted by banks. The effect of the proposals is to permit hedging of net margins in a fair value environment and avoid the creation of equity volatility. This is in line with the approach taken generally by banks. The financial reporting would be more consistent with the underlying economics of

the hedging strategy if the designation of the hedge and the assessment of effectiveness were not confined to one particular approach, as proposed in the draft, but dictated by the entity's risk management strategies. Our response to the four approaches discussed in the exposure draft is set out in paragraphs 15 to 18 below.

8. We also believe that the proposed standard would be improved if it were to take the line that the hedged item is actually an overall net position for both fair value and cash flow hedges. Under the proposals in the exposure draft, entities are encouraged to determine the net amount they wish to hedge based on their risk management systems. They are then required to artificially relate the net position back to a gross asset or liability position. The disconnect that this creates between the risk management system and the accounting could result in hedge accounting being achieved using assets or expected cash flows that are unrelated to the risk that is intended to be hedged, particularly as risk reduction is not an objective of hedge accounting under IAS 39.

9. Designating the net amount as the hedged item and basing effectiveness testing on this amount would result in a direct linkage between the risk being hedged under the risk management system and the hedge accounting, with the likely result that the appropriate amount of ineffectiveness that would be identified would be consistent with the entity's risk management strategy. In the longer term, the rather artificial approach in paragraph 133 of IAS 39 of relating hedging derivatives to gross positions is likely to undermine good accounting, as compliance with arbitrary rules would be seen as the primary objective of the accounting, rather than properly reflecting economic reality.

10. The arguments in BC12 are based on the premise that it may be difficult to measure the change in fair value of a portfolio of assets and liabilities arising from changes in interest rates. We agree that it would be inappropriate to assume that the change in the fair value of the hedging derivatives is equal to the change in fair value of the hedged net position. However, if assets and liabilities within a portfolio mature within the same time-period and are hedged with respect to the same benchmark interest rate, then the change in fair value of the portfolio (arising from changes in the risk-free interest rate) is unlikely to be any more difficult to compute for than the gross position.

11. For example, if fixed rate assets of 100 and liabilities of 80 mature within the same 30-day time period and are all exposed to changes in EURO LIBOR, then the fair value change in the net position, arising from changes in the risk-free rate, would be the same as the change in fair value of a portfolio of assets of 20 with the same maturity and risk exposure. It is not necessary to designate the 20 of assets in order to measure the net position.

Prepayment risk

12. The arguments about interest-rate risk and prepayment risk being interrelated are confusing and appear to contradict other aspects of A4(g) of IAS 39. We discuss this in detail in paragraphs 19 to 24 below.

13. We conclude that the Board should revisit its arguments and conclusions in respect of prepayment risk and embedded derivatives. Furthermore we note that prepayment of items such as mortgage loans is related as much to demographic factors as it is to changes in interest rates. Some banks can and do separate demographic and interest-linked prepayment risk. More banks may wish to do so in future as the derivatives market becomes more sophisticated and more products become available. The standard should not preclude such an approach.

Demand deposits

14. We agree that entities should be permitted to analyse portfolios into maturity time periods based on expected, rather than contractual, repricing dates. However, we find it odd that the Board, in these proposals, accepts that liabilities may be allocated into time-periods based on their expected maturities, but then prohibits those liabilities from being designated as part of a hedged item in a time-period in which a net liability position arises. The use of behavioural assumptions applies equally to liabilities as to assets. Most deposits, as with most loans, can be repaid on demand. Even deposits bearing little or no interest are viewed by banks as a continuing contract for customers to deposit money. These contracts have a behavioural maturity, which has been amply demonstrated by literature and statistical studies as being longer than the earliest period in which the counter party can demand payment. Banks seek to lock in the margin that results from being able to use the deposits to fund assets with contractual maturities longer than the contractual maturity of the demand deposits but which may have similar behavioural maturities. These issues are discussed in more detail below in paragraphs 30 to 36.

SPECIFIC QUESTIONS

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 (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,

(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?

15. The hedged item should be designated in line with the entity's risk management strategy. Our reasons for reaching this conclusion are set out below.

16. We agree with the proposal for the hedged item to be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than as individual assets or liabilities. For large volumes of small value items, it is impractical to designate individual items in a fair value hedging relationship, because the systems requirements would be prohibitive. However, we do not agree that the hedged item may not be an overall net position (see paragraphs 8 to 11 above). Nor do we believe that the standard should prescribe a method for designating the hedging relationship and assessing hedge effectiveness: these should be based on the entity's risk management strategy.

17. There are arguments for and against each of the four approaches considered in the Basis for Conclusions. However, while the conceptual discussion in the draft standard is interesting and helpful, the appropriateness of any particular approach can only be evaluated in the context of the entity's risk management strategy. We note that allowing the entity to adopt the approach that best reflects its risk management strategy will minimise resultant systems changes, which is one of the Board's objectives. In our view, all four approaches meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) arising from the hedge designation in accordance with the risk management strategy should be identified and recognised in profit or loss. In practice, all the factors set out in paragraph A35 will lead to ineffectiveness arising and being recognised in profit or loss. We therefore specifically disagree with the assertion in paragraph BC21(c) that it would be rare for ineffectiveness to arise under approach A.

18. As stated, we believe that any approach in line with the entity's documented strategy should lead to the availability of hedge accounting. If the Board is determined, nevertheless, to prescribe only one approach, our preference is for approach A. Approach C is a variant of B, and a workable solution that reflects what some banks do in practice: this would be our second choice. We do not support approach D as the sole prescribed approach. Our reasons for this order of preference are set out below.

19. The exposure draft (in BC21(e) and elsewhere) states that prepayment and interest rate risks cannot be identified separately. The Board's opposition to approaches A, B and C appears to depend on this assumption. However, IAS 39 generally requires a component approach, so not allowing separation conflicts with the principles underlying the standard.

20. Paragraph BC7 recognises that a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. In the example in BC20, a 25-year prepayable mortgage is viewed as a fixed term mortgage and a written option. If the entity chooses to hedge this using a five-year fixed/floating interest rate swap, this is equivalent to hedging the first five years of the first component. This relationship already qualifies for hedge accounting under IAS 39 (IGC 128-2), regardless of whether or not the asset is expected to prepay in year 5 or, indeed, whether the asset is prepayable at all. There is no reason why this approach should be permitted for a hedge of a specific asset or liability but precluded when applying the portfolio approach in the ED. Therefore we agree with the arguments in favour of approach A (and approaches B/C) in this regard.

21. The argument in BC21(d) against allowing this approach is that, under IAS 39, the fair value hedging model would require both components to be remeasured for changes in the hedged risk. We disagree with this interpretation. Since IAS 39 allows an item to be separated into both portions and layers of risk for the purpose of designating the hedged item, it should allow the prepayment option to be excluded from the hedging relationship. We are not aware of any guidance to the contrary in IAS 39.

22. We do not believe that it is usually the case that interest rate risk and prepayment rate risk are so closely linked that they cannot be separated. The arguments in paragraphs BC21(e) are that interest rate risk and prepayment rate risk are so closely interrelated that it is not appropriate to separate them; and that it is extremely difficult to measure the two components separately. The first argument contradicts the requirement in paragraph A4(g) of the June 2002 ED IAS 39. That paragraph, in conjunction with paragraph 23 of ED IAS 39 says that, except in restricted circumstances, a prepayment option is not closely related to the host debt instrument and, consequently, the prepayment option must be separated and measured at fair value. The Board needs to decide whether the arguments in BC21(e) or in A4(g) should prevail.

23. The conclusion of the second argument, that it is difficult to measure separately the embedded prepayment option, is that there could be a failure to separate the embedded derivative where the standard requires this. As a consequence, paragraph 26 of ED IAS 39 requires the entire combined contract to be treated as a financial instrument held for trading and thus measured at its fair value. This would lead to the conclusion that substantial elements of banks' balance sheets that carry prepayment risk, for example loans and mortgages, should be measured at fair value. This would be premature and inconsistent with IAS 39.

24. The fair value of a prepayable item changes not only due to changes in interest rates, but also when prepayment profiles change for other reasons. We do not

agree with the assertion that banks cannot separate prepayment risk from interest rate risk and hedge these risks separately. Some banks, as a matter of practice and because it is not always possible to purchase matching derivatives, choose not to separate these risks and to bear some income volatility. Other banks adopt risk-management strategies that deal separately with interest-rate and prepayment risk. These practices may become more common as the derivatives markets develop and as customer demand or other requirements lead to banks offering products, such as longer term fixed rate mortgages, where income volatility may be unacceptable unless matching derivatives are used. There seems no reason why banks should not be permitted to choose whether or not to hedge prepayment risk and interest rate risk separately.

25. In addition, we are concerned that approach D does not produce sensible results in some circumstances. Where the fair value movement on the hedged item is greater than the fair value movement on the hedging derivatives, under-hedging, there seems to be no mechanism to remove the fair value movements from the balance sheet on a reasonable basis other than when the items themselves are removed or the time bucket expires. This results in fair value movements being taken back to income when the related time bucket expires, but this will create income statement volatility in relation to hedge ineffectiveness that was recognised in previous periods when it arose. Approach D will require assets to be tracked in time buckets in order to provide information for calculating ineffectiveness, leading to significantly increased systems demands on entities. We therefore question whether approach D will satisfy the Board's own criteria (in paragraph 3(b) of the Background section of the ED) as to 'workable in practice' and 'not require ... major systems changes'. Approach A is likely to require less tagging than the other options.

26. We do not agree, in relation to approach C, that the Board would need to introduce an arbitrary rule to prevent the cushion from becoming too large' (paragraph BC21). If approach C is adopted in line with the entity's risk management strategy, the size of the cushion should be governed by the extent to which the entity chooses to hedge its net risk position. If the entire net position is hedged, any early prepayment will automatically lead to ineffectiveness in the hedge.

27. Paragraph 157 of ED IAS 39 states:

'An adjustment to the carrying amount of a hedged interest bearing financial instrument shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date the amortisation begins and shall be amortised fully by maturity.'

In many situations, particularly in a fair value macro hedge environment where banks are actually hedging net margin rather than fair value movements on the underlying items, it will be necessary to amortise the macro fair value adjustment in order to obtain the hedged net margin. Fair value adjustments that are amortised over the expected life of the underlying items will be

removed from the balance sheet over time and in any case when their related time bucket expires. Where the adjustment is being amortised, we are less concerned about assets contained in a hedged portfolio that are derecognised because they are repaid other than as expected, are sold, or become impaired since the impact of immediately removing the adjustment is less. Except in cases of a significant change to assets such as a securitisation that results in derecognition, the costs of tracking are likely to outweigh any benefits. Such a simplification of the proposals will greatly assist their practicality and will properly acknowledge that portfolios as a whole are being hedged, not individual items.

28. Paragraph 157 needs to be modified to acknowledge amortisation for fair value macro hedge accounting, because it is too specific to single financial instruments. The basis adjustment and proposed macro hedging are not attached to any specific financial instrument, so there are serious practical difficulties in calculating an effective yield for amortisation purposes. We recommend that the amendment to paragraph 157 should state that the amount of the collective fair value adjustments should be amortised on a rational and systematic basis.

29. As we are not recommending a new approach, amounts in the balance sheet line items referred to in paragraph 154 would be removed as envisaged by the Board, but at a time no later than the expiry of the time bucket.

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?

(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?

30. We do not 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.

31. If the Board accepts that it is appropriate to use a behavioural approach to allocating liabilities between time periods for risk management purposes, the remaining obstacle to their designation as hedged items is to demonstrate that the fair value of demand deposits varies in response to changes in market interest rates in the same way as other assets and liabilities included in the portfolio. We understand from some banks that it may be possible in practice to model the behaviour of deposits in response to changes in interest rates in a way that would enable an amount of deposits to qualify as part of the time-period portfolio as defined in paragraph 132: that is, that the deposits included in the portfolio respond in the same way to changes in market interest rates as other assets and liabilities included in the portfolio. If banks are able to carry out such modelling, we do not believe that the standard should preclude such allocation. Rather, we would include in the standard a requirement that the entity must be able to demonstrate that the requirements in paragraph 132 of IAS 39 are met.

32. We note that the Board's approach to demand deposits stems from the decision that the hedged item may not be a net position. In our view, the Board should accept that a net position, including demand deposits, may be hedged. It would then be much more likely that an entity could demonstrate that the fair value of the net position responds in the same way to changes in interest rates as does the equivalent amount of assets or liabilities (contractually) maturing in that time-period. This would not involve significant changes in the entity's risk management processes.

33. Therefore, for conceptual reasons, we do not agree with the proposal that demand deposits can only form part of the hedged item based on their contractual maturity. Perhaps more importantly, we set out below why we believe there are practical difficulties with the Board's proposals that may render the proposed approach unworkable unless deposits can be included in a designated hedged liability.

34. The proposals effectively prevent fair value macro hedge accounting from being achieved in any time bucket that is long on liabilities where there are demand deposits included in the liabilities based on behavioural, rather than contractual, maturity. This could make the proposals unworkable in practice. While some banks' initial position may show that all their time buckets can be hedged, there is no guarantee that this position will continue over time. Therefore, any bank using the proposals as drafted must accept the risk that not all time buckets will achieve hedge accounting in future. Given that items will move in time buckets as expectations change and as they get closer to maturity, trying to accommodate a time bucket that cannot be hedged is likely to prove difficult, if not impossible. Therefore, we also disagree with the proposed treatment of demand deposits on practical grounds.

35. The assumption that the fair value of a deposit with a demand feature is the amount repayable on demand was originally introduced into IAS 32 as a practical expedient to avoid requiring fair values to be calculated for such items for disclosure purposes. We do not necessarily agree that the fair value of a liability with a demand feature is not less than the amount payable on demand and note that the Board has an active research project on the appropriate measurement of items recognised in financial statements. The Board's decision should not prejudice the conclusions of this project.

36. In addition, we do not consider that recognising a fair value movement associated with a deposit with a demand feature is akin to recognising the liability at fair value. In common with fair value hedge accounting for assets as well as liabilities, only the fair value movement related to the risk being hedged is recognised. Recording a basis adjustment is not the same as recognising the items at fair value. Until the measurement project concludes, we advise the Board, for conceptual as well as practical reasons, to amend the proposals to treat assets and liabilities symmetrically.

DETAILED POINTS

Offsetting derivatives

37. Paragraph 126F permits the designation of offsetting derivatives as a hedging instrument. However, the Appendix to IGC 121-2 prohibits the use of offsetting derivatives:

"If an offsetting swap only partially offsets another interest rate swap that is designated as a hedge, the net position does not qualify as a hedging instrument because that would result in a portion of the hedging instrument being designated as a hedge, which is not permitted for accounting purposes." (IGC 121-2)

The Board therefore needs to make a consequential amendment to paragraph 126D of ED IAS 39, which prohibits designation for only a portion of the time period during which the hedging instrument remains outstanding.

Use of the term 'similar'

38. Paragraph A29 introduces the term 'similar' in the context of a group of similar items, which, by reference back to paragraph A26, may be a portfolio containing both assets and liabilities. However, the similar items test in paragraph 132 of current IAS 39 is generally interpreted as prohibiting the inclusion of assets and liabilities in the same portfolio. The Board should clarify whether or not the term has the same meaning in both contexts.

39. Paragraph A31 further introduces the term 'similar' in relation to a portfolio of derivatives. As the full fair value of the hedging instruments is 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

40. The Board states in paragraph 3 of the exposure draft that 'all material hedge ineffectiveness should be identified and recognised in profit or loss'. Materiality does not appear to have any special relevance in the context of portfolio hedging of interest rate risk. It is not applied to other hedging relationships in IAS 39. Moreover, given that the concept of materiality is addressed in the Framework, there is no need for individual standards to deal with it.

Applicability only to financial assets and liabilities carried at amortised cost

41. Given that available-for-sale assets are available for fair value hedging under IAS 39, we assume that they may 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.

42. **Definition of portfolio**

In the context of a fair value hedge of interest rate exposure of a portion of a portfolio of financial assets, paragraph 154 permits the gain or loss attributable to the hedged item to be presented in a separate line item within assets. 'Portfolio' is not defined here and is potentially open to abuse. The Board should ensure that such an approach is only permitted where the criteria discussed in the exposure draft are met.

Portion of a portfolio

43. While we can accept that the hedged item is a portion of a portfolio of assets or liabilities, we do not believe that the hedged item is a proportion of the portfolio. Paragraph BC17 explains that, where an entity is in a net liability position, it needs to have sufficient fixed rate liabilities other than core deposits that it can designate as the hedged item in order to obtain fair value hedge accounting. This implies that, if the entity wishes to hedge an amount of 20 from a portfolio of 100, fair value hedge accounting is possible provided the amount of core deposits does not exceed 80. However, paragraph A30 states that all of the assets and liabilities from which the hedged amount is drawn must qualify for fair value hedge accounting. This implies that fair value hedge

accounting is not possible if there is even a single core deposit in the portfolio of 100. Such a conclusion increases the impracticality of the proposals. In our view, 'an amount' is a portion and not a proportion, and the language in the final standard should be clear in this regard.

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