CL 20

13 November 2003

Ms Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Ms Thompson

Exposure draft of proposed amendments to IAS 39

As one of the organizations directly affected by proposals, we welcome the opportunity to comment on the proposed amendments to IAS 39 to attempt to allow fair value hedge accounting for a portfolio hedge of interest rate risk.

In our view, the proposals go some way toward meeting our concerns about the practical difficulties of applying fair value hedge accounting within the context of the hedge accounting principles. In particular, we support the:

- Clarification that derivatives, including offsetting derivatives, can be pooled as the hedging instruments;

- Ability to designate as the hedged item an amount of currency and to represent the fair value basis adjustments as a separate line within assets or liabilities, rather than having allocate it to individual items;

- Ability to schedule assets and liabilities into time buckets based on behavioral, rather than contractual, maturity in accordance with the scheduling that is performed for risk management purposes.

However, as acknowledged in the questions to this exposure draft, further consideration must be given to the methods of designating hedges and to the treatment of demand deposits. These issues must be satisfactorily resolved in order to produce a workable standard.

Consistent with the approach taken for other forms of hedge accounting in IAS 39, the method of determining ineffectiveness should not be mandated but left to be determined in accordance with the institution's risk management objectives. If, however, the Board is determined to mandate an approach, we do not consider approach D calculates the appropriate amount of ineffectiveness and would require extensive systems changes, contrary to the Board's own objectives. In our view, approach C is preferred as it is most consistent with the way institutions manage risk.

In addition, in order to produce a workable solution, core deposits scheduled into time buckets on a behavioral basis must be capable of being included as part of the amount representing the hedged item. This is necessary in order to treat assets and liabilities symmetrically and, consistent with all basis adjustments for fair value hedge accounting, is not the same as recognising fair value on initial recognition. In any case, fair value measurement is the subject of an IASB project, which is not complete and which should not be pre-empted.

Our responses to the specific questions are included in the appendix.

Yours sincerely

Sondra Tarshis
Senior Manager, IAS Accounting Policy

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. The disconnect that this creates between the risk management system and the accounting is undesirable. It can result in hedge accounting being achieved by selecting assets or expected cash flows that are unrelated to the risk that is intended to be hedged. While companies may welcome the flexibility that this gives them to select assets or expected cash flows in ways that reduce the chances of ineffectiveness arising, this is not in keeping with the principles underlying IAS 39. 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, which will result in the appropriate amount of ineffectiveness being identified. Since all items in a time bucket, both assets and liabilities, are expected to move in the same way in relation to the hedged risk, determining the fair value of a net position of say 20 seems no different to determining the fair value of a position of 20 assets.

However, for the purpose of advancing the discussion, we can accept that the hedged item is deemed to be a portion of a portfolio of assets or liabilities, that is an amount of currency. We do not believe that the hedged item is a proportion of a portfolio of assets or liabilities. We note that para BC17 explains that, where an entity is in a net liability position for a particular time bucket it needs to have sufficient fixed rate liabilities other than core deposits that it can designate as the hedged item, otherwise fair value hedge accounting is not possible. This implies that, assuming an entity that is long liabilities, including some demand deposits, and wishes to hedge an amount of 20 from a portfolio of 100, fair value hedge accounting is possible provided the amount of demand deposits does not exceed 80. However, para A30 states that, it follows from the designation of "an amount of currency", that all of the assets or liabilities from which this amount is drawn must be items that could have qualified for fair value hedge accounting if they had been hedged individually. This implies that, for the entity that is long liabilities and the liabilities include even a single demand deposit, fair value hedge accounting is not possible. Since the hedged item is a portion, this should not be the conclusion and we expect that the final standard will need to use language consistently in this regard.

The designation must also properly reflect the macro nature of the hedge in order to address the systems difficulties that it is intended to address. Having to make sure that the hedging adjustment disappears as individual items become impaired or prepay seems inconsistent with a macro approach and with designating an amount, rather than a portfolio. Para A39, states that when a loan is derecognised amounts relating to this loan must be removed from the time period it was included, if it can be determined, or from the earliest time available time period. A requirement to track individual loans is inconsistent with a macro approach and the language used in the final standard should properly reflect the macro approach.

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

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 many 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.

We do not agree with para BC21 (e) that indicates that interest rate risk and prepayment risk cannot be separately measured. The Board's opposition to Approaches A, B and C appears to depend on this assumption. However, IAS 39 generally requires a component approach, in particular, the identification and separate measurement of embedded derivatives. Not allowing separation conflicts with the principles underlying the standard.

The IAS 39 requirements to separate embedded derivatives mean that the risks have to be separated if the prepayment option is not clearly and closely related. There are at least two types of prepayment risk, actuarial prepayment which is not sensitive to interest rate risk and prepayment due to changes in interest rate risk. Where time buckets reflect mainly or exclusively actuarial prepayment it is wrong to recognise ineffectiveness resulting from the relatively small changes resulting from differences between expected actuarial prepayment and actual actuarial prepayment when these differences are not related to interest rates. Where prepayment options have been bifurcated and are being fair valued anyway then this fair value element may not even be included in the time bucket (unless it is being hedged with optionality in the derivative) but will be taken to income in any case.

Since the hedge accounting is driven by the risk management system, we see no reason why an arbitrary rule is necessary to prevent an excessive cushion under approach C.

(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 expected the repayment date, no ineffectiveness arises since, presumably, the hedged item still exists but the hedging instrument matured on the date of the expected repayment. Hedge accounting would then cease unless a new hedging instrument 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?*

The items would be removed from the balance sheet in accordance with para 157 of IAS 39 ED. In many situations, particularly in a macro fair value hedge environment where banks are actually hedging 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 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. Indeed, the tracking envisaged in paras A38-A40 would be extremely difficult, if not impossible, in relation to amortised adjustments. 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.

Para 157 needs to be modified to acknowledge amortisation for macro fair value hedge accounting. The language needs to reflect that fair value hedge accounting adjustments do not all relate to individual assets or liabilities.

In addition, the practical difficulties of applying an effective interest methodology to a portfolio basis adjustment should be recognised. It should be acceptable to use any systematic and rational method to amortise these basis adjustments.

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 do not agree that a requirement in IAS 32 relating to disclosure should be transferred into the measurement standard at this time. Such a move pre-empts decisions that should be taken in the context of the Board's valuation project. In the shorter term, we can 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 behavioral 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 can 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 that 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 follow 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 behavioral 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 recognized that no individual item is itself being adjusted, but an adjustment is being made to the hedged item, an amount of currency, for the purposes of achieving hedge accounting. This is consistent with basis adjustments generally used in fair value hedge accounting. Such a practical simplification is not conceptually the same as recognising a liability at less than the amount received from the depositor.