ALMA
UK ASSET AND LIABILITY MANAGEMENT ASSOCIATION

Christopher J F Clegg
Head of Balance Sheet Management
Abbey National plc
2 Triton Square
London NW1 3AN
e: chris.clegg@ants.co.uk
t: 020 7556 6293

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

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Dear Ms Thompson

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS39

Please find attached the response from ALMA, the UK Asset and Liability Management Association, to the Exposure Draft of Proposed Amendments to IAS39.

We are an association of ALM practitioners, with membership drawn from all of the major UK banks and building societies. I have been asked to respond to the exposure draft with a consensus view of our members, who have concerns that certain aspects of IAS39 are not compatible with accepted best practice in the management of balance sheet risk.

If there are issues in the response that you would like to discuss further, I and my fellow members would be pleased to hear from you.

Yours sincerely

Christopher J F Clegg
Chairman - ALMA

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UK ASSET AND LIABILITY MANAGEMENT ASSOCIATION

Response from ALMA to:

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

1 ALMA

ALMA, the UK Asset and Liability Management Association, comprises ALM professionals in financial institutions that are active in the UK. Founded in 1993, its membership is corporate and comprises all major UK banking groups, larger building societies and many insurance companies.

ALMA's purpose is to promote "best practice" in the field of ALM by sharing knowledge and experience, which is achieved through regular seminars and conferences. ALMA has also developed ALM training programs for its members.

Following discussion among its members, ALMA considers that there is sufficient agreement on certain issues that a response to the exposure draft is appropriate. This response is therefore a consensus from the ALM profession, rather than the view of any specific member institution.

2 INTERNATIONAL ACCOUNTING STANDARDS

ALMA supports the objective of the International Accounting Standards to provide greater clarity in financial accounts concerning the exposures to which companies, particularly financial institutions, are exposed. ALMA is strongly of the view that financial accounts should efficiently reflect the economic drivers of the business.

However, ALMA is concerned that some parts of IAS39 are not consistent with best practice in the management of economic risk and might cause to be presented a potentially misleading picture of a financial institution's economic exposure.

ALMA welcomes the recognition by the Board that further consultation is needed.

3 THE QUESTIONS

The Board has invited comments on the Exposure Draft and has asked for response to specific questions.

3.1 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.*

(a) Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness?

- **ALMA does not agree with the proposal that "Approach D", as described in BC19, should be used to designate the hedged amount.**

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

- **ALMA is strongly of the view that financial institutions should adhere to best practice in the management of economic risk. It would therefore propose "Approach C" as most closely aligned with the way in which ALM techniques are used to manage interest rate risk.**

  ALMA would support and restate the arguments set out in BC26(a) and in the alternative view AV2, particularly in the context of underhedging.

  To give a specific example, if a tranche of asset extends beyond its expected prepayment date, the asset continues to be effectively hedged up to its original expected prepayment date. This is consistent with paragraph 128, which states that an identified portion of the risk associated with an asset, in this case a proportion of the contractual maturity period, may be the hedged item.

(c) 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?

- **If the hedged item is properly documented, as described in the response to (b) above, then all material ineffectiveness would be identified. ALMA is therefore of the view that "Approach C" would meet this principle.**

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?

3.2 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.

(a) 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,

(b) 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?

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?

- **The Board has recognised, in draft paragraph 128A, that financial institutions may "*... hedge the change in fair value that is attributable to a change in the hedged interest rate based on expected, rather than contractual, repricing dates.*"**

  When viewed collectively, certain customer deposit accounts that are individually repayable on demand, demand deposits, behave as a liability with an expected repricing profile that is longer than that defined by the contractual terms.

  There is a substantial body of work that supports this and banks have developed hedging strategies to mitigate the economic uncertainty that arises.

  Furthermore, in their prudential supervision, regulators expect banks to manage this structural exposure.

  While it may be possible to treat any derivatives used to mitigate this exposure as Cashflow Hedges, ALMA believes that the consequent volatility in equity would misrepresent the bank's exposure to movements in interest rates. A further concern is that, depending on the interpretation of the regulator, such volatility might distort a bank's regulatory capital.

  ALMA is strongly of the view that financial accounts should efficiently reflect the economic drivers of the business. ALMA believes that this is also one of the Board's objectives. It is therefore desirable that a way is found to Fair Value hedge demand deposits. ALMA would therefore propose the following:

  - **The hedged item should be defined as the underlying interest rate element of a portfolio of demand deposits. This interest rate element will be based on the behavioural modelling of the portfolio and should be capable of being independently validated.**

    In each time period, the model will expect the portfolio to reduce by a proportion. However, it would also be expected that "new" liability will be added to the portfolio.

    The underlying interest rate at which this new liability is added would be that prevailing in the market at the time. Its Fair Value would therefore be the nominal amount and would not give rise to a gain or loss on initial recognition.

    As with other assets and liabilities where the expected and contractual repricing profiles differ, the assumptions used to produce the expected profile should be subject to regular testing and validation. Where these assumptions change and give rise to ineffectiveness, this should be recognised.

    In the prudent management of its exposures, a financial institution will not hedge individual accounts but products or tranches of products and recognise the collective behaviour of the individual accounts within the product.

  - **It is recognised that this approach is not consistent with the requirements of draft paragraph A30(b) 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."**

    However, ALMA believes that the potential distortions that the Standard, as drafted, introduces are such that the wording of this paragraph should be reviewed and the relevant wording amended. Such amendment, or even deletion, need not be inconsistent with the underlying principles of IAS39, as set out in the Appendix.