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The International Accounting Standards Board
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FSO/AREC/pf

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Dear Madam

**FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF
INTEREST RATE RISK**

Thank you for the opportunity to comment on the recently published Exposure Draft. In this letter we respond on the two items upon which you have requested comments, but we also raise important drafting / implementation issues which we believe to be important and needed to be addressed.

A. Issues on which comment has been requested

1. *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 IAS39 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?*

We believe that it should also be possible to permit a model in which a hedging derivative can be designated as a hedge of a net portfolio of assets *and* liabilities. We appreciate the need for the assets and liabilities to change in fair value in a similar manner in response to interest rate changes, so that ineffectiveness to be measured effectively. However, while this would limit the application of such a model, there would be cases when it would be useful and appropriate.

The method by which items are designated in the ED is an improvement on the text of IAS 39 in that it would be possible to designate an amount of assets or liabilities, rather than specific assets or liabilities, which is necessary if prepayable assets are to be hedged.

As it relates to the designation criteria and subsequent effectiveness testing, we do not agree with the use of method D as proposed in the ED:

- firstly, we believe that method D, while intellectually appealing is not in keeping with the text of the ED which repeatedly uses the word *portion* as opposed to *proportion* of the pool of assets that have been categorized by maturity. If the ED required that an entity designate

a *proportion* of the assets in a particular expected maturity bucket, this would be more consistent with the use of method D. However, we believe that methods A, B, or C are in keeping with the concept of designating a portion of assets that are being hedged. We believe that method A will result in almost never having significant ineffectiveness and do not support its use. Method B does not, in our view, allow entities the appropriate flexibility. Therefore, for the reasons discussed below, we support method C (or possibly an alternative method that is consistent with a model based on hedging a *portion* of an expected maturity category);

- secondly, banks often choose not to hedge the total expected interest rate position but deliberately leave a portion unhedged, due to the risk of prepayment. In this context it would be inappropriate to calculate an ineffectiveness charge just because there is a greater level of prepayment than expected, if it is within the margin allowed for in the hedging strategy. Similarly, it does not intuitively make sense to assess ineffectiveness if the level of prepayment is less than expected. In each case, ineffectiveness should be calculated as the extent to which the fair value of the hedging derivatives changes more or less than the fair value of the amount of the asset or liability selected to be hedged.

This leads us to prefer option C.

In applying method C we note that where banks determine the interest rate risk to be, say, 20 (assets of 100 offset by liabilities of 80) it follows that ineffectiveness should be measured by reference to the 20 of net risk rather than 100 of total assets. Although unclear, it appears in paragraph BC 19 that this point is accepted by the Board. In the example given, where the initial assets of 100 are revised downwards to 90, we would measure ineffectiveness as the change in fair value of the derivatives compared to the change in fair value of 90 multiplied by 10/90 (10 being the revised interest rate risk), ie the ineffectiveness of 6 referred to in BC 19.

This would of course, be a far bigger level of ineffectiveness than would be calculated using method D, where the change in fair value of assets of 90 is multiplied by 16/100. As a result, option C gives limited ineffectiveness as long as prepayments are not greater than the cushion, but greater ineffectiveness thereafter. This point has further significance in the context of one of the implementation issues we raise below, whether the normal prospective test of 'almost fully offset' is required to be applied to these proposals. If so, it is possible that use of method C could often result in the hedge being assessed as ineffective, unless there is a significant buffer.

One of the issues raised by the Board in BC 23 in relation to method C is that the level of buffer can be set so large that it is unlikely that there would ever be any ineffectiveness. We believe that this concern is overstated. If (in a different example) a bank chooses to hedge only 16 of an expected interest rate risk position of 70 (creating a buffer of 54) then the level of hedge will be comparatively small. If the bank is seeking to hedge effectively then it will not choose to hedge such a small proportion of its risk just to avoid recording ineffectiveness.

2. *Do you agree that a financial liability that the counterparty can redeem on demand cannot qualify for fair value hedge accounting at any time period beyond the shortest period in which the counterparty can demand repayment? 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?

While it would be inconsistent with the remainder of IAS 39 to treat demand deposits other than in the ED, we believe it should be made possible to use fair value hedging for demand deposits, as a pragmatic solution to this difficult issue.

To allow fair value hedging for demand deposits would achieve consistency with the treatment of prepayable assets and so create a genuine portfolio hedging model. It would avoid changes in the value of hedging instruments being recorded in equity for some maturity periods and as adjustments to assets for others.

While we understand the Board's technical concerns as to the ability of a demand deposit to have a fair value less than the amount repayable on demand, we believe that the latter is not a market price. When deposits are bought or sold (as between banks) the price will not be the notional amounts of the deposits. The buyer and seller will take account of the interest rate on the deposits as well as the value of the demand "option", in a similar manner to the valuation of prepayable assets.

Fair value hedging of demand deposits would only require the recorded value of the deposit to be adjusted for the change in value attributable to the hedged risk, so there will be no need to recognise a gain on initial recognition.

B. Other concerns

1. It is not clear how the proposals in the ED are supposed to interact with the requirements of paragraphs 142 and 146 of IAS 39. Are we to assume that portfolio hedges are, in addition to the requirements set out in the ED, expected to be almost fully offset in prospect and to be highly effective retrospectively, with actual results to be within the range of 80 – 125%?

While normal hedge relationships are entered into with an expectation of being highly effective, where there is prepayment risk there will be a much higher probability of partial ineffectiveness for each maturity period. Especially using method C rather than method D, application of paragraphs 142 and 146 is likely to mean that the proposals set out in the ED will often be inapplicable.

The text of IAS39 should be amended to make it clear that the ineffectiveness proposals in the ED are an alternative to the normal rules in IAS 39.

2. It is not clear in the ED how to deal with accumulated gains or losses on revaluation of hedged items where the hedge relationship changes or is discontinued, but the previously hedged item remains on the balance sheet. This will happen, for instance, if future expected payments are rescheduled or if the net interest rate position for a particular maturity period changes.

Paragraph 157 of IAS 39 states that when a hedged relationship terminates, any change in the value of the hedged item held in the balance sheet should be amortised to the income statement on a constant yield basis, so as to be fully amortised by the maturity of the hedged item. Similarly, for the proposals in the ED, some form of amortisation is logical, otherwise

significant assets or liabilities will remain in the balance sheet, only to be written off when the original planned maturity period expires.

As an example, assume that an asset of €1m has been established in the balance sheet in respect of €100 of hedged assets due to mature in period N. If the hedge relationship is then adjusted so that, going forward, only €20m of asset are hedged, what are we to do with the proportion of the €1m relating to the €80m of assets no longer being hedged? All else being equal, the fair value of the €20m of assets that continue to be hedged will tend towards their redemption value as maturity approaches and so the adjustment recorded in the balance sheet will automatically reduce towards nil. However, 80% of the €1m recorded in the balance sheet will, following the rules set out in the ED, continue to be held in the balance sheet until period N expires.

Our concerns are three-fold:

- i) The lack of clarity as to whether paragraph 157 of IAS 39 applies in this instance, or whether the proposals in the ED are supposed to be exempt from its application. The wording of the Standard and the Application Guidance will need to be amended to make this clear.
 - ii) Unless paragraph 157 does apply, significant amounts may continue to be recorded in the balance sheet following the approach set out in the ED, which could not be regarded as proper assets or liabilities.
 - iii) If it is necessary to apply paragraph 157, then the process could, be very complicated to apply and possibly impractical.
3. The ED frequently refers to the designated hedged item as a *portion* of the assets or liabilities (eg in paragraph 128A), but it is not clear what this means. Applying method D, we take it to mean that the designated item is supposed to replicate a *proportion* of the total assets or liabilities from which it is drawn. The meaning needs to be made clearer in the text. If our interpretation is correct, then paragraph A33 should be reworded, to make it clear that the revaluation should be the same as would be obtained from re-measurement the designated proportion of the *total* assets or liabilities, and multiplying this by the ratio of the value of the hedged amount to the total assets or liabilities.
 4. The ability for a hedging instrument to be a portfolio of similar derivatives (paragraphs 126F and A31) needs to be clarified in the text or by way of example. Would it be possible, for instance, to combine swaps with different maturity periods but which, on a combined basis, have a duration equivalent to the maturity of the hedged amount? We assume not, but it needs to be made clear. Also, if a group of derivatives used to hedge an amount is deemed ineffective, do all swaps in the group become ineffective or can an entity determine if there is a particular derivative or combination thereof that may be deemed the culprit while the others would continue to be regarded as effective?
 5. We question the implementation of the result of this ED in practice without it having been thoroughly field-tested. As it is used in practice, we believe that many further practical implementation questions will arise.

If you have any questions on any of these points please do not hesitate to contact Tony Clifford, Charlotte Jones or David Lindsell on 020 7951 2250, 020 7951 2362 or 020 7951 4463 respectively.

Yours faithfully

Ernst and Young LLP