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December 11, 2003

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

*RE: 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.*

Dear Ms. Thompson:

This letter is submitted on behalf of the American Council of Life Insurers (ACLI). The ACLI is the principal trade association of life insurance companies in the U.S., and its 399 members represent, in the aggregate, 75 percent of the assets of all domestic life insurers in the U.S. We appreciate the opportunity to comment on 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 (ED)*. We fully support the Board's effort to include portfolio hedges of the interest rate risk in financial assets and/or financial liabilities in IAS 39. We agree with the proposed changes. However, we do not believe that the changes are substantial enough for many entities to utilize existing systems and hedging methodologies to achieve hedge accounting on portfolios that comply with the underlying principles in IAS 39, nor do the changes reflect the Board's stated intent for IAS and US GAAP convergence.

In addition, we believe the following observations are essential in considering standards for hedge accounting that both fulfill the IASB's objectives and are feasible for implementation.

HEDGE EFFECTIVENESS TESTING

Retrospective hedge effectiveness testing, currently required by the proposed draft of IAS 39, is extremely burdensome for interest rate swap hedge transactions. It requires intricate computations that provide no additional information or benefit and would produce financial statement results similar to those of no ineffectiveness based on a matching of the critical terms of the hedged items. We recommend that the IASB continue to implement the simple meaning of the reading of IAS 39.151 to allow an assumption of no ineffectiveness in a hedging relationship involving an interest rate swap, if the critical

terms of an interest rate swap match the critical terms of the hedged item. We suggest adding the following or similar wording in a new paragraph 152A:

“An entity may assume no ineffectiveness in a hedging relationship involving an interest rate swap if the following criteria are met:

- The notional amount of the swap matches the principal amount of the interest bearing asset or liability
- The fair value of the swap at the inception of the hedging relationship is zero
- The formula for computing net settlements under the interest rate swap is the same for each settlement
- The interest-bearing asset or liability is not prepayable except in circumstances where an embedded call option is a mirror image of an embedded call option in the interest rate swap
- The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship
- For fair value hedges:
 - The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
 - There is no floor or ceiling on the variable interest rate of the swap
 - The interval between re-pricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable portion is at a market rate
- For cash flow hedges:
 - All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged and no interest payments beyond the term of the swap are designated as hedged
 - Floors or caps in the swap match a floor or cap in the asset or liability
 - Re-pricing dates match those of the variable rate asset or liability.”

This wording appears in US GAAP Statement of Financial Accounting Standard No. 133 (FAS 133), in paragraph 68 and is consistent with, though more specific than, the wording in IAS 39.151. These changes would provide uniformity with the underlying principles of IAS 39, but would significantly simplify the computations required in accounting for interest rate swap hedging transactions.

The following is provided as an example. In a one to one hedge of a fixed rate bond, a pay fixed/receive float swap is entered into in order to create a floating rate instrument. At inception and throughout the life of these holdings, the relevant financial terms of the swap match the terms of the bond. By definition, this hedge is and remains effective. FAS 133

requires only that documentation be maintained reflecting that the relevant financial terms match and remain matched. Additional effectiveness hedge testing required by IAS 39 would not produce different results, but creates an additional burden of activity and documentation that adds no value.

PROSPECTIVE CALCULATION FOR HEDGE EFFECTIVENESS TESTING

We would also like to comment on the Board's tentative decision at the October 2003 IASB meeting to revert to the proposal in the IAS 39 Exposure Draft regarding prospective effectiveness testing. Paragraph 146 indicates that "a hedge is normally regarded as highly effective if, at inception and throughout the life of the hedge, the entity can expect changes in the fair value or cash flows of the hedged item to be almost fully offset by the changes in the fair value or cash flows of the hedging instrument, and actual results are within a range of 80% to 125%." Paragraph 151 indicates that "If the critical terms of the hedging instrument and the entire hedge asset or liability or hedged forecasted transaction are the same, an entity could conclude that the changes in fair value or cash flows attributable to the risk being hedged are expected to offset each other fully at inception and on an on-going basis."

We agree that for each purchased hedging instrument, the entity should document why the hedge is expected to be effective. The terms "highly effective" and "almost fully offset" are defined in paragraph 146 for retrospective or "actual" tests when changes in cash flows or fair value of the derivatives are within 80-125% of the hedged item. We believe the prospective hedge determination should be based on the same criteria, but that the prospective test may be based upon either a qualitative or quantitative determination, regardless of the planned retrospective test. At inception of a hedging relationship, if an entity can make a reasonable determination on a qualitative basis that the relationship is expected to be effective (i.e. within 80-125%) based upon critical terms of the relationship, then additional mathematical or statistical testing should not be required. The primary purpose of the prospective test at designation of the hedge is to document management's intent and to document how the hedge will offset variability in fair values or cash flows. Under this assumption, the time consuming process of designing complicated prospective quantitative tests is unnecessary when qualitative tests are sufficient.

Similarly, if an entity chooses to document a prospective test based on a quantitative measure, that entity should not be prohibited from designating a hedging relationship based upon a quantitative prospective test result of 82% when on a retrospective basis, the hedge would have been considered effective. We do not believe that prospective quantitative tests or more restrictive prospective effectiveness rules are necessary to qualify for hedge accounting. We believe that our interpretation of requirements for a prospective test is in compliance with the underlying principles of IAS 39 and is compatible with the language in paragraphs 146 and 151. In order to clarify that prospective and retrospective tests should be based upon the same criteria, we recommend the following underlined change to paragraph 146: "a hedge is normally regarded as highly effective if, at inception and throughout the life of the hedge, the entity can expect changes in the fair value or cash flows of the hedged item to be almost fully offset (e.g. within 80-125%) by the changes in the fair value or cash flows of the hedging instrument."

This change will not only provide an executable, principle-based standard, but will reflect the Board's intent to move toward convergence with US Standards. Differentiation between the quantitative, bright-line definitions for the retrospective and prospective tests will create additional differences to be re-addressed in the future.

CUMULATIVE CATCH UP METHOD FOR ACCOUNTING FOR CHANGES IN ESTIMATED CASH FLOWS

While not directly related to hedge accounting, we would like to take the opportunity to request clarification on a critical issue creating significant obstacles for US companies in implementing IAS. The Board has indicated that a method, designated as the cumulative catch-up method, which is a hybrid of the retrospective and the prospective methods for determining effective interest, is to be the standard for IAS. In seeking clarification and status regarding this method for IAS, the staff indicated to us that:

- The Board settled on the catch-up method, as that term is used in FASB Concepts Statement 7. The Board's thinking was the same as the FASB's. Under US GAAP, several pronouncements that require this method come to mind, including Statement 114 (loans), Statement 97 (DAC on universal life), and Statement 113 (reinsurance).
- The catch-up method requires exactly the same inputs as the prospective method (existing balance, original rate, estimated remaining cash flows). The prospective method adjusts the effective rate, while the catch-up method adjusts the balance.

Our research of US GAAP literature indicates that the term “catch up” method is used only once. It is, in fact, in FAS Concept 7 (CON7), Appendix B, commenting on the differences between the conclusions reached in CON 7 and those found in FAS 114: “The ‘discounted’ approach adopted in the Statement (FAS 114) is a “catch-up” approach to the interest method of allocation. That is, the balance is adjusted to the present value of estimated future cash flows, using the original effective interest rate.”

US GAAP guidance in FAS 91 for debt and equity securities, EITF 99-20 for beneficial interests in securitized assets, and FAS 114 for mortgage loans, among others cited by the IAS staff, allow only the retrospective or the prospective method for calculating effective interest. In every case, the interest rate is adjusted and not held at a fixed rate. However, the IAS cumulative catch-up method, as clearly indicated by the examples outlined in the appendix to the September IASB meeting Information for Observers, is neither the retrospective or prospective methods. Rather it holds the interest rate constant and adjusts the balance of the asset. Consequently, this represents a significant departure from current US GAAP accounting practice.

This divergence presents substantial implementation hurdles since none of the major securities accounting systems used by US insurance companies have the capability of

accounting in accordance with the IAS cumulative catch up method (i.e., maintaining fixed coupon rate, creating a valuation allowance based on the change in the estimated cash flows which is amortized at a rate over the remaining life of the asset to create level yield). Through discussions with the vendors, alterations to the accounting systems would be sizable in terms of both time and money, in order to render them compliant with this new IAS standard. Therefore, we have great concerns about our understanding of the IASB's use of the cumulative catch-up method and any assumptions that this would be consistent with US GAAP.

Thank you for the opportunity to comment. We appreciate your consideration of the practical issues involved in these important topics and would be happy to discuss our comments with you at your convenience.

Sincerely,

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