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Dear Sandra

Exposure Draft of proposed amendments to IAS 39
Fair Value Hedge accounting for a Portfolio Hedge of Interest Rate Risk

We appreciate the opportunity to respond to the International Accounting Standards Board's Exposure Draft of its proposed amendments to IAS 39. This letter represents the views of KPMG International.

We support the IASB's attempt to provide a practical solution to enable fair value hedging to be applied more readily to a portfolio hedge of interest rate risk. We believe it is important that, within the principles of hedge accounting in IAS 39, approaches are found that allow appropriate and accepted risk management methods to be reflected in hedge accounting without major systems changes. Wherever possible, we believe inconsistencies should be avoided between the approach followed for risk management and the hedge accounting. In particular, we believe the approach described in paragraph 133 of IAS 39, where a hedged item for accounting purposes is selected with little or no regard to the item that is being hedged in economic terms, should be avoided wherever possible.

We note, however, that the proposed approach, unless also adopted in the USA, would create a difference with SFAS 133 that is contrary to the Board's convergence objective. Although we support the Board's objective in making these amendments, we would urge the Board, within its stated principles, to ensure that any guidance provides entities with an approach that they are able and intend to apply in practice in time for 2005.



In general we support an approach of the type proposed in the Exposure Draft. However, we believe the methodology set out in the ED is too prescriptive in the following areas:

- We would support an approach under which a net position may be designated as the hedged item, although we understand that would be a significant change to IAS 39. If the Board is not prepared to make such a change in the context of this limited scope amendment, then we would support an approach under which effectiveness testing is based on the net position;
- Consistent with the permission to hedge ‘portions’ and layers of risk in IAS 39, we believe the Board should consider whether its proposal to include prepayment risk in the hedged item goes beyond the existing requirements in IAS 39; and
- We believe that ‘over-hedging’ of the net position should result in ineffectiveness. However, we do not believe that ‘under-hedging’ should give rise to accounting ineffectiveness.

In order to provide an approach that is workable in practice, we believe the proposals should recognise more directly the principle that an entity is ‘over-hedged’ only between the time that changes in interest rates (or other factors) are expected to accelerate the incidence of prepayments of a hedged item and the time when the entity responds by redesignating its hedging relationships.

We note that the proposals provide only one possible solution based on the allocation of amounts into time-periods. We understand that some banks apply more sophisticated approaches to interest-rate risk management and that these proposals will not be attractive to them.

Finally, we note that foreign currency risk management by a corporate entity using a central treasury ‘netting centre’ creates similar issues in terms of the need for a practical solution that aligns risk management and hedge accounting within the constraints of the principles in IAS 39. We refer to our comment letter on the proposed amendments to IAS 32 and IAS 39. We would encourage the Board to consider these issues further once the current round of amendments is completed.

Our responses to the questions raised in the Invitation to Comment are set out below.

Question 1

How should the hedged item be designated?

Consistent with the way in which a bank manages interest rate risk, we would support an approach under which a net position within a specified repricing/expected maturity time-band may be designated as the hedged item. The requirement for a portfolio to be defined narrowly, such that each item responds in the same way to the risk being hedged, would be extended to

portfolios of assets and liabilities in which each item responds in the same way (either positively or negatively) to changes in the risk being hedged.

We note that the arguments in BC12 are based on the premise that measuring the change in fair value of a portfolio of assets and liabilities due to changes in interest rates might be difficult. We agree that it would be inappropriate to assume that the change in the fair value of the hedging derivatives equals the change in fair value of the hedged net position. However, if assets and liabilities within a portfolio (a) mature within the same narrow time-period and (b) are hedged with respect to the same benchmark interest rate, then we would assume the change in fair value of the portfolio (due to changes in the risk-free interest rate) is not difficult to compute. 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, due to 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.

We recognise that designating the net position as the hedged item would be a significant change to the requirements in IAS 39 that the Board may not wish to consider as part of these limited amendments. We suggest, however, that at least for the purpose of effectiveness testing, it is recognised that the hedged item is the net position. If the net position were the hedged item for effectiveness testing purposes, then we believe Approach C is the appropriate method to measure the impact of over-hedging. Over-hedging would then arise only when the net asset or liability position is less than the notional amount of the portfolio of hedging instruments.

Our proposed approach to prepayment risk

We note that 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 5-year fixed/floating interest rate swap, this is equivalent to hedging the first 5 years of the first component.

The argument in BC 21(d) against allowing this approach to be applied is that the IAS 39 fair value hedging model would require both components to be remeasured for changes in the hedged risk. Since IAS 39 allows an item to be separated into both portions and layers of risk for the purpose of designating the hedged item, we understand that IAS 39 would currently allow the prepayment option to be excluded from the hedging relationship. We are not aware of any guidance to the contrary in IAS 39. Although not explicit with respect to prepayment risk, IGC 128-3 recognises that hedge accounting is not restricted to the entire exposure to the interest rate risk. We note, however, that US GAAP would not permit prepayment risk to be separated from interest rate risk. We encourage the Board to consider further whether its proposals on prepayment risk go further than is currently required and, if so, whether the proposals should be prescriptive in this area.

The arguments that follow in BC21(e) are (i) that interest rate risk and prepayment risk are so closely interrelated that it would be inappropriate to separate them and (ii) that it is extremely

difficult to measure the two components separately. With respect to (i) the Standard does not preclude similar risks from being separated, for example it allows fair value changes due to changes in the spot/forward differential to be excluded from the hedged item even though this is clearly interrelated with the spot exchange rate and market interest rates. With respect to (ii) we understand that at least a number of banks are able to measure separately, and even hedge, prepayment risk. We note that IGC 121-2, in respect of the cash flow hedging model, states that 'the fair value exposure attributable to prepayment risk can generally be hedged with options'. We would therefore permit an entity to exclude prepayment risk from the hedged item as long as it can be measured reliably.

Our proposed approach to under- and over-hedging

We do not agree that both over- and under-hedging should always lead to ineffectiveness under the model proposed and so we find it difficult to support Approach D as being the only acceptable approach. It seems that Approach D extends the position in IAS 39.137A that the hedged item in a fair value hedge may be an identified portion of an asset to specify that it must be a proportion, or percentage, of the amount of the asset. Of all the alternatives, Approach D is also the most complex and is likely to be the most difficult to achieve without significant systems changes.

The main reason for the Board's preference for Approach D seems to be that the effects of changes in the expected timing of prepayments, either forwards or backwards, should give rise to ineffectiveness. In Appendix 1 we explain why we disagree with that view, referring to the case set out in the Illustrative Example. Our conclusions from Appendix 1 are:

1. Changes in interest rates, or other factors, that change an entity's expectations about prepayments should impact the income statement when prepayments are expected earlier than previously estimated, because the entity is over-hedged;
2. When prepayments are expected later than previously estimated, there should be no income statement impact. The entity simply has an un-hedged exposure with respect to part of the term of the hedged item. We note that IAS 39 does not require an entity to hedge an interest rate exposure;
3. The proposed approach could result in multiple income statement impacts because 'ineffectiveness' will occur in both the time period in which the item was originally placed and in the time-period to which it is moved. Although these impacts may partially offset, we are concerned that this may not always be the case; and
4. In economic terms, an entity is over-hedged only from the time that interest rates (or other demographic factors) change until it rebalances its economic position. We believe the proposals should clarify that an entity may reduce the impact of over-

hedging by ensuring that it responds swiftly to a change in interest rates that impacts expectations about prepayments.

In broad terms we would support an approach similar to Approaches B and C, which we regard as variants of a 'top layer' approach. However, we believe the proposals should be limited to establishing a principle that ineffectiveness due to 'over-hedging' is recognised when prepayments take place, or are now expected to take place, earlier than previously estimated. We note that applying any of the possible approaches would likely require significant systems changes to track movements between time-periods. Indeed, it may be extremely difficult to determine whether a change in the amount allocated to any single period arises because of (a) delays in expected prepayments or (b) accelerated expected prepayments or (c) purchases and disposals. As long as ineffectiveness arising from over-hedging is recognised, we believe entities should be permitted to develop an approach that requires the least change to whatever existing systems are in place.

In order to achieve a solution that is workable, we believe the Standard should place more emphasis on the idea that over-hedging occurs only between the date that expectations change and the date that the economic hedges are rebalanced to reflect changed expectations.

Finally, we believe the proposals should address how hedge accounting is to be terminated if either the hedge ceases to be effective or is discontinued for certain periods but not for others. We believe it should also clarify that a prospective effectiveness test should be performed even when critical terms are matched under the approach followed.

Approaches A, B and C and the 'material ineffectiveness' principle

Paragraph BC 21 sets out the arguments against Approach A, which the Board (BC23) also uses to reject Approaches B and C. We note that BC21(a) and (b) argue against Approach A but not against approach B/C.

BC 21(c) argues that IAS 39 requires ineffectiveness to be recognised when the derivative is smaller than the hedged item. This is true, for example in the case where a derivative with a notional amount of 20 is designated as a fair value hedge of an asset with a face amount of 100. In practice, however, the hedged item would be designated as a portion (20%, i.e. 20) of the asset. In that case no ineffectiveness would arise if a new asset is purchased, because the new asset is not part of the hedged item. This is recognised in IGC 128-4. The argument in BC21(c) is, in our view, flawed.

The arguments in BC 21(d) and (e) and (f) and (g) have been dealt with under 'prepayment risk' above, and our conclusion is that an entity should be permitted to hedge interest rate risk for part of the contractual term of the asset and excluding the prepayment option from the hedged item. This is true equally for hedges of individual assets and for portfolios.

We believe, therefore, that there are sound arguments against all the Board's stated reasons for rejecting Approaches B and C. As noted above, we regard Approaches B and C as essentially

similar, with the only difference being that, under Approach C, only 16 out of the net position of 20 is hedged. However, we would support Approach C only if the net position were the hedged item or the net position were considered for effectiveness testing, because the amount of 20 (from which the hedged item of 16 is drawn) exists only if the hedged item is recognised as being the net position.

Based on the guidance in IAS 39, we agree with the Board that Approach A is inconsistent with a fair value hedging model. However, we note that, in economic terms, the hedged item is the same whether the accounting solution is achieved through a cash flow or fair value hedge accounting route. If the idea is to provide entities with a choice of models to achieve hedge accounting for the same economic hedge, then it seems inappropriate to exclude a bottom-layer approach from the fair value solution when it forms such a central pillar of the cash flow model in IGC 121-2. This is another reason why we would deal with ineffectiveness through a principle on over-hedging rather than by providing prescriptive approaches.

We believe it is important to distinguish between under-hedging, as described above, and ineffectiveness due to other factors as described in A35. We agree that ineffectiveness arising from maturity mis-matches and other factors (A35(b) to (d)) should be recognised. Because of the distinction between the two concepts, we believe our proposed approach meets the Board's principle on effectiveness.

How and when would hedging adjustments be removed from the balance sheet?

On balance we support the proposal in the ED to release the adjustment in respect of each time-period into income at the latest when that time-period expires. Although arbitrary, we also support the proposed treatment for early disposals of assets, to permit the amount to be removed from the earliest time-period available. However, we note that paragraph A39 is unclear in this respect. Initially it seems to require tracking of the amounts deferred in different periods related to the same hedged item, so that these amounts can be released on derecognition. Such an approach would, we assume, be impractical. Only at the very end of A39 is the practical solution introduced, as explained further in A40.

Although we support this practical accommodation, we note that it represents a significant exception to the requirement in IAS 39 that may, in practice, produce significant volatility in income compared to the result that could be achieved by designating specified hedged items or from using a cash flow hedge accounting model. We are unsure if, in the proposed solution, the Board is assuming that amortisation of the hedging adjustments would take place in each period so that, in general terms, balances in each time-period will be small by the time that period expires. If so, we believe that should be stated. The Basis for Conclusions should explain why the Board believes this element of the solution is acceptable and how it believes the proposed approach will achieve a result that is consistent with the requirements for basis adjustment and its subsequent amortisation as part of an amended effective yield calculation that would be applied on an individual asset basis.

We understand that the purpose of hedge accounting in this context is to support the risk management objective of the entity by reflecting the effect of the economic hedge to reduce volatility in the interest margin. We wonder whether this can be achieved using the simplified approach under these proposals. We assume that the Board would also support other pragmatic approaches to releasing the amounts deferred as hedging adjustments as long as (a) they approximate the result that would have been achieved had the individual amounts been designated as hedged items and (b) as a minimum, the amount related to each time period is fully released into income when that time period has expired. We believe the Board should consider, and clarify, whether other approaches to recycling the hedge adjustment may also be appropriate.

Question 2

We agree that all of the assets and liabilities that make up the hedged position must be items that could have qualified for hedge accounting if they had been designated individually. We also agree that the fair value of a liability that the counterparty may redeem on demand is not less than the amount payable on demand, because this is the amount that depositors have provided in an arms length transaction. Although it is true that the portfolio of deposits might be settled (perhaps with another bank) for less than its face value, it is clear that IAS 39 currently does not contemplate valuation adjustments based on portfolios, large holdings, etc. We also support the view in the Basis for Conclusions that deposit balances do not generally remain outstanding, but rather are withdrawn and replaced via regular transactions with the customer.

On balance, however, as a practical measure for the purpose of portfolio hedging of interest rate risk only, we would support an approach that allows such deposits to be classified into time-bands based on their expected maturities and to form part of a hedged item. We do not see this as being significantly different from allocating assets into time-bands based on expected maturities, although, of course, it does involve increasing maturities beyond the contractual term rather than assuming prepayments before the contractual term is complete.

However, we would permit such an approach only to the extent the entity is able to demonstrate that the fair value of the allocated deposits responds to changes in interest rates in a similar way to other items included in that maturity band. Since deposits typically carry interest at below the risk-free interest rate and their continued existence will depend on complex behavioural factors as well as interest rates, we do not believe it is sufficient to assume that a simple allocation of deposits to time periods based on their expected maturities is appropriate. The Standard should recognise that further analysis, and perhaps complex modelling may be necessary in order to determine amounts of deposits that should be allocated into time-periods so that the fair value of the allocated amount will respond in the same way to changes in interest rates as other items in the portfolio.

Because we would support such an approach only for the purpose of hedge accounting, we would not allow the portfolio fair value concept to be used on initial recognition to recognise a gain from transactions with depositors.

Other comments

With regard to hedging instruments, we note that paragraph A31 would permit only portfolios of similar derivatives to be designated as the hedging instrument. It is unclear what the addition of the word 'similar' is intended to achieve and perhaps this could be clarified.

We also believe the proposals should clarify whether it is intended that an entity should be permitted to identify several portfolios – for example loans and, separately, available-for-sale securities – and to apply the model to each portfolio. We assume that would not be prohibited.

The proposals seem to accept that it is appropriate to group together, for the purpose of hedge accounting, fixed rate instruments that are expected to mature in a specified time period with variable rate instruments that reprice in the same time-period. We wonder whether the risk characteristics of these two types of instrument are sufficiently similar for inclusion in the same portfolio, and we suggest that the Board clarify its intentions in the basis for Conclusions.

Once again, we appreciate the opportunity to comment on the proposals. Please contact Terry Harding at 020 7694 8640 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG

Appendix 1 – Approaches to under- and over-hedging based on the Illustrative Example

We refer to the case set out in the Illustrative Example, where Company A has scheduled assets of 100 and liabilities of 80 into a 12-13 month time-bucket (P13) and uses a pay 12.5 month fixed, receive LIBOR swap to hedge the net position. In case 1 we assume that interest rates increase so that prepayments are expected later than previously estimated. In case 2 we assume that rates fall so that prepayments are expected earlier than previously estimated.

Case 1 (IE4)

LIBOR has risen and so items that were expected to prepay in earlier periods are rescheduled into P13 and the amount of assets in the P13 bucket increases to 120. Under the proposed approach, ineffectiveness results. In our view there is no ineffectiveness, but rather, with the benefit of hindsight, Company A has been underhedged. Assume the effect of the rate change has been to move the 20 of assets from P7 to P13. In the previous period, Company A will (we assume) have hedged the assets for their expected maturity to P7. The change in rates simply means that P8 to P13 was unhedged in respect of those items.

The amount previously hedged in P7 will have reduced by 20, in simple terms, because those amounts have moved to P13. Under the proposed approach, 'ineffectiveness' would be recognised due to 'over-hedging' in P7 and due to 'under-hedging' in P13. However, the reality is that Company A was properly hedged for P1-P7 and under-hedged in P8-P13.

We are concerned that the proposed approach will give rise to a 'double-dose' of ineffectiveness, when the reality is that the entity was, in hindsight, simply not hedged. Of course, the impact of the 'over-hedge' in P7 may reduce the impact of the 'under-hedge' in P13, although we are not convinced that will always be the case. Since there is no requirement to hedge in IAS 39, we do not believe any ineffectiveness should arise in this example.

Case 2

Using the same example, assume now that interest rates fall and customers are expected to prepay early. The amount of assets in P13 reduces from 100 to 80 and the amount in P7 increases by 20. Under the proposed approach, it seems that ineffectiveness would arise in P13 due to 'over-hedging' and also in P7 due to 'under-hedging'. The reality is that, with the benefit of hindsight, Company A was over-hedged for P7-P13.

A further consideration, however, is how often the entity rebalances its hedges and when, during these periods, the interest rate changes. In Case 2, Company A is only over-hedged between the date that interest rates change (and therefore prepayment expectations change) and the date it responds to this by rebalancing its economic hedges. The assumption, in the proposed approach, that 'ineffectiveness' arises from the previous hedge designation date is not necessarily valid. Indeed, proper risk management might suggest that Company A would rebalance its economic hedges as soon as expectations change, otherwise it would be economically over-hedged.