

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London, EC4M 9QQ
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Canon Street
London
EC4M 6XH
United Kingdom
CommentLetters@iasb.org.uk

Friday 14th November, 2003

Fair value hedge accounting for a portfolio hedge of interest rate risk

Dear Ms Thompson

ISDA appreciates the opportunity to comment on the recently published “Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk”.

Our members represent leading participants in the privately negotiated derivatives industry and include most of the world’s major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such we believe ISDA brings a unique and broad perspective to the IASB’s work on accounting for financial instruments.

Over the past twelve months we have worked closely with you on specific aspects of the proposed amendments to IAS 39, specifically in relation to the fair value measurement of derivative portfolios and we hope that you have found this informative and beneficial to the overall process.

We welcome this opportunity to continue our assistance through comments on the latest proposals on the treatment of portfolio hedging. We recognise that these proposals represent a compromise on the IASB’s part, following a lengthy dialogue with representatives from the European banking industry. However we believe that the compromises made do not go far enough to provide a workable solution for banks that manage their exposure on a portfolio basis.

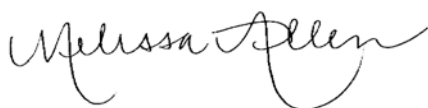
We have set out as an appendix, ISDA's response to the two questions posed in the Exposure Draft, along with recommended changes which we believe are required to result in an approach that is operationally viable and consistent with underlying risk management practices.

In particular, it is our view that:

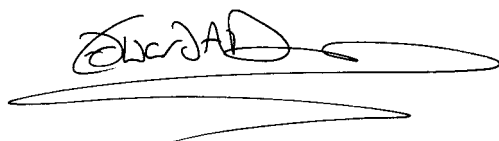
- The hedged item in a portfolio hedge should be designated to a net asset or liability position in order to align the accounting results with the actual economic substance;
- The measure of effectiveness should only consider the hedged portion, and as such should not lead to ineffectiveness when prepayments are slower than expected;
- Core deposits should be afforded fair value hedge accounting when included in a portfolio hedge; and
- The interrelation between the ED and certain paragraphs of IAS 39 should be clarified.

We would be pleased to discuss our comments with the Board or staff. Please contact Ed Duncan, Assistant Director of European Policy for ISDA, at 7330 3574.

Yours sincerely



Melissa Allen
Chair of the ISDA European Accounting Committee
Global Risk Solutions
BNPParibas



Ed Duncan
Assistant Director of European Policy at ISDA

APPENDIX

Question 1

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?

ISDA welcomes the idea, introduced by the ED, that an amount of assets or liabilities in a maturity time period can be designated as the hedged item rather than specific items. This is more consistent with the risk management techniques employed by banks, particularly in relation to retail portfolios where there are many underlying assets and liabilities but few hedging derivatives. However, to genuinely reflect the risk management methods followed, ISDA believes that a hedging derivative should be designated as a hedge of a net portfolio of assets and liabilities. Allocation of a hedge to a gross asset or liability position for accounting purposes would be inconsistent with the portfolio relationship of the underlying economic substance of the hedging relationship. Therefore, ISDA recommends that the approach set out in the ED be extended to allow designation of a net position.

Further, ISDA does not believe that the approach adopted in the ED to measure ineffectiveness is either consistent with the principles set out in the rest of IAS 39 or the underlying risk management techniques of banks.

For example, if assets of CU100 are offset by liabilities of CU80, leaving a net position of CU20, which is hedged by a derivative, then the entire portfolio of assets has been hedged. CU80 is hedged naturally by the liabilities and CU20 is hedged by the derivative. If CU5 of the assets prepay early, there will be ineffectiveness as there is now an over hedge of CU5.

If, however, the assets prepay slower than expected, the ineffectiveness should be nil, since the hedged position has not changed. If a company elects under the current IAS principles to designate a fair value hedge of, for example, the first five years of a 10-year bond as outlined in IGC 128-2, changes in expectations regarding year 6 of the bond would not lead to ineffectiveness, as this period was not included in the designated hedged portion of the bond. Furthermore, when the standard hedge accounting rules are applied, if a company hedges assets of CU20, it will not report ineffectiveness if the CU20 increases to CU30 during the period.

In reality a bank will be concerned about the prospect of a portion of the portfolio prepaying quicker than expected and will not fully hedge the net position of CU20. Rather, it will leave a portion that is neither hedged by the derivative nor by the liabilities in the balance sheet. In the example above the derivative entered into might be CU12 leaving an unhedged net position of CU8. Therefore, if the prepayments are CU5 for the period then there should be no ineffectiveness as the position is still under hedged by CU3. However, if the prepayments exceed the CU8 unhedged position then ineffectiveness will arise.

Therefore, of the four methods being considered by the IASB, ISDA believes that Method C is closest to risk management techniques employed and is most consistent with the hedging principles set out in IAS 39.

Question 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?

ISDA believes that demand deposits have economic maturities that can be replicated and built into a Bank's assessment of its interest rate exposure. We believe that the standard should allow these deposits to be treated based on their economic maturity rather than their contractual maturity, and therefore ensure that the accounting treatment truly reflects the underlying economic substance.

The IAS 39 definition of fair value is the price that transactions would change hands between willing, knowledgeable buyers and sellers. It is clear that whilst core deposits are not actively traded, that on occasions when banks have acquired other banks the core deposits have been valued at an amount that differs from the face value and is based, in part, upon the economic maturities of the deposits.

It should also be recognised that core deposits are viewed as a portfolio and it is the value of the portfolio that is important. For example, if a bank only had one demand deposit, there would be a reasonable probability that the deposit would be withdrawn immediately and thus, if this deposit were sold on its own to another bank, its fair value could in fact be very close to the demand amount. However, the price that a willing buyer would accept for a portfolio of core deposits is determined by the economic behaviour of the portfolio, which in turn is driven by the economic maturities of the portfolio and not by the contractual demand amount.

Because a bank's exposure is not to any individual demand account but to the entire portfolio, any economic hedging strategy will be based upon the expected economic behaviour of the portfolio. Behavioralising the 'forced prepayment' feature included in demand deposits is consistent with the technique recommended in the ED for prepayable assets. Consequently, ISDA believes that the economic arguments for the assets should be applied consistently when hedging liabilities.

In practice, a bank may be in a net fixed-rate asset position in some time buckets and a net fixed-rate liability position in others. Over time this can fluctuate between net assets and net liabilities. If core deposits remain ineligible for fair value hedging then a bank may have to switch between cash flow and fair value hedging. The operational requirements to manage such transitions and the accounting that will follow will be challenging and difficult to interpret.

In order to more appropriately reflect the economics of the portfolio hedging relationship ISDA therefore recommends that the IASB allow demand deposits to be considered a hedged item in a fair value portfolio hedge.

Other comments

ISDA believes that the following issues will also need to be addressed before the proposals will produce an operationally viable standard: -

1. ISDA believes that it is unclear how the proposals in the ED interact with the requirements of paragraphs 142 and 146 of IAS 39. For example it is unclear whether the portfolio hedges are, in addition to the requirements set out in the ED, expected to be highly effective in prospect, and for actual results to be within the range of 80 – 125%

While normal hedge relationships are entered into with an expectation of being highly effective, assets that contain prepayment risk will generally lead to some ineffectiveness for each maturity period. Therefore, applying paragraphs 142 and 146 is likely to mean that the proposals set out in the ED will often be inapplicable.

If the text of IAS39 is amended to make it clear that the ineffectiveness proposals in the ED are an alternative to the normal rules in IAS 39 then this problem will be resolved.

2. We welcome the proposed amendment to allow a portfolio of offsetting derivatives to be designated as a combined hedging instrument, as this is more in line with actual hedging activities. Furthermore, we agree with the IASB's proposal that this amendment be applicable to all hedging relationships and not just for portfolio hedging.

However, when portfolio hedging is applied, it may also be necessary to split derivatives into time periods in the same way as the hedged assets and liabilities are divided into time periods. For example, an amortising loan will be allocated to time periods in a manner that corresponds to the principle repayment dates. The exposure could be hedged either using an amortising swap or a series of standard swaps corresponding to the principle reduction dates. If the amortising swap cannot be split and allocated to the relevant time periods then a different accounting result would be achieved depending on which of the economically equivalent strategies are followed. Therefore, we recommend that paragraph 126F of the ED be expanded to allow for a portion of a derivative to be designated as a hedging instrument in a portfolio hedge. If there are concerns that a derivative is divided into portions, some of which are hedges and others which are held for trading, the amendment could stipulate that while a portion of a derivative can be designated as a hedge for a particular time period, all portions of the derivative must be used in one or more hedging relationships.

3. We also believe that paragraph 132 of IAS 39 will need to be clarified with regards to a hedged portfolio of interest rate risk. The paragraph currently states that ‘the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.’ This statement has been interpreted by some to require that the expected maturity periods of each asset and/or liability included in the portfolio must be comparatively narrow. If this is the case, the proposals in the ED will require a bank to divide its portfolio of assets and liabilities into sub-portfolios which are so small that hedging of individual assets and liabilities would potentially be required.

It is true that the fair value of a ten-year bond is more sensitive to interest rate movements than a five-year bond. However, if for example, both a ten-year bond and a five-year bond are included in a portfolio hedge of time period three then, for example, the present value of the amount included in time period three would move consistently as interest rates in period three change.

ISDA recommends that the standard be clarified on this issue.

4. 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 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 CU1m is established in the balance sheet representing the change in value of CU100 of hedged assets due to mature in period N. If the hedged relationship is then adjusted so that, going forward, only CU20m of asset are hedged, it is not clear what should be done with the proportion of the CU1m relating to the CU80m of assets no longer being hedged. All else being equal, the fair value of the CU20m 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 CU1m 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.

If this is not the intended outcome, the wording of the Standard will need to be amended to address how these amounts should be treated.