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Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
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UNITED KINGDOM

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 Sir David,

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (the IASB's or Board's) proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39), *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (the ED).

We commend the Board for its willingness to consider serious concerns raised by constituents over IAS 39 and to evaluate approaches that are responsive to these concerns. We remain hopeful that a final standard can be developed that retains the integrity of hedge accounting as set forth in IAS 39 while accommodating portfolio hedges of interest rate risk.

When making our assessment as to whether the ED has accomplished its aims we have borne the following points of reference in mind:

1. Will the recommended approach enable users of financial statements to identify successful and unsuccessful hedging strategies?

2. Does the recommended approach satisfy the three principles most relevant to fair value hedging as discussed in paragraph 3 of the ED?

3. Does the recommended approach simplify the application of hedge accounting in an operationally feasible way?

We understand that these points of reference can point in different directions. For example, satisfying point 1 could very well be at odds with point 3 (i.e. capturing

information to ensure that hedge strategies are effectively measured). Thus, the Board will have to continue to exercise a great deal of judgement in weighing up such trade-offs.

Our analysis of the above reference points as applied to the ED is as follows.

Identification of Successful and Unsuccessful Hedging Strategies – The mechanics of a method to achieve portfolio hedge accounting should readily identify poorly conceived hedges or hedges that are ineffective. Additionally, the mechanics of such a method should not preclude economically viable hedges. With the exception of Approach D, we have concerns that the other approaches discussed in the ED fail to satisfy this requirement. Unfortunately, Approach D perhaps suffers from identifying too much ineffectiveness, for example in cases of derecognition, and thus forcing successful hedgers to report a lack of success. See our comments in paragraph 1.1.1 in the Appendix.

Adherence to Principles – One of the key principles cited by the Board is that deferred gains and losses represent neither assets nor liabilities and thus do not warrant balance sheet recognition. On balance we believe that Approach D adheres to this principle more than the other approaches, however we consider the ED lacks specific guidance in certain key areas that may breach this principle. For example, it is not clear how amortisation of gains and losses should be treated on discontinued hedges when it is not possible to specifically identify the hedged items by maturity bucket (see Appendix paragraph 1.1.3).

Operational Simplification – We support the Board's objective of making changes to simplify the application of IAS 39 when such changes do not violate the fundamental concepts or principles in IAS 39 and other literature. We are concerned, however, that the ED does not achieve this objective. We note that whichever approach is applied in the ED, the result will create an additional layer of exceptions to an already complex standard. At a minimum, we believe that any exception from the basic measurement and hedge accounting requirements in IAS 39 needs to be clearly defined and operational. It is an important objective of creating an exception and a solution for fair value hedge accounting for a portfolio of interest rate risk. We question whether this goal has been achieved with Approach D. We note that while the other approaches discussed in the ED may appear simpler than Approach D, they have their own unique operational issues. Nevertheless, if Approach D cannot be made operational, we suggest that the Board consider pursuing Approach A, which appears to have the benefit of certainty in application and fewer practical hurdles that practitioners will need to overcome.

We suggest that the Board consider using our reference points to evaluate whether or not a final standard achieves a proper balance.

We are aware that the Board's conclusion to restrict the ability to designate demand deposits as a hedged item in a portfolio fair value hedge of interest rate risk beyond their contractual maturity date is a source of very considerable consternation in the banking community. Many entities remain firmly convinced that demand deposits remain stable over time. They are used as a long-term source of funding of their loan portfolios and the banks consider this situation generates an interest rate exposure, which they hedge with interest rate swaps. We acknowledge that the extensive debate on this subject has not yielded a solution that is acceptable to the Board in the context of the core principles. We are concerned, however, that the credibility of the standard could be undermined if, in

practice, it led to the enormous volatility in reported results for banks that does not reflect the true underlying economics that has been predicted by some industry commentators.

We urge the Board therefore to give serious consideration to any empirical evidence (based on historical results rather than theoretical scenarios) produced by the banking industry. If such empirical evidence reveals dramatic consequences, we believe the Board will need to seek an urgent practical solution. In the absence of such evidence, we recognise that the ED has made considerable progress in the area of portfolio hedging and should be allowed to proceed accordingly.

In summary, we encourage the Board to continue its work on fair value hedge accounting for a portfolio of interest rate risk. The Appendix sets out our answers to the questions raised in the ED as well as other comments.

We appreciate the opportunity to provide our comments. If you have any questions concerning our response, please contact Ken Wild at +44 207 007 0907.

Sincerely,

Deloitte Touche Tohmatsu

Appendix

Question 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 IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit and 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?

1.1 Hedged item

We believe that Approach D has more conceptual merit than the other approaches that were described in the basis of conclusions. Approach D is in many ways an extension of the current standard, specifically paragraph 133, that permits designation of a proportion of an asset or liability equivalent to a net exposure. We recognise though that even this approach is not entirely consistent with the current standard as IAS 39 does not currently allow the fair value movements in respect of the hedged item to be recognised separately on the balance sheet whilst not being attributed to specific assets or liabilities. However, we do consider that this exception is an acceptable accommodation that needs to exist in all four approaches.

The proposal requires that the hedged item be designated as a percentage of currency units within a designated time bucket. We believe that the Board should provide clarification as to how the width of a time bucket can be assessed for appropriateness. If the Board feels that this should be a decision left to the entity, it should state that this is the case.

We suggest the Board clarify what it considers to be the definition of a portfolio. Would merely having an asset and a liability designated together constitute a portfolio? For example, if an entity has one asset valued at 100 and a liability valued at 80, could an entity determine that the combination of the asset and liability constitute a portfolio and therefore the entity could apply the ED? Taken to the extreme, would an asset of say, 100 and an offsetting liability of 1 be considered to constitute a portfolio?

1.1.1 Interaction with impairment and derecognition guidance

Ineffectiveness arises in Approach D where the actual cash flows inherent in the fixed rate instruments in a time bucket differ to the estimated cash flows. This ineffectiveness can arise from an impairment or a derecognition event in the reporting period.

Consistent with the tentative conclusions of the May IASB Board meeting, we expect the revised version of IAS 39 to confirm that impairment is based on an "incurred but not reported model". This model allows impairment based on statistical techniques identifying incurred losses that have not yet been specifically identified. It is not clear from the ED

how an impairment provision that is recognised prior to individual identification of a specific debtor balance going bad can be allocated to a specific time bucket. Clarity is needed on how impairment should be applied across time buckets, and whether in fact impairment should result in ineffectiveness where specific balances have not yet been identified as impaired (i.e. on a group impairment evaluation).

Additionally, clarity is also needed as to how ineffectiveness is measured and allocated across time buckets for partial derecognition transactions, for example where some risks and rewards have been retained (whilst some have been transferred), and the transferor retains a residual interest in the assets that have been subject to the transfer. Retained interests in securitised assets have unique characteristics that impact their fair value that distinguish them from other financial assets. In many cases continuing involvement exists due to the transferor retaining credit risk, which is generally relatively insensitive to movements in interest rates. For example, an entity sells a portfolio of loans for 100, but writes a put option over the residual credit risk for 5 when expected credit losses are 10. As the loans are not readily obtainable in the market we therefore derecognise 95, and continue to recognise the residual interest of 5. Does this mean that all cash flows that were subject to interest rate risk should be removed from the time buckets resulting in full ineffectiveness, or just part of the cash flows because a portion of the asset is retained? The interaction of the derecognition requirements within IAS 39 and those in the ED is particularly relevant as it is fixed rate assets, such as mortgages, that are commonly used in securitisation transactions that do not generally achieve full derecognition.

We note that paragraph A39 of the ED states that where derecognition of an asset cannot be specifically identified, the cash flows should be removed from the "earliest available time period", i.e. the first time bucket that is hedged. In order to avoid potentially significant levels of ineffectiveness in the early time buckets, an entity would need to track all cash flows inherent in all fixed rate instruments in order to determine which cash flows that correspond to the derecognised instrument should be removed from which time buckets. This requirement largely eliminates much of the benefit of pooling similar instruments together and hedging the cash flows as a whole.

1.1.2 Ineffectiveness measurement

Paragraph 151 of the current standard states that hedge ineffectiveness measurement need only be calculated at a minimum every reporting period. We are concerned that this may no longer be the case as practically an entity would be required to test ineffectiveness as frequently as the duration of each time bucket. This is because the ED requires expected cash flows (rather than contracted cash flows) to be hedged and therefore there is a corresponding requirement to report ineffectiveness more frequently as these expected cash flows change. If the result of applying the ED will result in increased frequency of hedge ineffectiveness measurement, the standard should state this.

Additionally, it is our experience that the availability of prepayment information, i.e. data indicating changes in prepayment rates, is not necessarily timely. This information could only be available for a particular monthly time bucket some months following the initial designation when the time bucket has already elapsed and new designations have occurred. We would suggest that if the entity is unable to obtain timely data, then an expectation of changes in that data could be used subject to certain restrictions. There should be

continuous back testing of expectations such that if this back testing of data proves that the entity's expected changes in cash flows have consistently not been sufficiently accurate the entity should be precluded from hedge accounting until such time as sufficient accuracy can be demonstrated.

We envisage that the determination of ineffectiveness in the first time bucket will prove to be problematic. By definition, cash flows in the first time bucket will no longer exist when we come to assess hedge effectiveness, as actually, they will have occurred. For example, if we assume that the derivative hedging the cash flows in the first time bucket matures we will have either a final cash payment or receipt which will be the change in fair value of the derivative for that period. When we come to calculate the effectiveness of the hedge for the first time bucket our revised expected cash flows are by definition zero (as all cash flows in that bucket will have been derecognised). As a result, when we apply our initial percentage to the hedged position, and then determine the fair value movement in the revised expected cash flows, this will also be zero. When this is compared to the fair value of the derivative the entire hedge relationship will be one hundred percent ineffective. An entity would have to compare the fair value of the actual cash flows received/paid on the hedged items with the fair value of the derivatives to determine actual ineffectiveness in this first time bucket. This would eliminate much of the benefit of pooling similar instruments together and hedging the cash flows as a whole. As an alternative to tracking all the individual cash flows, ineffectiveness in the first time bucket could be determined as a function of the fair value changes in all subsequent time buckets. Once again, this would negate much of the benefit of pooling similar instruments together and hedging the cash flows as a whole.

The ED states that only material ineffectiveness is recognised in earnings. We believe the standard should confirm that when determining the extent of hedge ineffectiveness, an entity would need to identify prospectively the hypothetical derivative that would result in no hedge ineffectiveness. The entity would need to identify the hypothetical derivative for each time bucket for each designation.

1.1.3 Cessation of hedge accounting

Paragraph 157 of the current standard states that when fair value hedge accounting ceases, the adjustment made to the carrying amount of the recognised asset/liability as a result of hedge accounting is amortised in full to net income over the remaining life of the instrument. Yet, for a portfolio of interest rate risk, if hedge accounting ceases because a particular time bucket is de-designated, or an entity no longer wishes to hedge a specific fixed rate instrument in a particular time bucket, how should the amortisation be recognised when the adjustment to the carrying amount is related to multiple cash flows that are not specifically identified?

Amortisation prescribed in the current standard is practicable because the underlying hedged item is specifically identified at inception of the hedge. This assumption no longer applies when portions of cash flows inherent in fixed rate instruments are pooled into time buckets. We did consider in the case where hedge accounting ceases, and it is not possible to identify the specific assets that are no longer subject to the hedge, that the amortisation period should be limited to the remaining maturity of the derivative that was initially used at inception of the hedge subject to their being sufficient assets/liabilities in future time

buckets to cover at least the equivalent of the notional of the derivative. This would have the benefit of a consistent approach to amortisation that will avoid 'cherry picking'. However, we are aware that this treatment does highlight the conceptual problem in that an adjustment to the fair value of the hedged assets/liabilities recorded in the balance sheet will look like a deferred gain or loss. Whichever solution is adopted, it must ensure that there is no possibility of selective amortisation over arbitrary periods.

1.2 Hedged risk

We do not consider the ED is clear enough as to what risk is being hedged. The purpose of the ED is to allow fair value hedge accounting in respect of the fair value impact of movements in interest rates on designated expected cash flows inherent in fixed rate instruments. The illustrative example shows the ineffectiveness arising from movements in prepayment risk, but does not indicate whether the movement in prepayment risk is due to movements in interest rate, or some other external macro-economic event. If the change in prepayment rates is as a result of the latter, we question whether this ineffectiveness is derived from changes in the designated risk, i.e. interest rates. We believe the standard should clarify what principle is being applied in determining hedge ineffectiveness due to changes in prepayment rates. The standard should state whether ineffectiveness arises due to changes in prepayment rates, or due to changes in prepayment rates that result solely from movements in interest rates.

1.3 Hedging instruments

1.3.1 Allowable hedging instruments

The illustrative example in the ED (specifically paragraph IE3) envisages that the maturity of the hedging instrument will equal the maturity of the time bucket. The ED assumes that the derivative hedges only the exposure in that time bucket. This is not the way financial institutions manage their risk. Financial institutions use derivatives of various maturities to hedge the interest rate exposure for a collection of cash flows across various time buckets since their objective is to hedge interest rate risk over a portfolio. It follows that it should be permitted to allow derivatives of varying maturities to be used in hedging the portfolio as long as hedge effectiveness can be demonstrated and measured for each time bucket.

1.3.2 Offsetting derivatives

Amendments were made to paragraph 126F that will apply to all hedge accounting relationships, not only those relating to a fair value portfolio hedge of interest rate risk. The amendments will allow an entity to designate derivatives with offsetting positions as a hedging instrument. Paragraph BC35 in the basis of conclusions states that allowing offsetting derivatives that would have previously been recorded in net income has "substantially the same effect" whether they are designated as a hedging instrument or not. The rationale in the basis of conclusion is only relevant however in the case of fair value hedges, where fair value movements in the derivatives are recorded in net income prior to and following hedge accounting. The rationale does not apply in the case of cash flow hedging or a hedge of a net investment in a foreign operation where as a result of hedge accounting the movements in fair value of the derivative are recorded in equity. We support the amendment and the rationale inherent in the basis of conclusions but believe

paragraph 126F will be applied more widely than the basis of conclusions seems to suggest. Whatever the intended effect, Paragraph 126F and the basis of conclusions should be consistent. We would suggest that the IASB consider the wider implications on other hedging strategies that do not involve fair value hedges.

The ED does not make clear what a "portfolio of similar derivatives" means (paragraph A31). Would a portfolio of interest rate derivatives, which include forwards, swaps and options, be considered to contain similar derivatives?

We appreciate the current restrictions on limiting the use of written options as hedging instruments will also apply when designating offsetting derivatives. We understand that a combination of a purchased option and written option is an acceptable hedging instrument if no net premium is received (for example, a zero cost collar). We believe though that the standard should also state that where a written option is used in combination with an off-market derivative and no net premium is received, this should not be a permissible hedging instrument. For example, this would apply to an on-market sold interest rate floor and an off-market interest rate swap where the net premium is zero at inception.

We also believe it would be helpful to clarify that with respect to designating instruments with offsetting risk positions the standard explicitly states that this does not apply to cash instruments, e.g. hedging of foreign exchange risk with non-derivatives such as the net of a long and short foreign denominated bond position.

1.4 Disclosure

The standard should clarify how the disclosure of the single line item should be presented. In the case where the portfolio of hedged items include both available-for-sale and originated loan and receivable fixed income instruments, the ED is not clear how the movement in fair value with respect to interest rate risk for assets that cross two classification categories should be presented. Should it be allocated to the two asset classifications or retained in a single line item in all cases?

We also note that paragraph 154 (a) appears to indicate that a separate line item should be disclosed for each particular maturity time period. However, in paragraph A38 the implication is that a one-line disclosure is required for the sum of all time periods. We presume the latter disclosure is intended, and therefore paragraph 154 should reflect this.

1.5 Scope

We agree that the scope of the ED should be restricted to hedging of interest rate risk only. However, we are aware that practitioners will wish to see the theory extended to hedge accounting of other risks, such as commodity price risk and foreign exchange risk, or other industries where net asset and liability management is used, for example in the insurance industry. Until there is a thorough understanding and analysis of the implications of how this could be applied to hedge accounting of other risks and other industries, we agree that the scope should be limited to fair value hedge accounting for a portfolio of interest rate risk.

Question 2

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,

(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?

We acknowledge that the valuation of core deposits is and will remain a controversial issue. It is an area on which the Joint Working Group of standard setters spent considerable time without obtaining a definitive view. At the same time, we are of the view that a standard that allows entities to achieve a substantial degree of fair value hedging for a portfolio of interest rate risk, needs to be issued as soon as possible. However, we believe that it would be unwise to ignore the stated concern of the banking industry that the exclusion from fair value hedge accounting of a net liability position which consists wholly or in part of demand deposits will lead to dramatic volatility in reported results that does not reflect the true underlying economic position, provided their concern is supported by clear empirical evidence derived from adjusted historical results (as opposed to theoretical scenarios). Many entities remain firmly convinced that demand deposits remain stable over time. They are used as a long-term source of funding of their loan portfolios and the banks consider that this situation generates an interest rate risk exposure, which they hedge with interest rate swaps.

To the extent that such clear evidence has been furnished to the IASB by the banking industry, we believe the IASB should urgently seek a practical solution. In the absence of such evidence, we recognise that the ED has made considerable progress in the area of portfolio hedging, and should be allowed to proceed accordingly.

We believe the final standard should clarify what principle should be applied in determining the amount of expected cash flows to be included in the various time buckets. We understand that the principle in the ED is that cash flows inherent in fixed rate instruments should be included in time buckets up to 'the earlier of the expected maturity, or contracted maturity'. This principle articulates the IASB's current rationale in limiting cash flows to the prepayment date on pre-payable assets and limiting cash flows on demand deposits to their demand date.

Other comments

We suggest that the guidance on fair value hedge accounting a portfolio of interest rate risk be included in a separate section within IAS 39 as opposed to a series of amendments to various paragraphs within the standard. IAS 39 is a complex standard to read and apply as

it is, and a publication of a separate application note will avoid complicating it even further.