Organizacion Internacional
de Comisiones de Valores

International Organization
of Securities Commissions

Organisation internationale
des commissions de valeurs

Organizacao Internacional
das Comissoes de Valores

November 14, 2003

OICU-IOSCO

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) appreciates the opportunity to provide our thoughts regarding 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* (the Fair Value Hedge ED).

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement.[1] Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1 and are not intended to include all the comments that might be provided by individual members on behalf of their respective jurisdictions.

Context for Our Comments

We understand that the International Accounting Standards Board (IASB or the Board) issued this exposure document addressing certain fair value macrohedges in connection with its ongoing deliberations of the June 2002 Exposure Draft of Proposed Amendments to IAS 32, *Financial Instruments: Disclosure and Presentation,* and IAS 39, *Financial Instruments: Recognition and Measurement* (the IAS 32/39 ED). We also understand that the IAS 32/39 ED was not intended to be a fundamental reconsideration of the accounting for financial instruments. It was intended to serve as a limited "repair and maintenance" of the existing financial instrument accounting standards as part of the IASB's broader project on improvements and convergence. Specifically, the IAS 32/39 ED was intended to eliminate apparent internal conflicts within the existing financial instrument accounting standards, make the standards more operational, and result in greater international convergence with standards issued by other national standard setters. Our comments on the

[1] See IOSCO website, www.iosco.org

Fair Value Hedge ED are provided with this context in mind. If the project scope had been broader, our comments may have been different.

Our review of Fair Value Hedge ED was somewhat complicated by the fact that some of the proposed guidance in the IAS 32/39 ED has been modified by tentative decisions reached by the Board in its ongoing re-deliberations. Given the interactions among all the changes in progress, we may have had additional comments had we been able to review a comprehensive document.

Comments on the IASB's Due Process

In its November 6, 2002, comment letter on the IAS 32/39 ED, Standing Committee No. 1 urged the Board to ensure that all constituent concerns were thoroughly understood and openly discussed. In that regard, we suggested that the IASB and its staff consider holding a public roundtable that would permit representatives of various stakeholders in the financial reporting community to exchange views, questions, and concerns in a public forum. We applaud the Board's decision to hold such public roundtables in March 2003 and believe that the Fair Value Hedge ED is a direct result of the Board listening to constituents' concerns. We believe the Fair Value Hedge ED is an attempt to address those concerns within the context of the scope of the amendments to IAS 39 and the principles that underlie the IAS 39 approach to derivative and hedge accounting, as well as within the scope of the IASB's conceptual underpinnings in its *Framework for the Preparation and Presentation of Financial Statements.*

We also commend the Board for reaching out to constituents during the re-deliberation phase of the amendments to IAS 32 and 39. We believe the Board has made significant efforts to obtain input from interested parties and explore issues and potential resolutions. We encourage the Board to continue these efforts in this and other projects on its agenda. This includes the Board's willingness to meet with constituents and industry groups, such as it did with banking representatives. Reflecting upon this experience, we believe that the Board could further improve its process by inviting securities regulators and banking supervisors to these meetings when appropriate. This added transparency would aid in identifying the best solutions as quickly as possible, as well as expedite the sharing of regulators' concerns from investor protection and safety and soundness perspectives.

Finally, we express our appreciation for the Board's efforts to address the concerns and open issues related to the amendments of the financial instrument accounting standards in a timely fashion. Standing Committee No. 1 believes it is critical that a comprehensive basis of accounting have standards addressing financial instruments. Additionally, timely publication of the final amended financial instrument accounting standards by the March 2004 deadline established to provide adequate lead time for preparers will be crucial to the successful adoption of International Financial Reporting Standards across the European Union and other countries adopting IFRS in 2005.

General Comments

From the perspective of international convergence, the IAS 39 ED in many instances provides for closer alignment between the IAS literature and generally accepted accounting principles established by standard setters in other nations. We understand that the IASB's proposal for portfolio hedging represents a pragmatic approach towards providing a method by which entities may achieve fair value hedging for a portfolio of interest bearing items in a manner that meets the principles that underlie IAS 39's requirements on derivative and hedge accounting. As a result we realize that some divergence from financial instrument accounting standards developed by the standard setting bodies of individual nations is likely.[2] However in order to minimize the number of such divergences that may result from the proposed guidance, we believe that the IASB should consult with international accounting standard setters to develop a converged accounting standard for financial instruments. This would not preclude the IASB from acting independently, but rather ensure that the Board is fully informed as to whether its proposed approach would ultimately result in convergence or divergence in international practice for financial instrument accounting. It would also assist the IASB in ascertaining whether resulting divergence, if any, was preferable or merely acceptable.

It appears that the proposed or modified paragraphs in the Fair Value Hedge ED are essentially to be inserted into the IAS 32/39 ED. Thus, we have read the Fair Value Hedge ED under the assumption that all the relevant hedging guidance in IAS 39 would be equally applicable to macrohedges under the proposal. Importantly, this would include the expectation of hedge effectiveness at the inception of the hedge, the requirement to only include items with similar risk characteristics in a portfolio of assets or liabilities to be hedged, and robust documentation of the hedge relationship. We believe that discipline is necessary both for the IAS 39 hedge accounting models in general and for the proposed macrohedge model specifically.

Standing Committee No. 1 has highlighted in various letters over the years the importance of the Board's decision to write accounting standards that do not deviate from the principles that underlie other IFRSs and the Framework. We observe that the Board has endeavored to craft the provisions of this ED in a

[2] For instance, the proposed macrohedge approach in the Fair Value Hedge ED does not seem to be consistent with the portfolio approach under U.S. GAAP. These differences include not requiring the fair value adjustment of the hedged item to be "pushed down" to specific assets or liabilities in the portfolio and allowing the use of expected repricing dates to reflect optionality in hedged items.

similar manner and our support for the ED's provisions is backed primarily by the Board's endeavors and ability to do so.

The remainder of our letter will first provide our comments in response to the specific questions raised in the Fair Value Hedge ED's "Invitation to Comment." We then will provide additional, more detailed technical comments and requests or suggestions for clarifications, referenced to specific paragraphs.

Comments in Response to Specific Questions in the Fair Value Hedge ED

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 recognized 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?***

Response – The members of Standing Committee No. 1 generally have a preference for the proposed designation and resulting effect on measuring ineffectiveness described as Approach D in paragraph BC19 of the Fair Value Hedge ED. We believe that this Approach represents an important middle ground that balances a) practical considerations and desires to minimize the disruptions to current economic hedging practices and b) the discipline and rigor of IAS 39, especially the transaction-based focus of the standard and the explicit requirement that special hedge accounting only be allowed in cases when the effectiveness of a hedge can be proven and when ineffectiveness (both over- and under-effectiveness) can be measured and recognized. While our preference would be for the Board to adopt Approach D, we do acknowledge that Approach C does have some merit, particularly in instances in which an entity has chosen not to hedge 100% of its exposure. However, we also believe that under Approach C entities could manipulate the manner in which they allocate anticipated asset/liability maturities to future time periods in order to avoid recording ineffectiveness in their income statement.[3] Thus, our ability to support Approach C would be conditioned upon the Board being able to place sufficient parameters around the manner in which an entity allocates anticipated asset maturities to future time periods in order to prevent opportunities for such abuses. Two parameters that we have identified as helping to achieve this goal include:

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[3] See example in Appendix.

- Requiring that entities allocate ***all*** of their financial assets and liabilities to time periods coinciding with the items' expected repayment date.
- Prohibiting designation of a hedged amount that exceeds the net economic position identified through the allocation process described in the previous bullet point.

The members of Standing Committee No. 1 do not support approaches A and B for the reasons enumerated by the Board in the basis for conclusions.

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 recognized 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 characterize the change in value of the hedged item?

Response – Standing Committee No. 1 observes that the Fair Value Hedge ED's provisions explicitly permit an entity to apply fair value hedge accounting to a portion of an entity's assets equal to the entity's *net assets,* but only to the extent that the entity's core deposit balances do not exceed the amount of the entity's fixed rate assets. We also note that the last sentence of BC 17 indicates that it would not be possible to achieve fair value hedge accounting for a portion of an entity's liabilities equal to the entity's excess of core deposits over fixed rate assets. We believe that the last sentence of BC 17 does not preclude an entity from applying IAS 39's cash flow hedging provisions to such a net liability. We agree with such an interpretation and recommend that the Board consider inserting an additional sentence into the Basis to this effect.

We note that many of the parties that have suggested that the Board consider permitting the designation of a portion of an entity's liabilities equal to the entity's excess of core deposits over fixed rate assets as the hedged item in a fair value hedge have done so because of the negative perception of the volatility in stockholders' equity that can result from application of the cash flow hedging model. In order to ensure that the provisions of the Fair Value

Hedge ED serve the best interest of both preparers and users, we would encourage the Board to reach out to users of financial statements to investigate the nature of the information that they would find useful with regards to such hedging relationships. In addition, we would suggest that the Board consider whether this information could be provided in a manner that would address the needs of users while also mitigating the concerns of preparers, possibly through a prominent (and separate) line item display within stockholders' equity or separate disclosure of the impact that such cash flow hedging relationships have on an entity's equity accounts.

Additional Detailed Comments

We also have the following detailed comments and requests or suggestions for clarification.

Proposed Amendment to the Standard

Paragraph 126F – We read paragraph 126F to be written primarily for those entities that enter into a derivative position and then "close out" that position (or a portion thereof) using an offsetting, mirror-image derivative instrument. We believe this paragraph would allow those entities to use the combination, or "net," of those instruments as a hedging instrument. However, at the March 2003 public roundtables, several commenters discussed what was described as a common transaction where an entity issued fixed-rate debt, swapped it to a floating rate with an interest rate swap covering the entire life of the debt, and then swapped it back to a fixed rate with an interest rate swap covering a shorter period from issuance to an interim date, in essence creating a synthetic forward starting "receive-fixed, pay-float" swap that would require payment of fixed amounts during the early periods in which the two swaps offset. It was asserted that this was a more cost effective strategy for some companies than merely entering into an actual forward starting swap. It is not clear to the members of Standing Committee No. 1 whether this paragraph would somehow allow hedge accounting for this synthetic forward starting swap and, if so, which hedge accounting model would apply to each of the synthetic forward starting swap's life stages (i.e. its earlier receive fixed pay fixed periods and its later receive fixed pay float periods)? That is, if hedge accounting were allowed, would the hedge relationship be considered a fair value hedge in its entirety, a cash flow hedge in its entirety, or a combination of the two over time?

Paragraph 128A – The first sentence of this paragraph indicates that "... the portion hedged may be designated in terms of an amount of currency (e.g. dollars, euro, pounds) rather than as individual assets (or liabilities). It is not clear to the members of Standing Committee No. 1 whether the Board's intent is to provide for the application of the macro fair value hedge accounting described in the ED to a single hedge of interest rate risk for a portfolio of items denominated in a single currency or whether the Board is signaling its belief that it is possible to apply the macro fair value hedging model to a single hedge of interest rate risk on a portfolio of items that are denominated in several different currencies. If the Board's intention is the latter, the Board may wish to elaborate on criteria that must be considered prior to making such a designation. For instance, would hedge accounting be permitted across all currencies, or only for those currencies whose exchange rates are highly correlated with one another?

Paragraph 128A also states that the entity "may hedge the change in fair value . . . based on expected, rather that contractual, repricing dates." This method of scheduling cash flows based on expected repricing dates essentially introduces a cash flow hedge concept into the fair value hedge model. We believe the Basis for Conclusions should clarify whether this application is limited to this specific *portfolio* hedging strategy or if would it apply more broadly to fair value hedges of *specific* assets or liabilities with embedded optionality. That is, when hedging prepayment risk in individual hedged items, must an option (either freestanding or embedded) be utilized?

Finally, the proposed method and illustrations focus on the use of the expected repricing date methodology. Could this proposed fair value macrohedge strategy also be applied when explicitly hedging the option component in financial assets or liabilities with either freestanding options or option components embedded in the hedging instruments?

Additional Comments on Proposed Amendment to the Standard

We have several additional questions on the proposed model that might suggest the need for additional guidance or, alternatively, additional emphasis in the Implementation Guidance or Basis for Conclusions:

- Based upon the fact that the provisions of this ED are laid over the provisions of IAS 39, we believe that IAS 39's designation and documentation provisions would apply to the macro hedging strategies contained in the ED. The Board should indicate in the final standard if its intention is otherwise.
- Should there be additional guidance on whether (and if so, how) to amortize fair value changes that have been recorded in the single asset or liability line as they pertain to the hedged item? For example, how should paragraph 157 of IAS 39 (as proposed to be amended) be applied in this fair value hedge strategy, since the hedge will likely be de-designated and re-designated in a dynamic strategy or in a rolling hedge strategy, with differing amounts being hedged period-to-period or different hedging instruments being utilized period-to-period? Was it the Board's intent to

signal (via the guidance contained in paragraphs A38 and A39) that in these instances amortization would not be required or permitted, but rather that amounts that had been deferred to the balance sheet would be reclassified to income upon the earlier of the hedged item's de-recognition or the arrival of the expected repricing date?

- The ED is silent with regards to any incremental disclosures that would be required for those applying the ED's macro hedging provisions. Similar to prior comments on designation and documentation, we are assuming that the IAS 39's disclosure provisions with regards to hedge accounting would apply to fair value macrohedging relationships. We would suggest that the Board clarify its intent in the final standard.

Proposed Amendments to Appendix A – Implementation Guidance

Paragraphs A26(a)-(b) – We believe that the example should further emphasize the considerations of the guidance in IAS 39 for determining the similarity of items to include in the portfolio. Perhaps the guidance should also include discussion on the reasonableness of the time intervals used for maturity time periods. For example, it seems that monthly maturity time periods would be appropriate. However, would a wider interval, perhaps a quarterly or annual maturity time period, be appropriate?

Paragraph 26(h) – We believe that this paragraph should emphasize the need for the recognized ineffectiveness (that is, the currency amount offset of the change in the hedged item and change in hedging instrument) to be within the parameters specified in IAS 39 for an ongoing effective hedge.

Paragraph A33 – This paragraph seems to introduce the concept that a statistical measure or other estimation technique can be used to measure the currency amount of ineffectiveness to be recognized. Prior to this, it seemed apparent that statistical measures were used to assess effectiveness, but not measure the amount of ineffectiveness (see IAS 39 Implementation Guidance Q&A – Question 146-1). Are the caveats in the second sentence of paragraph A33 strong enough to prevent a possible erosion of discipline specifically in the application of this hedge model and more generally in all IAS 39 hedge models?

Paragraph A38 – We believe that the last sentence should be corrected to read, "~~All three~~ <u>The remaining</u> periods are then adjusted . . .."

Paragraph A39 – Similar to the comment above on paragraph A33, does the practical expedient in the last sentence of this paragraph erode the discipline inherent in IAS 39? We believe determining which time period (or reasonable range of time periods) a loan was assigned to should not be overly difficult if the entity adequately documented its assumptions and methodologies for the determination of maturity time periods.

Proposed Illustrative Example

Paragraph IE3 – This example uses a mid-month convention for the swap. In order to avoid a discussion of ineffectiveness that may result if items in the portfolio of assets did not all share this assumed repricing date we would suggest that the Board add a simplifying assumption to fact pattern asserting that the hedged item are expected to reprice mid-month.

Additional Comments on Proposed Illustrative Example – While the example is helpful, we believe extending the example out through several time periods would provide additional clarity. In particular, the example does not illustrate the common complexities that would occur in the accounting over multiple periods, including the accumulation of balances in the contra-asset account, the need to track those amounts, and the accounting at maturity of the time period.

Proposed Basis for Conclusions

The following comments are intended to assist the Board in identifying items in the Basis for Conclusions that may require clarification. We understand that the Basis for Conclusions may change consistent with changes made to the proposed IFRS during the re-deliberation process, thus obviating the need for some of these comments.

Paragraph BC24 – We believe that the last sentence should be reworded to read "... both when estimated prepayments ~~decrease~~ increase, resulting in more in a particular maturity time period, and when they decrease, resulting in less.

Paragraph BC28 – As discussed in our comment on paragraph IE3, we believe that the example in that paragraph would be more helpful if it were expanded to include several time periods. Additionally, we believe that paragraph BC28 includes some important concepts that could more clearly be illustrated by expanding the Illustrative Example as described in our comments above. If the Board were to include an expanded example in the final standard, we believe that making explicit reference to IE3 as an example of the principles being discussed could expand the usefulness of paragraph BC 28.

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This concludes our comments on the Fair Value Hedge ED.

If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 202-942-4400.

Sincerely,

Scott S. Taub

Scott Taub
Chairman
IOSCO Standing Committee No. 1

Appendix

As stated in paragraph 19 of the Basis for Conclusions, Approach C does not result in any ineffectiveness in instances in which an amount of assets that is less than the 'top' layer prepays earlier than expected. The ED's provisions do not require that an entity allocate its ***entire*** portfolio of interest bearing assets and liabilities to time periods in order to determine the amount of assets or liabilities that it will designate as being hedged each period. Thus, if the Board were to consider accepting the use of Approach C, we believe that an entity could allocate its entire portfolio to individual time periods for purposes of determining its economic exposure in each period, while excluding certain liabilities from its *designated* hedged portfolio in order to artificially increase the amount of assets that are designated as being hedged. This would have the effect of providing a potentially significant "cushion" to absorb unexpected prepayments. The example below provides an illustration of our concern.

Assume that Bank A has identified the following assets and liabilities as maturing in time period 1.

	Assets	**Liabilities**	**Net Position**
Branch 1	**1,000**	**500**	**500**
Branch 2	**2,500**	**1,900**	**600**
Branch 3	**2,000**	**1,600**	**400**
Total	**5,500**	**4,000**	**1,500**

Bank A enters into a derivative to economically hedge its net asset exposure of 1,500. However, for purposes of determining the amount of assets that it will designate as being hedged, Bank A chooses not to include the 1,900 liability of Branch 2 in its hedged portfolio. Thus, Bank A designates assets totaling 3,400 (the net position of its designated portfolio) as being hedged. Two outcomes are now possible.

Outcome #1

Bank A experiences actual asset prepayments that exceed the initial estimate Bank A made of its economic exposure (1,500) by an amount that is less than 1,900. In this instance, because Bank A has artificially created a 1,900 cushion by excluding the liabilities of Branch 2 from the portfolio that it has designated as being hedged, no ineffectiveness will be recorded in its financial statements. This is true even though substantially more than the economic position at risk (1,500) has prepaid and thus economic ineffectiveness has resulted.

Outcome #2

Bank A experiences actual asset prepayments that exceed the initial estimate Bank A made of its economic exposure (1,500) by an amount that exceeds 1,900. In this instance, even though Bank A had artificially created a 1,900 cushion by excluding the liabilities of Branch 2 from the portfolio that it has designated as being hedged, ineffectiveness will be recorded pertaining to the portion of asset prepayments in excess of 3,400 (1,500 forecasted net position + 1,900 cushion created through crafty designation). Total ineffectiveness recorded is substantially less than both that which would have resulted had Bank A designated its forecasted net position of 1,500 as being hedged and that which has been economically incurred.

If the Board were to reconsider whether Approach C would be an appropriate method by which an entity measures the amount of ineffectiveness recorded in a fair value hedge of a portfolio of financial assets and liabilities, the members of Standing Committee No. 1 would request that the Board consider incorporating into Approach C, the two anti-abuse parameters identified in our response to Question 1.