Rajan Kapoor
Group Chief Accountant

The Royal Bank of Scotland Group

Group Finance

24 St Andrew Square
Edinburgh EH2 1AF

Telephone: 0131 523 0556
Facsimile: 0131 523 2037
Website: www.rbs.co.uk

Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

14 November 2003

Dear Ms Thompson

Exposure Draft of Proposed Amendments to IAS 39 'Financial Instruments: Recognition and Measurement
<u>Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk</u>

The Royal Bank of Scotland Group is one of the world's largest banks with shares listed on the London and New York Stock Exchanges. The Group's financial statements are prepared under UK GAAP and reconciled to US GAAP for its US filings. We support the introduction of IFRS and the aim of global harmonisation of accounting standards.

We welcome the publication of the exposure draft, which represents a significant initiative in extending the application of fair value hedging to portfolios of assets and liabilities. In particular, the proposals that assets and liabilities can be scheduled into repricing bands on the basis of expected rather than contractual maturities and that offsetting derivatives can qualify as hedging instruments bring much-needed flexibility to the application of IAS 39.

However, we are disappointed that the Board has rendered these positive developments nugatory by not extending fair value hedging to core deposits. As we comment below in our answer to the second question asked by the Board, we are firmly of the view that core deposits are properly regarded as fixed rate instruments. The Board's decision to that core deposits cannot qualify for fair value hedge accounting for any time period beyond the shortest period that the counterparty can demand payment means that many banks will be unable to make the proposals workable.

Our responses to the specific question in the ED are attached.

Yours sincerely

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 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?

Of the four approaches to designation set out in paragraph BC19, we favour approach C. We do not agree with the Board's view that ineffectiveness should be recognised if, due to changes in prepayment rates, the net asset or liability position in a particular time bucket exceeds that originally expected. The Board's arguments in favour of recognising ineffectiveness in such cases rest principally on the change in fair value of the prepayment option. This seems to us to contradict the ED's treatment of prepayment risk, which is dealt with through using expected repricing dates. It also seems to contradict the principle in paragraph 128 of the ED of revised IAS 39 that only a portion of a risk associated with only a portion of an item's cash flows or fair value may be hedged (in this case a portion of the contractual maturity). In addition as noted in the alternative view (paragraph AV2) recognising ineffectiveness on an under-hedged position is inconsistent with IGC 121.

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?

Our view is that fair value of demand deposits is meaningful only at the portfolio level. It is clear that the fair value of the financial instrument element (ie ignoring other income and expense streams associated with current accounts) of a portfolio of demand deposit is less than its face value. We have some sympathy with the Board's view that deposits should not be recorded at less than the amount repayable and an immediate gain recognised. In general, this gain is offset by the cost of originating the deposits and of providing ongoing servicing associated with a current account. Thus recording the deposit initially at par does not preclude recording changes in the fair value of demand deposits (attributable to the hedged risk) where these are hedged consistent with the approach to assets. Adjusting the carrying value of a hedged item for changes in value attributable to the risk hedged does not constitute fair value measurement.

The Board adduced two further arguments for deciding that core deposits cannot qualify for hedge accounting:

(a) Deposits included in the balance sheet are short-term. The liability being hedged is the forecast receipt and rollover of new deposits. Under IAS 39 forecast transactions cannot qualify for fair value hedge accounting.

    Our view is that hedging core deposits as long-term zero coupon liabilities is not a breach of IAS 39's prohibition on fair value hedging forecast transactions. In hedging core deposits on the basis of maturities longer than demand, financial institutions are not hedging the forecast receipt and rollover of deposits. Expected transactions on accounts mean that a portfolio of current accounts has the characteristics of a long-term liability. This treatment is analogous to the treatment of assets with zero-cost prepayment options in a macro-hedge paradigm.

(b) A portfolio of core deposits is similar to a portfolio of trade payables.

    We see significant differences between a portfolio of trade payables and a portfolio of current accounts. A current account is not simply a payable and cannot be considered similar to an obligation arising from the purchase of goods and services. A current account usually provides the customer with an array of payment mechanisms. Trade payables must be settled and will be replaced by new payables but it is of the essence of a current account that amounts may be paid into the account and withdrawn as long as the account remains open. In any event, provided there are valid arguments for allowing demand deposits to qualify for fair value hedge accounting, these are not undermined by similarities between demand deposits and trade payables.

The Board's proposes that fair value hedging would not be available where a net liability position is made up of core deposits. There are significant practical difficulties with this proposal. If a bank's exposures include time buckets with both net liability and net asset positions, it will be compelled to adopt a mixture of fair value and cash flow hedging. As the make up of individual buckets evolve over time the same bucket may have cash flow and fair value hedges associated with it. The administrative overhead in operating such a system may well be prohibitive and the accounting would bear little relationship to the risk management objective.We are firmly of the view that a credible approach to the fair value hedging of interest rate risk on a portfolio basis must include demand deposits as fixed rate liabilities. Otherwise the financial statement will not faithfully the underlying economics of asset and liability management.