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Ref T/701/004A

Dear Ms Thompson

ED6: Amendment to IAS 39 Financial Instruments: Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

In general, the proposed amendment is likely to have the greatest impact on financial reporting for banks. There are however two areas where it might impact on financial reporting for contracts issued by insurance undertakings.

In relation to some life insurance business, the insurer may enter into interest rate swap agreements as a general commercial hedge against adverse movements in the value of assets backing insurance liabilities. Similar arrangements may also hedge against increases in policy lapse rates associated with any increase in interest rates.

While we understand and fully accept the need for a rigorous framework for hedge accounting, we believe the proposed amendment to IAS 39 is too limited in scope and disregards some elements of the way in which entities actually manage risk. In particular, we believe it should be extended to cover the types of arrangement described above, insofar as they provide an element of hedge effectiveness.

The hedging instruments in these circumstances however are entered into on a portfolio basis and therefore the analysis into maturity time periods envisaged in paragraph A26 (b) is not possible.

The other issue arises from question 2(a) in the Exposure Draft. Paragraph A30(b) refers to the provision in IAS39 that the fair value of a liability with a demand feature (for example a contract issued by an insurer that the policyholder can cancel at any time) cannot be less than the amount payable on demand (the "deposit floor"). It uses this to justify the view that fair value hedge accounting cannot apply to liabilities repayable on demand for any time period beyond the shortest period in which the holder can demand repayment.

This, however, makes no allowance either for the portfolio nature of the liabilities in question or for the behaviour of the holders of such liabilities. The first line of paragraph A 30(b), in referring to items that would have qualified for fair value hedge accounting if they had been hedged individually, disregards the position where contracts are written on a portfolio basis and as a result, it is possible to forecast with reasonable accuracy the extent to which holders will exercise their right to repayment on demand (ie surrender rights) over the portfolio as a whole and reflect this in the pricing of the contract. This in turn would be an important element in determining the exit cost for the liabilities in question.

In the context of some contracts issued by insurers, the adoption of the deposit floor approach does not correspond to actual policyholder behaviour or reflect the circumstances of the insurer as a going concern. The reality is that most policies will not be surrendered. Given that, the Board has decided that deferred acquisition costs cannot be treated as intangible assets under IAS 38 (Intangible Assets), it should be possible instead to include future management expenses or their equivalent in the cash flows used for determining fair value liabilities notwithstanding that the resulting fair value falls below the deposit floor.

Yours sincerely

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