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Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

Re: Exposure Draft of Proposed Amendments to IAS 39, Financial Instruments: Recognition and Measurement related to Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

Dear Ms. Thompson:

Citigroup appreciates the opportunity to respond to the Exposure Draft, *Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement* related to Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk (Proposed Amendments or Exposure Draft). Overall, we support many of the changes in the Proposed Amendments and believe they represent improvements to the current guidance in IAS 39. However, we believe that it is imperative that the Board clarifies certain proposed changes. Our comments on specific questions and requests for additional guidance in certain areas are provided below.

We applaud the method proposed by the Board to accommodate fair value hedge accounting for a portfolio hedge of interest rate risk. We think the Board has found balance between the precision with which it is practical for an entity to hedge interest rate risk and the information value hedge accounting provides to financial statement users. The Board's proposals clearly recognize the substantial economic effectiveness of common strategies to hedge interest rate risk of portfolios.

We would like to acknowledge the Board's responsiveness to industry input in preparing the Exposure Draft, and further commend the Board for addressing issues in a timely manner.

We strongly encourage the Board to provide a comprehensive realistic example in the final standard that applies the model proposed in the Exposure Draft. Otherwise, we expect entities will make wide-ranging interpretations that lead to significant inconsistencies (lack of comparability) in practice. The current example in the Exposure Draft is far too simple to provide instructive guidance for constituents. The example should illustrate an acceptable methodology for allocating the identified portfolio into maturity time periods and an acceptable technique to determine the change in fair value of the hedged item.

Response to Exposure Draft

Overall we support the Board's conclusion that hedges of interest rate risk should require the inclusion of prepayment risk. We agree with the Board's proposed approach (referred to as approach D) for designation and the resultant effect on measuring effectiveness for fair value hedges of the interest rate risk associated with a portfolio of financial assets (or financial liabilities). We support approach D for the reasons cited by the Board in paragraph BC24. We understand that including prepayment risk when hedging interest rate risk increases the difficulty of implementing IAS 39 and significantly increases the operational burden and ongoing administration of such hedging strategies. However, we believe the other approaches considered by the Board (referred to as approaches A, B and C) represent a fundamental departure from the principles that underlie hedging individual risks of a financial asset or liability. Approaches A, B, and C implicitly seek to mask some sources of ineffectiveness. If the Board were to support any of those other approaches (A, B or C), it would be effectively identifying another risk (prepayment risk) that may be separately hedged or not hedged (in addition to market price, credit, foreign exchange, and interest rate risk). We believe that prepayment risk is an intertwined subcomponent of interest rate risk. To separate interest rate risk and prepayment risk from a risk management standpoint can be very misleading.

We assume that a fair value portfolio hedge constructed based on the proposals in the Exposure Draft must comply with the effectiveness tests or requirements in paragraphs 142 and 146 of IAS 39. Otherwise, the Board would be violating one of its principles related to qualification for special hedge accounting. We request that the Board clarify its intent with regard to this matter.

We understand that at the October 2003 Board meeting the Board again reversed its previous tentative conclusions regarding what should be the requirement for prospective effectiveness testing. The Board tentatively agreed that a hedge is regarded as highly effective if, at inception and throughout the life of the hedge, the entity expects changes in fair value of the hedged item to be *almost fully offset* by the changes in fair value of the hedging instrument. In practice some have asserted that the words *almost fully offset* require an expectation of effectiveness within the narrow range of 95 – 105%.

While many hedging relationships are entered into with the expectation that they will meet such high levels of effectiveness, a fair value hedge of a portfolio of prepayable fixed rate loans often cannot support an expectation of effectiveness within the range of 95 – 105%. Because expected repricing dates for the portfolio of loans will constantly be revised, it is likely that there will be partial ineffectiveness for each maturity period. For each maturity period designated as a separate hedged item, it is simply not practical to construct highly customized derivatives that provide or reflect a mirror image of the prepayment risk embedded in the hedged items. We believe that establishing a hedge accounting entrance test based on such a small degree of ineffectiveness to be too demanding. In fact, it represents a severe limitation to the applicability of the proposals in the Exposure Draft. Thus, we strongly encourage the Board to revert to its previous tentative conclusion that required an expectation of effectiveness within a range of 80 – 125%.

Request for Additional Guidance

Similar Criterion
We believe the Board should clarify how the grouping of similar assets requirements of paragraph 132 of IAS 39 should be applied to the portfolio hedging proposals in the Exposure Draft. Paragraph 132 of IAS 39 indicates, "if similar assets or similar liabilities are aggregated and hedged as a group, the individual assets or individual liabilities in the group share the risk exposure for which they are designated as being hedged. Furthermore, 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." Does this mean that the scheduled maturity dates for all assets and liabilities in the portfolio must be similar? Can an entity group prepayable and non-prepayable loans in a single portfolio hedging relationship? We believe the Board solved those concerns by permitting entities to define hedged items on the basis of expected, rather than contractual, repricing dates. Defining hedged items based on expected repricing dates enables an entity to combine or group assets and liabilities with different scheduled maturity dates, mix prepayable and non-prepayable assets in the same portfolio hedge, etc. We believe that if the fair value of the hedged item is measured based on changes in a benchmark interest rate (LIBOR), a portfolio of *similar* loans would not be limited to loans of a similar type, size, nature and location of collateral, or coupon interest rate.

In contrast, if portfolios of assets and liabilities must be defined or grouped in a narrow restrictive manner to qualify for hedge accounting under the proposals in the Exposure Draft, entities will be required to divide their portfolios of assets and liabilities into numerous sub-portfolios. The proposals in the Exposure Draft will then require that each sub-portfolio be divided further into separate hedged items for monthly maturity time periods. Causing such an exponential proliferation of hedging relationships will dramatically reduce the operational value of the proposals in the Exposure Draft.

Given the changes to the method of a portfolio hedge of interest rate risk, the Board should clarify what is considered *similar* for portfolio hedging strategies and the required characteristics needed to apply portfolio hedge accounting.

Matters relating to the Hedging Instruments
We strongly support the proposed amendment to paragraph 126F of IAS 39 to explicitly permit two or more derivatives to be jointly designated as a hedging instrument including circumstances where certain risks arising from some derivatives offset those arising from others. It is very common for several derivatives to be designated in aggregate as a combined hedging instrument and certain risks of those derivatives offset one another. We observe that this provision related to the designation of hedging instruments is consistent with FASB Statement 133 and supports a very common risk management practice (especially for hedges of a portfolio). Financial institutions frequently rebalance hedge positions, entering into incremental derivatives that are combined with existing derivatives to create the required hedge position. The cost of many hedging strategies would significantly increase without such a provision.

The proposals in the Exposure Draft permit the hedged item to be designated in terms of an amount of assets (or liabilities) in a maturity time period (effectively, permitting the hedged item to be divided into discrete portions). In contrast, IAS 39 does not permit separating a derivative into similar separate time periods and designating any time period component as a hedging instrument. Instead, IAS 39 limits separating interest rate-based derivatives into only proportions representing pro rata parts of a derivative (such as 50 percent). The IAS 39 limitation on splitting the hedging instrument into proportions (not portions) will cause a reduction in the number of entities that are able to utilize the proposed portfolio hedge accounting model. The hedging instrument (a single interest rate swap with a fixed life of 12.5 months) identified in paragraph IE3 of the illustrative example in the Exposure Draft is not reflective of the derivatives used by banks to hedge loan portfolios. Generally, a bank does not enter into one or more derivatives to hedge the fair value exposures for only a single month. Instead, a bank will often designate multiple interest rate-based derivatives to hedge the interest rate exposures for various months (maturity time periods).

Amortization of Changes in Fair Value of the Hedged Items

Generally, fair value hedges of portfolios of prepayable assets will not be static. Paragraph 128A of the Exposure Draft states that for "a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate based on expected, rather than contractual, repricing dates." Often expected repricing dates will change over the life of prepayable assets and the designated hedging instrument(s) may not provide exact offset. Thus, as entities revise their expectations about prepayments, clearly the underlying hedges (and hedged items) will constantly be designated, dedesignated and re-designated (paragraph A38 references hedge redesignations). Should amortization of the gain or loss attributable to the hedge item (relating to a specific maturity time period for a portfolio of loans) that arose during a hedging relationship that is subsequently discontinued commence when that hedging relationship is discontinued or is it permissible to postpone amortization as long as the portfolio of loans remains designated as the hedged item in a fair value hedge?

Paragraph 157 of IAS 39 indicates that amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. It is not clear from paragraph 157 of IAS 39 when amortization of the gain or loss related to the hedged item should begin in a situation in which the hedging relationship is dedesignated or discontinued in accordance with paragraph 156 of IAS 39, but that hedging relationship is followed immediately by a new hedging relationship that includes the same hedged item. Based on the proposed provisions in the Exposure Draft, entities may take the view that amortization is elective and not required under such a scenario. With respect to the proposals in the Exposure Draft, we believe that amortization of the gain or loss related to the hedged item (for a specific maturity time period) should commence when the hedging relationship is discontinued. If the hedging entity does not amortize the gain or loss related to the hedged item, there may be a significant catch-up adjustment at the end of the designated time period when the loan(s) mature. We believe that amortization of the gain or loss would be more representationally faithful to the underlying economics of the transaction and to the IAS 39 fair value hedge accounting model. Regardless, we believe the Board should clarify their intent with respect to how these amounts should be treated.

We believe the proposed changes represent a substantial improvement in the operationality of IAS 39. However, we believe the Board needs to clarify its intention with respect to a number of issues concerning certain of the proposed changes addressed in the Exposure Draft. Given the relatively short time before the amended standard will be effective, we do not believe it is appropriate for the Board to defer clarification or interpretation of these issues. Instead, we encourage the Board to add explanatory language and detailed examples in the amended standard.

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Other Matters

We applaud the IAS 39 Implementation Guidance Committee (IGC) and the IASB for their efforts to establish implementation guidance on very important and complex subjects. We believe that as the effective date for IAS 39 (as amended) approaches and more companies begin to prepare to adopt International Accounting Standards, preparers, practitioners and users of financial statements will require further clarification and guidance to properly implement IAS 39. Thus, we request that the IGC and the IASB continue to establish additional implementation guidance on IAS 39.

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We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Robert Traficanti
Vice President and Deputy Controller