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Douglas J Flint
Group Finance Director

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

Dear Sandra,

IASB's 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'

I welcome publication of the exposure draft as much for its indication of a willingness to recognise the importance of unintended consequences as for its technical content. It is a practical response to comments on the exposure draft of proposed amendments to IAS 39 which would not have extended fair value hedging principles to portfolios on a macro basis.

It is important that a financial instruments accounting standard does not unwittingly impact highly effective competitive and market structures within the financial industry as a result of highly technical text, the consequences of which have not been tested at all for possible impact on the way financial systems might operate in the future. It is, however, also equally important that financial markets and users of financial reports can have confidence that standards are in place to ensure the banking industry reports results that reflect the true economics of the balance sheet positions and risks it manages.

My specific comments on the exposure draft are as follows:

Hedge designation and the resulting effect on measuring ineffectiveness

I welcome the proposal to permit designation of the hedged item in terms of the amount of assets or liabilities in a maturity time period, rather than requiring designation of individual assets and liabilities. This reflects market practice and is evidentially sound.

I do, however, disagree with the IASB's proposals on hedge designation and the resulting effect on measuring ineffectiveness. In my view, it should be permitted to regard the hedged risk of a portfolio as solely the interest rate risk and not the prepayment risk. These risks are clearly different and are managed and hedged separately. Therefore, ineffectiveness should not arise if prepayments occur later than expected, i.e. on underhedging. Gains and losses arising in respect of this 'unhedged' exposure should be recognised as they accrue, not as ineffectiveness.

In terms of the various methods proposed, I support method C, the 'top layer with cushion' approach, as it flows most logically from a bank's risk management strategy. I could not support the proposal that the hedged item be designated using method D, the 'proportionate' approach, as I think it is flawed. Although theoretically possible, it is not how risk is managed. In any event, the systems required to follow such an approach would be disproportionately costly to implement

Demand deposits

In my view it is inconsistent for the IASB to permit assets and liabilities to be allocated to time periods based on expected maturities but to prohibit demand deposits from being designated as part of a hedged item in a time period in which a net liability position arises. Although most deposits are contractually repayable on demand, there is robust data to demonstrate that demand deposits have a behavioural maturity significantly longer than their contractual maturity. The proposals as they stand may be unworkable for banks in situations where in any time period there are excess liabilities that include demand deposits.

The above concerns are addressed more fully, together with a number of other issues, in the British Bankers' Association's comment letter, which has my support.

Conclusion

I believe strongly that accounting should portray accurately the economic results of the way business is done and should, wherever possible, align with the risk management framework which is articulated to shareholders as being the basis on which stewardship of their assets is being conducted. I recognise the theoretical difficulties but believe that a failure to find a way to address the role of demand deposits in the overall management of interest rate risk in the retail banking sector could be instrumental in forcing risk to be managed in a way that looks more to managing accounting rather than economic impact; the possibility of unintended consequences cannot be ignored and, given the role of financial systems within our economic and capital formation systems, it is understandable that the broad concerns expressed on this topic continue to be aired forcibly.

Yours sincerely

Douglas J Flint
Group Finance Director