Institute of
CHARTERED ACCOUNTANTS
of New Zealand

Accounting and Professional Standards

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Dear Sandra

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 Financial Reporting Standards Board (the FRSB) of the Institute of Chartered Accountants of New Zealand has reviewed the proposed amendment to IAS 39. The FRSB also sought the views of affected constituents. The Board has paid particular attention to views expressed by our Central Bank, the Reserve Bank of New Zealand (the RBNZ), given its role in managing the Prudential Supervision of registered banks in New Zealand. The RBNZ consulted with local banking institutions and their auditors.

Our constituents believe that the IASB has developed a framework that is broadly consistent with how banks manage banking book risk. Specifically, the repricing schedule is based on behavioural maturity, which caters for both interest rate and repricing-option risk. The key exception is demand deposits. Our constituents have indicated that this issue requires further review. Banks, and the New Zealand supervisory disclosure framework, regard demand deposits, or rate insensitive retail products, as having a repricing characteristic beyond their contractual maturity.

Addressing the specific questions posed in the exposure draft:

Question 1

Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness?

We support treating effectiveness using a portfolio approach rather than individual assets. We recognise that this proposal is designed to reduce compliance costs without any major decrease to benefits. More importantly it does not compromise reliability and relevance and maintains consistency with the main principles in IAS 39.

Approach D is consistent with the IASB's hedging principles and does reflect at least some fair value risk. However, the general view within the New Zealand banking

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industry is that an accrual or cash flow measure is the appropriate basis on which to reflect interest rate risk in the banking book, including where the banking book includes derivative hedges. **Approach A** is perceived as providing a more appropriate reflection of the industry perspective of banking book interest rate risk.

Just as the accrual based measurement of loans and receivables reflects a pragmatic departure from fair value concepts, the RBNZ supports some pragmatism on this issue, giving entities the option of using **Approach A** with a requirement to disclose the approach taken.

Question 2

Do you agree that on-demand deposits cannot qualify for fair value hedge accounting?

Although the proposed amendment drew positive comment for what was seen as appropriate movement from the IASB on the matter of portfolio hedging there were some concerns that the proposals fell short of expectations. In particular, the treatment of demand deposits in financial reports prepared under the proposals will not reflect the way our banks and the RBNZ assess risk.

New Zealand Banks regard the core level of demand deposits that depositors retain with the bank as a hedge (as least in part) of interest rate risk on longer term fixed rate banking book assets. This reflects the fact that a core level of demand deposits is retained in these accounts. That is, the behavioural maturity extends beyond the contractual maturity.

From a purely economic, or fair value, perspective it is difficult to see how the interest rate re-pricing characteristics of a demand deposit provide an effective fair value hedge on long term loan. The RBNZ refer to these instruments as rating insensitive retail products, and by implication their fair value is relatively insensitive to interest rate changes. Consistent with the industry accrual view of interest rate risk in the banking book, the RBNZ allows demand deposits to be viewed as a hedge of longer term assets in calculating the market risk position of an individual bank. One implication is that the discount rate is close to zero, which raises the issue of whether the rollover of demand deposits is more about liquidity than interest rate risk.

In short, the RBNZ believes a gap remains between the way the banking industry views demand deposits and how they will be reported under IAS 39.

Other Matters

Adoption Date

We wish to seek clarification of the adoption date. Can an entity start using portfolio hedging as soon as the proposed standard is approved or must they wait until the start of the next reporting period?

Change in Accounting Policy

The proposed standard should make an explicit statement as to whether the proposals constitute a change in accounting policy or a change in methodology.

Administrative Matters

We note that all the examples are for one reporting period. It would be helpful if some examples covered multiple periods. Further, the de-recognition example used the value of 10 in several steps. Repeating a common amount makes it difficult to track an item through a complete cycle. As a matter of course we suggest that the amounts used in examples be designed to create unique element values.

Yours sincerely

pp. **Tony van Zijl**
Chairman - Financial Reporting Standards Board