CCDG
COUNCIL ON CORPORATE
DISCLOSURE & GOVERNANCE

[by Post and E-mail]
CL 83

21 November 2003

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

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RESPONSE TO EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39

The Council for Corporate Disclosure and Governance (CCDG) appreciates the opportunity to comment on the Exposure Draft of the proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement* published by the International Accounting Standards Board (IASB) in August 2003. The CCDG has sought comments from the key sectors, which are likely to be affected by the proposed ED. Our comments address the two specific questions set out in the "Invitation to Comment" section and include general and other comments as follows.

General Comments

The proposed ED is a marked improvement from the existing standard in that it allows macro hedging, eliminates the need to identify specific hedged items, and eliminates the need to update fair value changes of hedged items individually. We are agreeable to the concept of macro hedging proposed by IASB. There are, however, some practical issues relating to the proposed ED and they are outlined below for IASB's further consideration.

Question 1 – Proposed designation and effectiveness measurement

Draft paragraph 128A proposes that in a fair value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than *as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount. For example, it may hedge the change in the fair value of the designated amount attributable to changes in interest rates on the basis of expected, rather than contractual, repricing dates. However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (e.g. in the light of recent prepayment experience), or actual repricing dates differ from those expected. Draft paragraph A36 describes how the amount of such ineffectiveness is calculated. Paragraphs BC16-BC27 of the Basis for Conclusions set out alternative methods of designation that the Board considered, their effect on measuring ineffectiveness and the basis for the Board's decision including why it rejected these alternative methods.*

Do you agree with the proposed designation and the resulting effect on measuring effectiveness? 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 recognized 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?*

Response to Question 1

The CCDG notes the merits of the proposed designation and the resulting effect on measuring effectiveness. We are of the view that the standard should be principle-based, and that the merits and drawbacks of the four approaches outlined in BC 19 should be further considered by the IASB in deciding which approach or alternative approaches would be most appropriate to ensure the provision of meaningful accounting information, while taking into consideration the risk management practices of banks internationally.

Comments expressed by respondents during CCDG's consultation process on issues that may arise from the proposed method of designation, as explained in the Basis of Conclusions, are appended below:-

(i) <u>Designation of hedge amount</u>

Basis for Conclusions, BC 19 outlines four approaches of hedge designation and its consequential measurement of ineffectiveness. However, the ED does not specify a basis of designation and does not include requirements as to the degree of hedging a company has to undertake. As such, it is unclear as to whether:

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(a) the four approaches outlined in BC 19 are available as alternatives in that flexibility is rendered to the preparers of the financial statements , or
(b) the percentage basis is the prescribed approach, in which case, the approach should be spelt out specifically.

Some banks have noted Approach A as explained in the Basis for Conclusions and feel that there are merits to support this approach:

- Assumptions on (a) the average life span of the loans and (b) the probability of prepayment are based on historical trends. These assumptions introduce subjectivity into the current profit and loss statement. Furthermore, prepayments may also occur due to non-interest rate related economic factors such as market competition.
- The entity is hedging interest rate risk rather than prepayment risk. Any change to the portfolio because of change in prepayment patterns should not affect the effectiveness of the hedge in mitigating interest rate risk.

The same banks are of the view that the above is in line with IAS 39 as it is not apparent that there is any principle underlying IAS 39 that material ineffectiveness arising from under-hedging should be identified and recognized. In the application of normal hedging rules, should a company decide to hedge net assets of $20m when its overall interest rate risk position is $30m, there is no requirement to measure ineffectiveness, even if the $30m increase to $40m during the hedge process.

The banks also noted in A37 which proposed that once ineffectiveness has been calculated, a new estimate of the "hedged portion" has to be re-established, taking into account any new assets/ liabilities that have been added to the overall portfolio. While the banks do not disagree with the Board's proposal, they recognize that complex system changes will be required to handle this 'dynamic' hedge designation, which is a major issue to the bank. It may potentially require revaluation of all assets and liabilities of the portfolio from which the "hedged portion" is drawn and calculation of the fair value of the "hedged portion" as a percentage of the total fair value. Moreover, as the ED specifically does not allow the assumption that the value of the "hedged portion" changes by the same amount as the fair value of the hedging derivative, there is no acceptable "short-cut" method to ease the practical difficulties of implementation.

(ii) Ineffectiveness test

As identified in 1(i)(b), given that no methods were specified for the ineffectiveness measurement of macro hedges, the question arises as to whether the assessment method for

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general hedges is also applicable to macro hedges and thus whether the same method require macro hedges to be unwound. The banks are of the view that this assessment method should not apply to macro hedges, which should be taken on a rolled forward basis. Based on the current ED, it is unclear as to whether:

(a) ineffectiveness should be allowed to continue by way of macro hedges; and
(b) macro hedges can be exempted from the "80-125%" rule and there are concerns if the rule still applied.

(iii) Expected repricing dates and maturity time periods

Paragraph A26 (a) and (b) states "
The entity identifies a portfolio of items whose interest rate risk it wished to hedge. The portfolio may comprise both assets and liabilities. The entity analyses the portfolio into maturity time periods based on expected, rather than contractual, repricing dates."

The respondents are of the view that the proposed ED may wish to consider providing some guiding principles for determination of the expected repricing dates and maturity time periods in order to increase comparability of hedging results across entities.

The respondents commented that paragraph A26(b) of the ED requires the hedge portfolio to be analysed into different time buckets based on expected repricing dates. Historical experience may not be reflective of future payment trends. Prepayment patterns could be affected by factors other than interest rates, such as competition, migration and downsizing. The process could be subjective which would in turn affect the computation of hedge effectiveness. Guidelines on this subject matter would be useful.

(iv) Change in the fair value of the hedged item

Paragraph A26(f) requires the entity to measure the change in the fair value of the hedged item that is attributable to the hedged risk based on the expected repricing dates determined in paragraph A26(b).

The respondents are of the view that the fair value of customer loans, bonds and deposits may change due to variation in interest rates, credit ratings and market conditions. For the testing and recognition of hedge effectiveness in the profit/loss statement, fair value is to be computed solely based on interest rate risk hedged i.e. variation in interest rates. Differentiating the fair value of the various components of the risks would be challenging as market prices are normally quoted for the instruments as a whole. The respondents propose more guidelines to ensure consistent application across entities.

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(v) Derecognition of items

Views were expressed that the amounts that are presented in the balance sheet line items referred to in paragraph 154 should be removed from the balance sheet when the assets/liabilities are derecognised. The amount of gain or loss on the hedged item to be removed is the proportion that the amount of designated hedged items bears to the total assets/liabilities in the portfolio.

Question 2 – Accounting for demand deposits

Draft paragraph A30(b) proposes that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair value hedge accounting if they had been designated individually. It follows that a financial liability that the counterparty can redeem on demand (i.e. demand deposits and some time deposits) cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. Paragraphs BC13-BC15 of the Basis for Conclusions set out the reasons for this proposal.

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 you view result in such a liability being recognized 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 characterize the change in value of the hedge item.

Response to Question 2

The CCDG notes the merits 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. We note that allowing demand deposits to qualify for hedge accounting could result in demand deposits being valued at amounts less than the amounts payable on demand. This could result in a material overstatement of a bank's financial position under certain circumstances.

Appended below are the comments expressed by respondents during CCDG's consultation process:

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Banks often use macro-hedges to lock in the interest rate spread earned on their deposit base. If core deposits are not permitted to qualify as the hedged items, derivatives that are entered into cannot be attached to an eligible hedge accounting relationship despite being established as an economic hedge. There is support by banks for the view that demand deposits should qualify for fair value accounting. Reasons given include the following:

- Although demand deposits are payable on demand, expected repayments and repricing could be estimated based on historical behavioural patterns and fair value could be computed accordingly based on these behavioural patterns.
- Assets with prepayable features are allowed to be scheduled into different time buckets based on expected repayment dates. By not allowing demand deposits to be scheduled based on expected withdrawal dates is not consistent with the treatment proposed in the ED for assets.
- Banks have been managing the risks of the demand deposits using the behavioural repayment pattern rather than the contractual repayment dates.
- To apply cash flow hedge accounting for demand deposits will cause undesirable movements in the equity account.

Overall, the CCDG notes that there are strong arguments for and against the fair value hedge accounting for demand deposits and suggests that the IASB study these issues further.

Other Comments

The bank respondents also identified the following issues.

(i) Early termination of the macro- hedging relationship

For macro-hedges, the hedge items may contain numerous assets (or liabilities) and to amortise the fair value adjustment against the carrying amount of the hedged items would be complex and impractical. The proposed ED is not clear on the accounting treatment to be adopted when there is a termination of the macro-hedging relationship e.g. when the hedging instrument is terminated earlier than anticipated and the hedged item is still in the books. Guidelines on this subject matter would be most useful. A possible solution would be to allow the amortisation of the adjustment over the original life of the hedging instrument for both the hedged items and the hedging instrument.

Paragraph 157 of the earlier Exposure Draft on amendments to IAS 32 and IAS 39 states that "when the hedging relationship ceases, the adjustment to the carrying amount of a hedged interest-bearing financial instrument shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be

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adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins and shall be amortised fully by maturity."

(ii) Considerable system changes and manual efforts

To comply with the proposed ED, a complicated process will need to be established to calculate and record ineffectiveness. Considerable systems changes are also required such as estimating and tracking the expected repricing dates and prepayment amounts; fair valuing the hedged items and the related hedged risk; and incorporating the testing of effectiveness, amortisation of adjustments to the carrying amount of the hedged item to comply with the new proposed procedures.

This practical problem was also identified by respondents as highlighted in the response to Q1(i), paragraph 4. An extension of the effective date of this standard would assist banks in making the systems and administrative changes to comply with the procedures.

Should you require any further clarification, please contact Mr Ramchand Jagtiani, Deputy Director, at the Institute of Certified Public Accountants of Singapore via email at jagtiani@icpas.org.sg should you require further information. Thank you.

Yours sincerely,

Derek How
Secretary, CCDG

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