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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"

Introduction

The Deutsche Bundesbank welcomes the opportunity to comment on the "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" presented by the IASB. The comments by the Deutsche Bundesbank's Banking and Financial Supervision Department are made primarily in the light of the potential impact of the Exposure Draft on credit institutions, in particular, from a prudential perspective.

In general, we welcome the IASB's willingness to amend IAS 39 to basically enable fair value hedge accounting for a portfolio hedge of interest rate risk. In this context, we further salute the IASB's willingness to consider the arguments of the credit institutions and banking supervisors within the framework of the consultation process on the Exposure Draft IAS 39 (June 2002).

We certainly recognise the progress which the current Exposure Draft represents in terms of balance sheet fair value hedge accounting for a portfolio hedge of interest rate risk. This constitutes a first major step towards enabling credit institutions to implement their modern risk management procedures within the framework of the IAS/IFRS accounting standards.

However, we still see major problems with the Exposure Draft, which could considerably limit the practical applicability of macro-hedge accounting for interest rate risks and which need to be overcome with the aid of those concerned.

General remarks

In general, we are open to every initiative concerning the balance sheet reporting of enterprises' – in particular credit institutions' – economic circumstances, which contributes towards strengthening the stability of the financial system through clarity, transparency, accurate valuation and a risk-adequate presentation of the enterprise's situation.

As in the case of the formulation of accounting standards in general, we are in favour of a principle-based approach to fair value hedge accounting for a portfolio of interest rate risk, too. This should be based on state-of-the-art, tried and tested risk management procedures such as those employed by credit institutions.

In the current Exposure Draft, we see major problems in the way in which the effectiveness of the hedge is measured and in the question of how to account for core deposits within macro-hedge accounting. As the two questions which precede the Exposure Draft also deal with precisely these issues, in answering these questions we have discussed the problems mentioned in detail.

On the whole, we consider that the approaches proposed are not yet sufficiently practicable and we therefore advocate that the dialogue between the IASB and the banking industry be continued in order to reach a satisfactory solution for all concerned in the near future prior to the introduction of the IAS/IFRS in the European Union in 2005.

The question raised in the Exposure Draft

Question 1

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.[1] However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (eg 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 decisions including why it rejected these alternative methods.

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

We agree with the procedure proposed by the IASB for designating the hedged item, according to which financial assets and liabilities are to be allocated to appropriate maturity time periods on the basis of their expected maturity or fixation periods, and the hedged item can be determined as an amount resulting from the balance of financial assets and liabilities for each maturity band. We welcome the fact that the hedged item is to be designated in terms of an amount of assets or liabilities and that specific financial assets or liability instruments are not to be designated.

Moreover, we agree with the IASB's view that all material ineffectiveness of a hedging relationship should be identified and recognised. In our opinion, this is a fundamental prerequisite for transparent hedge accounting and is also in line with the general principles of hedge accounting in IAS 39.

In this context, we also recognise the reasoning underlying the proposed approach to retrospectively measuring effectiveness (Approach D). The intention is clearly that both over-hedge and under-hedge situations should result in ineffectiveness being recognised in profit and loss, as is required by the principles of hedge accounting in IAS 39.

However, in our view, in amending the IAS 39 to include the possibility of macro-hedge accounting, a new definition of the term "ineffectiveness" is used. Thus, in our opinion, the approaches considered in the current Exposure Draft, in particular the proposed Approach D, measure primarily the effectiveness of the bank's expectations concerning the allocation of financial assets and liabilities to the maturity time periods, and not the effectiveness of the hedging relationship itself. The hedge accounting principles in the current IAS 39 are based on a different consideration. As long as the relationship between the respective values of the hedged item and the hedging instrument fluctuates in the specified range of 80% to 125%, the hedging relationship is accordingly deemed effective and is recognised as such for hedge accounting purposes (paragraph 146 of the Exposure Draft IAS 39). If this range is no longer achieved, the hedging relationship can no longer be recognised and must be dissolved. Consequently the former hedged item must once again be measured at amortised cost, while the changes in the fair value of the hedging instrument continue to be recognised in profit and loss. However, within the range specified in paragraph 146 of the Exposure Draft IAS 39, diverging changes in the values of the financial instruments within the hedging relationship will likewise be classified as ineffectiveness if the countervailing changes in the value of the hedged item and the hedging instrument do not completely offset each other in the profit and loss account, the exception being the ideal case of total congruence in the changes in value. Thus, on the one hand, if the 80-125% range is overshot or undershot, for hedge accounting purposes this amounts to a derecognition criterion for the overall hedging relationship, on the other hand, any ineffectiveness within the 80-125% range is also identified.

As mentioned, all the proposed approaches are based upon a new definition of the term “effectiveness”, which reflects the ongoing adjustments by the banks to the customers’ changing repayment/redemption behaviour, describing these adjustments as ineffectiveness. We see no need to reflect differing under-hedge positions (different hedge ratios) in the balance sheet provided the absolute hedged amount is amortised with both its components (hedging item, hedged amount). Only in the event of an over-hedge situation, is there any justification for recognising such “ineffectiveness”, which, incidentally, occurs automatically in the measurement sequence: in the case of complete effectiveness in the narrower sense[1], the changes in the value of the hedged item in the form of the newly adjusted net position within a given maturity time period is the same as the change in value of the hedged derivative, as long as the net position is not smaller than the hedging derivative. As soon as the net position is reduced and consequently becomes smaller than the hedging derivative, the change in the value of the new net position becomes less than that of the hedging derivative. In this context, such over-hedge situations are automatically recognised in profit and loss. This is also the case if one designates the net position as part of the gross amount of assets or liabilities for designating the hedged item. Method C probably comes closest to this approach. In view of these interrelations, it would, however, be better to reformulate the measurement rules for hedge accounting in IAS 39 neutrally as few central principles. In our opinion, there is no need to designate a specific method. The IASB’s established relations to the credit institutions, which have demonstrated their worth in the past through the willingness of both sides to listen to each other with open minds, should be utilised in this context.

[1] Effectiveness in the narrower sense is the effectiveness of a hedge vis-à-vis changes in a specified benchmark interest rate, which is intended to be representative of the interest rate risk within the time period and is defined by the bank as part of its risk management strategy.

Question 2

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 (ie 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 your view result in such a liability being recognised 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 characterise the change in value of the hedged item?

We fully agree with the IASB that, for accounting and measurement purposes, core deposits must, in general, be recognised at their nominal value.

However, it is another question entirely whether this necessarily excludes changes in these values within the framework of the portfolio hedge, or whether such changes in value can be recognised as a reflection of a hedged interest rate risk. This would reflect the fact that such deposits, notwithstanding their contractual term, are available to the bank over the longer term in the form of a permanent average balance and, in relation to this de facto term, are often remunerated at below the market rate. This interpretation has also found its way into interest rate risk management, which – as mentioned – ought to be the starting point for constructing a consistent accounting system. The IASB has already taken the initial step towards recognising this view by admitting that core deposits can be allocated to maturity time periods according to their expected term. It does not appear consistent to then exclude them if they are part of a net liabilities position. In conclusion, we consider it perfectly acceptable and consistent to allocate all core deposits, like other assets and liabilities, to maturity time periods according to their expected term, and to allow the resultant net position to be used, without restriction, for a complete or partial hedging of the interest rate risk and to recognise this in the accounts. It is irrelevant whether the net liability position comprises core deposits or other types of deposit. There is no need to switch from fair value hedging to cash flow hedging as soon as core deposits are included in the net liability position. The prescription of such a methodological change should be avoided as this would result in undesirable artificial equity capital volatility.