THE BANKING COUNCIL

South Africa

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Dear Madam

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Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

We would like to thank the South African Institute of Chartered Accountants and the International Accounting Standards Board for the opportunity to comment on the Exposure Draft of Proposed Amendments to IAS 39 and AC 133, Financial Instruments: Recognition and Measurement – Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk.

The Banking Council South Africa has considered the proposed changes to AC133 through Exposure Draft, ED166. As an overall comment, we welcome the introduction of fair value hedge accounting for portfolios of interest rate risk. However, we believe that, having accepted the principles of portfolio hedging, it would be appropriate to give due consideration to some of the practical application rules that banks would wish to adopt and the systems implications of such adoption.

COMMENTS ON ED 166: FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF INTEREST RATE RISK

The process that South African banks have identified as being within the overall intention of portfolio hedge accounting, and will achieve the same effect as intended in the exposure draft, but will be more readily adaptable to existing systems, is proposed as follows:

- Banks would identify a portfolio of assets and liabilities whose interest rate risk they wish to hedge. The portfolio would comprise both assets and liabilities.
- Banks would then analyse the portfolio into maturity periods based on contractual repricing dates. It is accepted that, for all practical purposes, contractual maturity is more appropriate than expected maturity. Furthermore, we do not believe that prepayments of financial assets will materially change hedge effectiveness. As hedge effectiveness is regularly measured in any event, it is believed unlikely that there will be any significant differences between expected maturity and contractual maturity.
- Based on this analysis, banks would hedge all, or a portion, of the surplus assets or liabilities in each maturity band. It is therefore believed that this should be an acceptable basis for identifying the hedged items.

- All assets and liabilities included in the portfolio will be fair valued for interest rate risk only.
- All changes in the interest rate fair value relating to the portfolio and the hedging instrument will be accounted for in the income statement.

Under existing accounting standards this approach cannot be followed because assets and liabilities cannot be fair valued for a specific risk, but may only be accounted for at fair value in total, unless it is a hedged item. A further concern is that the interest rate risk of a specific portfolio of assets or liabilities may be more appropriately hedged with other assets or liabilities, rather than with derivatives. The Banking Council response to the specific questions is as follows:

1a) How should the hedged item be designated and why?

The hedged item should be designated as the surplus or deficit of assets over liabilities of the specifically identified portfolio within each identified contractual maturity band.

Keeping track of the specific portion of assets or liabilities in each maturity band that has been designated as hedged items can be onerous (as we are dealing with high volume low value items) and would go against the principle detailed in the background to the statement, 3(b), which, in summary, states that it is the Board's aim to develop an approach that is workable, and can use the current risk management systems to prepare financial statements without necessitating major system changes.

Furthermore, the process of recognising the changes in the interest rate fair value for both the hedged portfolio and the hedging instrument in the income statement will eliminate any inappropriate recognition of income or expenditure. An overriding limitation in this process is that hedge effectiveness is maintained throughout the hedging process. The possible concern that hedge effectiveness may be lost is addressed below.

1b) 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?***

In terms of measuring hedge effectiveness, if we measure the change in the fair value of the surplus asset or liability position for the hedged risk vs. the change in the fair value of the derivatives, and this ratio falls within the 80%-125% rule, then we believe we can conclude that hedge effectiveness has been achieved.

The fair value adjustment relating to interest rate risk of both the surplus asset or liability position and the derivatives should be processed to the income statement. As a result of this process, all material ineffectiveness will be identified and recognised in profit and loss.

1c) Under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraphs 154 be removed from the balance sheet?

As banks will be able to identify the fair value adjustments for the assets and liabilities, these adjustments can be processed in separate line items as required by paragraph 154. Under the proposed approach, these amounts will be removed from the balance sheet when the assets or liabilities to which they relate are derecognised as envisaged by the statement.

The asset or liability created will represent the adjustment of the hedged portfolio to fair value for interest rate risk at any given time.

2) Do you agree with the Board's decision (which confirms an existing requirements in IAS 32) that the fair value of such a financial liability is not less than the amount payable on demand?

We do agree that, with regards to a financial liability, a counter party who can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counter party can demand payment. It is for this reason that banks would tend to favour using contractual maturity rather than expected maturity for both liabilities and assets.

Yours faithfully

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