



AUSTRALIAN BANKERS' ASSOCIATION

Level 3, 56 Pitt Street
Sydney NSW 2000

Telephone: (02) 8298 0417
Facsimile: (02) 8298 0402

CL 62

Louise R Thomson
Group Manager, Group Accounting Policy
National Australia Bank
Level 26, 500 Bourke Street
MELBOURNE VIC 3000
Phone: +61 3 8641 3481
Fax: +61 3 9208 8768
Email: louise_r_thomson@national.com.au

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

Dear Ms Thompson

**Australian Bankers' Association Comments on Exposure Draft on Fair Value
Hedge Accounting for a Portfolio of Interest Rate Risk**

The Australian Bankers' Association ("the ABA") is the national organisation representing all licensed banking institutions in Australia, including all of the major retail banks. We are responding to your invitation to comment on the exposure draft of proposed amendments to IAS 39 in relation to fair value hedge accounting for a portfolio of interest rate risk ('the exposure draft').

Summary

The exposure draft is a positive step forward and brings the accounting standards closer to economic risk management practice. While the exposure draft goes some way to alleviating the issues surrounding "macro hedging", as requested by numerous financial institutions around the world, the ABA believes there are still a number of areas which warrant further attention.

Specifically, the two principal areas of focus for the ABA are the issues relating to the impact of prepayments and the treatment of core deposits. In summary:

- ❑ the ABA strongly favours approach A in determining the amount of ineffectiveness due to changes in prepayment behaviour. We believe that there are major problems with Approach D which make it unworkable and not reflective of the underlying economics;
- ❑ where the bank recovers the economic cost of early prepayments under its contract with the customer, this “break cost” amount received is an accurate measure of the fair value of the fixed interest rate risk of the prepayment. Recovery of such economic break costs is allowed in the Australian regulatory environment. We believe that the cash flows associated with these products should be based on the contractual (not expected) terms; and
- ❑ core deposits should be a hedge-able item in a fair value macro hedge. That is, these liabilities should be able to be valued based on expected, rather than contractual lives, as would be referenced in the determination of fair value by a willing buyer and seller in an arms length transaction.

Our detailed responses on the questions you posed are set out below.

Question 1: Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness?

The ABA agrees with the broad proposal around the designation of hedged items (that is, that the hedged item may be designated in terms of an *amount* of assets or liabilities). This reduces the administrative burden of having to tag individual loans or deposits, as noted in paragraph BC5(c). It also more closely reflects the risk management practice of most financial institutions. We also concur that the hedging instrument can be a portfolio of derivatives. The latter is particularly important in dynamically hedging a portfolio of loans and deposits where prepayment rates can vary.

The Basis for Conclusions notes four alternative approaches to how any over- or under-hedging should be treated. The International Accounting Standards Board (“the IASB”) note in BC24 that approach D is their preferred option. Under approach D we have a number of issues in relation to prepayment-related ineffectiveness. The ABA favours approach A over approach D for the following reasons:

- ❑ It is closest to how most risk managers actually assess and manage the economic risk. Not all on-balance sheet fixed rate exposures are necessarily hedged. Hence, faster prepayment speeds should not automatically create hedging ineffectiveness, as happens with all the approaches noted by the IASB other than approach A.

- It is consistent with the principles underlying cash flow hedging on the same issue (IAS 39 Implementation Guidance Paragraph 121).
- We agree with the arguments set out in BC20 in support of approach A. Namely:
 - that the entity is hedging interest rate risk rather than prepayment risk, and therefore the occurrence of prepayments does not affect how effective the hedge was in mitigating interest rate risk.
 - that the approach captures all ineffectiveness on the hedged portion, and simply allows that hedged portion to be defined in a manner that the first part of any potential ineffectiveness relates to the unhedged portion (consistent with normal banking risk management practice).
- BC21c notes that there will be no ineffectiveness created if there is no hedging undertaken – even though changes in prepayment speeds will affect the notional fair value of the underlying assets and liabilities. We believe the IASB should encourage (rather than discourage) hedging so as to maintain the entity’s overall fair value. Approach B is particularly severe, with the all over-hedging considered to be ineffective. Approach D may give a similar result, depending upon the hedge ratio.
- If the IASB wishes to bring the fair value of over- or under-hedging to account in the current period, approach D simply does not achieve this aim. The profit or loss impact under approach D will depend upon the hedge ratios at different parts of the “gap” position (as well as any over- or under-hedging). These differences in hedge ratios will introduce randomness in hedge effectiveness calculations and subsequent profit and loss account postings that is inconsistent with our understanding of the Board’s conceptual objectives for measuring and reporting ineffectiveness under IAS 39.
- It is difficult in practice to accurately measure the expected rate of prepayments. Prepayments can vary markedly and for reasons other than movements in interest rates. However, over time, they typically revert to some long-run average. Simply marking-to-market short-term fluctuations in prepayment speeds would introduce exaggerated volatility into the profit and loss account under approaches B, C and D.

Prepayment Risk Considerations

The ABA concurs with the argument set out in the Basis for Conclusions paragraph BC5(a) explaining why the IASB is supportive of the measuring of the ineffectiveness caused by some products having prepayment options. However, where the product design eliminates this risk by passing it onto customers, then we would argue that no such economic ineffectiveness exists, and therefore it is inappropriate to measure and report such ineffectiveness in the financial statements.

Australian banks often charge mark-to-market style “break costs” where borrowers or depositors break out of a fixed rate facility prior to the contractual re-pricing date. In these circumstances, the customer reimburses the bank for any movements in market interest rates. While the bank might reasonably expect a certain amount of prepayments to occur, the existence of these break costs insulates the bank against adverse rate movements. Where prepayment of a fixed rate facility with such a break cost clause occurs, the customer payment is taken directly to the profit and loss account together with the break cost on the hedge. It is therefore prudent for the bank to hedge the cash flows specified in the fixed rate contract. The ABA requests the IASB to consider the exclusion of such products with market value break costs from the prepayment calculations. With these products the expected cash flows should be the contractual cash flows.

The ABA also believes it is necessary to carefully interpret paragraphs A36 and IE4 so that revisions to prepayment rates are based on an entity’s documented risk management assumptions. It is the prospective effectiveness that is important to the long-term prepayment pattern and the assessment of hedge ineffectiveness.

In itself, a volatile interest rate environment may exacerbate the impact on the profit and loss account through prepayment fluctuations altering the effective duration of a portfolio of fixed rate loans or deposits under a macro hedge. However, it is not appropriate to automatically revise the prepayment speeds based solely on recent interest rate trends. Interest rate movements may be only part of a complex set of factors influencing prepayments. These include transaction costs and customer “shoe leather” time; the features and prices of a range of different mortgage or deposit products; whether customers wish to increase or decrease the size of a loan or deposit due to wealth effects; new motor vehicle models (particularly for personal loans) and publicity and public opinion as to whether it is a good time to lock-in or to re-finance.

By comparison, valuations in other industries do not rely solely on short-term fluctuations in current conditions as the only valid input to assumptions. For example, actuarial valuations for insurance companies tend to use longer-term average interest rates in their calculations. The ABA suggests that documented risk management assumptions, stressing long term averages, should be considered in the analysis for any revision of prepayment speeds.

Response to sub-questions

In summary, we do not agree with the proposal by the IASB to adopt approach D for measuring ineffectiveness. In particular, the inclusion of hedge ratios that are not related to changes in prepayment speeds introduces randomness into the effectiveness calculations.

In answer to Question 1(a), we believe that approach A should be selected for the reasons outlined above.

In answer to Question 1(b), we believe that approach A would adequately identify and recognise material economic ineffectiveness consistent with the bank's stated risk management strategy. We note that where product design (i.e. recovery of break costs) mitigates prepayment risks then banks should only hedge the contractual (rather than expected) cash flows.

In answer to Question 1(c), we note that under the proposed macro hedging model, an entity is allowed to readjust the hedge ratio after each effectiveness testing period therefore allowing different amounts of net assets/liabilities to be hedged over the term of each time bucket. Upon analysis of the accounting entries that will be generated, we have noted that the fair value adjustment to either the net asset or liability position will not fully reverse out over time and therefore at the expiry of each time bucket a net asset or liability position will remain on the balance sheet. The process of either amortising this adjustment over the term of each time bucket or removing the remaining net asset or liability position from the balance sheet upon expiry of the time bucket produces additional volatility in the profit and loss account.

Based on our preliminary analysis, we believe that amortisation or adjustment over the period will generate a result in the profit and loss that is inconsistent with the economics of the hedging relationship. In an example of a perfect hedge, the impact of fair valuing the hedge and underlying transactions should be zero over the life of the transaction.

Question 2: 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?

The ABA strongly disagrees with the concept that a demand (or "core") deposit cannot be fair value hedged. We believe entities with interest rate risk that is heavily influenced by products that are on demand in form but exhibit characteristics of a fixed rate nature can be placed at a material competitive disadvantage, both in product pricing and financial performance, if they are denied fair value hedge accounting. The mere fact that these products exist should not preclude them from being effectively risk managed and the related hedges brought to account appropriately. We note below a number of important practical problems associated with using cash flow hedging for these and related items, which increases the need for macro hedging to be workable for financial institutions. These problems include "basis risks", a possible shortage of suitable cash flows to hedge, heightened operational risks, possible regulatory capital issues and hedge capacity issues.

The amount of core deposits is significant. Non-interest bearing call accounts represent over 5% of banking system deposits in Australia. We estimate that this proportion rises to around 20% when other low-interest demand deposits are included. Such core deposits form an important part of most Australian banks' hedging strategies.

The ABA wishes to draw to the attention of the IASB the following arguments in favour of allowing core deposits to qualify as the hedged item under fair value hedging. These are in addition to the reasons noted by the IASB itself in paragraph BC13.

i) Expertise of risk managers

The ABA believes that the risk management community should decide what constitutes interest rate risk. The accounting framework should ensure that the financial accounts accurately reflect the underlying economics and risk features of the products concerned and that there is sufficient disclosure of the key assumptions. We note that there are analogies to the valuation of many insurance products.

The key economic characteristics of core deposits are that they are “sticky” – both from a pricing and a retention perspective. They do not reprice in line with prevailing wholesale market rates. Hence, they exhibit strong similarities to traditional fixed rate items and their fair market value will fluctuate with the level of interest rates.

The argument presented in BC14(d) is only valid in terms of the theoretical view of the redemption value of an at-call deposit. However, it doesn't reflect the underlying economic value to the bank as a going concern business, being the fair value of the future cash flows (including interest margin) that the entity will earn. We believe fair value hedge accounting is just as valid for core deposits and similar items as for products with more traditional fixed-rate risk features.

The issue of how to value and hedge products such as core deposits has occupied the minds of risk managers for many years. There are a number of different models to measure and manage the interest rate risks of these products. These include so-called “replicating portfolios” and more sophisticated stochastic models that try to measure the optionality associated with the indeterminate nature of the cash flows. In each case, the essence of the approach is to protect or lock-in the margin that the entity will earn over time on a going concern basis. Where offsetting fixed rate assets don't routinely occur, they can be synthetically created with interest rate swaps.

For any product in which the entity bears interest rate risk, it is necessary to make informed estimates of the run-off and/or any increases that are permitted. This is regardless of whether the product is notionally at-call. Risk managers commonly assess core deposits as a portfolio and determine a stable balance that can be viewed as a level above which turnover occurs. The characteristics of a fixed rate product then relate to this core balance.

Risk managers may also argue that clearly demonstrated behaviour by customers in maintaining their deposit balance is proof of a “firm commitment” and should therefore be able to qualify for fair value hedge accounting.

ii) Compatibility with market and regulatory practice

Market practice amongst risk managers is that core deposits present significant risk to an entity's earnings volatility and in turn, fair value. This risk can be in part managed by ascribing risk characteristics to the deposits that mirror fixed rate behaviours of contractual fixed rate deposits. Whilst the practices and the assumptions are not perfect, they result in a far more stable view of the entity's net fair value than if not adopted at all.

The validity of the approach is recognised by regulators in most jurisdictions and acknowledged within the Basel II capital adequacy proposals. For both liquidity and interest rate risk management purposes, Australian banks place the vast bulk of their retail call deposits outside the "at-call" bucket. To treat core deposits solely on an at-call basis will place the standard at odds with the approach by BIS, regulators in many jurisdictions (from both a liquidity and market risk perspective) and the risk management community generally.

The IASB exposure draft on amendments to IAS 38, Intangible Assets, recognises that identifiable intangible assets in an acquisition, such as core deposits, will be recorded in the Statement of Financial Position at their fair value. The fair value of assets that relate to the depositor relationship would be based on the estimated benefits attributable to the relationships in existence at the date of acquisition. This fair value of core deposits recognises that these deposits exhibit characteristics of a fixed rate nature in addition to the customer list value. It is the fair value of these fixed rate characteristics of core deposits that would be classified as an intangible asset.

The ABA believes the consistent application of principles is required across the accounting framework. To recognise that core deposits may have a fair value in an acquisition and to disallow management recognition in the financial instrument standard does not represent consistent application of these accounting principles.

iii) Turnover of funds

We do not accept the argument put by the Board at paragraph BC14(a) that the funds should be valued as if they will be immediately withdrawn in full and that we should not consider forecast funds inflows. In the context of macro hedging, it is portfolio dynamics that are most significant, rather than individual accounts.

Banks and many other entities have long and detailed records of core deposit transaction history. These are used by risk managers to estimate the expected repricing characteristics of demand deposits, as well as providing input into the design of liquidity policies. Conceptually, this process is no different to that for estimating fixed-rate loan prepayments or the provisioning process for insurance companies, which the IASB encourages. These also rely on portfolio-level forecasts of future transactions and customer behaviour.

The amount of hedging is made with respect to the current level of the core deposits. These are “recognised liabilities” on the balance sheet and as such should qualify for fair value macro hedging under paragraph 137.

iv) Transparency

A large financial institution has interest rate exposures for a multitude of products over a long period of time. For instance, it is common for banks to measure exposures on a monthly or quarterly basis out to 10 years (and beyond). There will be numerous hedged items corresponding to each net gap exposure. It is highly likely that the interest rate exposures will fluctuate between net asset and net liabilities. However, these will be reported in the accounts in a highly summarised form.

Transparency of information across entities and industries is important to the understanding of the entity and the allocation of investment capital. To support our recommendation for core deposits to be recognised as a hedged item in a fair value hedge and to improve transparency, the ABA also recommends that an entity should disclose details of the key assumptions and any changes to these for each major product category. This is one of the main tenets of IAS 32 paragraph 59. Key stakeholders can then opine as to the appropriateness or otherwise of the entity’s risk management policies and key assumptions.

v) Problems with cash flow hedging

Cash flow hedging can be an alternative to fair value hedging for many items. However, there is often substantial basis risk (creating ineffectiveness) between the floating leg of swaps and the “rate drivers” of the hedged item.

Cash flow hedging is particularly unsuitable for deposit products that pay negligible interest rates because there is minimal cash flow to hedge. This can be a problem for banks that need to cash flow hedge assets such as trade receivables, credit cards and various non-rate sensitive loans.

Where a cash flow hedge of variable rate assets is undertaken because a fair value hedge is not allowed, volatility of shareholders equity in either direction will result. If Tier 1 Capital calculations for banking prudential purposes are affected by the impact of cash flow hedges on equity, banks will need to provide more capital when hedges are out of the money, and less when hedges are in the money despite the fact that there are no changes to the underlying business. Consequently this alternative will create a compliance and business issue.

vi) Changes business behaviour

The macro hedging proposals as they currently stand will force banks to use cash flow hedging for at least their core deposits. Should they choose to use macro hedging for the rest of their balance sheet, these banks will have duplicate systems to manage, with heightened operational risks. It may also require increased volumes of external

hedging, as internal netting opportunities will decline. This in turn increases transaction costs and credit exposures.

Another unintended consequence of the proposed new accounting standards could be changes in product design and pricing and to the mix of banks' funding.

Response to sub-questions

(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?

The ABA does not agree with the IASB's view that the fair value of a core deposit cannot be lower than the amount payable on demand.

It is undoubtedly true that customers can withdraw their funds at any time. While it is theoretically possible for holders of demand deposits to withdraw all of their funds, the probability of this eventuating is extremely remote. The interest rate risk issue of core deposits is more that they have no defined maturity, rather than that they are at call.

We accept that the amount payable on demand is the fair value from an individual depositor's perspective. However, the bank views the deposits quite differently. It values them as a portfolio of deposits in a going concern business. The fair value is defined as the present value of all the expected future income and expenses of the particular product. This includes the impact of movements in the interest rate margin component, as well as the cost of funds/ reinvestment rate. The fair value of the core deposit portfolio needs to be included in any realistic measure of the long-term fair value to the entity.

To ignore this perspective will merely serve to frustrate what is universally regarded as prudent risk management of that part of a bank's balance sheet.

As noted above, we acknowledge that there are practical issues in quantifying the repricing term and that there are few liquid secondary markets against which to calibrate the estimates. However, banks are in a good position to provide reasonable estimates of the fair value of core deposits. These will be far more accurate than assuming a nil revaluation.

Over time, any changes in the valuation of both the core deposit and the hedge will flow to the profit and loss account. There may be some ineffectiveness, depending on the bank's ongoing assumptions about the stability of the funding and its fixed-rate characteristics. This accounting treatment is the same as for any balance sheet item with fixed rate repricing features.

(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?

The ABA would initially recognise core deposits on balance sheet at their fair value, which is the face value of the deposit funds accepted. Changes in the fair value of the core deposits due to movement in interest rates can only eventuate from a market interest rate movement subsequent to acceptance of the deposit.

BC14(c) notes a possible inconsistency by recording the core deposit at face value in the accounts on initial recognition and yet also wishing to value the item at a present value. We do not see this as a material issue. As noted in BC13d, the assets or liabilities enter the hedging portfolio at their carrying amounts. At origination, the face value of the core deposits is also the most accurate measure of their value to the entity. The bank issues the deposits at face value in the expectation that it will earn a certain interest spread over time. Similarly, at origination, any related hedging will have nil market value.

Conclusion

To summarise the position of the ABA, we feel that the latest exposure draft represents a positive advancement by the IASB in this complex area.

We would, however, strongly recommend the selection of approach A in determining ineffectiveness. We also seek that where the product design passes the interest rate risk to the consumer then hedging should be to the contractual (not expected) cash flows.

We also urge the IASB to allow core deposits to be a hedged item within the macro hedging framework. This will achieve a level playing field versus other standard fixed rate product types.

We thank you for the opportunity to respond to the exposure draft, and hope that you find our feedback helpful and constructive. Please do not hesitate to contact me if you would like to discuss our members' views in more detail.

Yours sincerely

Louise R Thomson
Group Manager, Group Accounting Policy
National Australia Bank

Chairman of the Australia Bankers' Association Accounting Sub-Committee