AUSTRALIAN ACCOUNTING STANDARDS BOARD

PO Box 204
Collins St West Vic 8007

Telephone: (03) 9617 7600
Facsimile: (03) 9617 7608

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Ms Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Ms Thompson,

ED of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement

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

In response to the IASB invitation to comment, the Australian Accounting Standards Board has prepared the following submission addressing the specific questions asked and commenting on the IASB's proposals in respect of fair value hedge accounting for a portfolio hedge of interest rate risk.

The AASB encourages the IASB to undertake a comprehensive review of accounting for financial instruments, including hedge accounting requirements. We acknowledge that a comprehensive review cannot be completed prior to 1 January 2005, and accordingly, the Exposure Draft is an interim measure. Our comments to the Exposure Draft are made in the context of the requirements that will be in place for 1 January 2005.

The AASB considers that the Exposure Draft is inconsistent with a principle based hedge accounting model and provides a rules based "exception" for the hedging of interest rate risk on a portfolio basis to qualify for fair value hedge accounting. The AASB considers that if the IASB allows an exception for the hedging of interest rate risk on a portfolio basis to qualify for fair value hedge accounting, it is unclear why exceptions should not also be available for the hedging of other risks (for example, foreign currency risk and commodity price risk) on a portfolio basis. Portfolio hedge accounting for other risks would be consistent with the three principles that the IASB consider most relevant to fair value hedge accounting, being:

(i) derivatives should be measured at fair value;
(ii) all material hedge ineffectiveness should be identified and recognised in profit or loss; and
(iii) only items that are assets and liabilities should be reported as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities.

> However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be presented in the balance sheet.

The Basis for Conclusions states that the reason for restricting the scope of the proposals to hedges of interest rate risk is the combination of three factors that do not arise under other hedging arrangements (paragraph BC4 (b)).[1] We note that paragraph A32 comments that a change in interest rates affects the fair value of a prepayable item in two ways:

- the fair value of the contracted cash flows to contractual maturity date change (because the rate used to discount the cash flows changes); and
- the fair value of the prepayment option changes (reflecting, among other things that the liklelihood of prepayment is affected by interest rates).

We understand that many entities do not consider separately, the two impacts. Instead, they incorporate the impact of prepayment by grouping the hedged portfolio into maturity time periods based on expected repricing dates and hedge all or part of the resulting overall net position in each time period. We note that this approach does not require an entity to differentiate between the two impacts. Accordingly, we hypothesise that on occasions only one impact (the change in the fair value of the contracted cash flows to contractual maturity date) will be present. We believe that the existence of a prepayment feature is irrelevant when considering whether to allow portfolio hedging. The primary consideration should be the presentation to users of relevant results that do not impose undue cost on preparers.

If the IASB rejects our view "that the existence of a prepayment feature is irrelevant when considering whether to allow portfolio hedging", we have received advice from some constituents that it is their experience that the combination of the three factors identified in paragraph BC5 does arise under other hedging arrangements. They cite as an example, the industry practice of portfolio hedging of commodity risk - where there is schedule risk (i.e., a timing delivery risk that is similar to prepayment risk). In this example, the net position changes each period as items reprice or are derecognised and new items added, and within the portfolio adjusting the carrying amounts of all of the hedged items for the effect of changes in the hedged risk, will again require a significant allocation of resources. Accordingly, we think that the proposed amendment to IAS 39 should apply to a portfolio hedge of any risk factor that has the same combination of issues identified in paragraph BC5.

Further, we note that entities who manage risks (other than interest rate risk) on a portfolio basis must choose either to make significant operational and systems changes to accommodate the individual designation requirements of IAS 39 *Financial Instruments: Recognition and Measurement*, or accept that fair value hedge accounting is unavailable to them. The former would result in significant, and in some cases prohibitive costs being incurred, while the latter would reduce the relevance of reported results. We are particularly concerned that the inconsistent measurement and display of transactions will result in users of financial statements being unable to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position.

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1 Paragraph BC5 identifies three main reasons why a portfolio hedge of interest rate risk may not qualify for fair value hedge accounting under IAS 39. They are prepayment risk, the IAS 39 prohibition on the designation of an overall net position as the hedged item, and the fair value hedge accounting requirement that the carrying amount of the hedged item be adjusted for the effect of changes in the hedged risk.

The AASB's comments to the IASB's specific questions and the AASB's other comments follow.

Please contact us if further information or clarification is required.

Yours sincerely,

David Boymal

David Boymal
Chairman

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

INVITATION TO COMMENT

Question 1

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 principles underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit and 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?

Of the designation methods proposed, we agree that approach D is the most consistent with IAS 39's requirements in respect of measuring ineffectiveness. However, we believe that the calculation of ineffectiveness using a percentage based approach lacks a rigorous conceptual basis. The purpose of the hedging strategy employed by an entity in the case of a portfolio hedge is to hedge changes in the value of a net position. It follows that it should be changes in the value of that net position that are used to calculate ineffectiveness. Despite this, we agree that for pragmatic reasons it may be appropriate to adopt approach D as an interim measure subject to a longer term project on financial instruments and hedge accounting.

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? If not

(a) do you agree with the Boards decision (which confirms an existing requirement in IAS 32) that the fair value of such a financial liability is not less that 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 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 time period in which the counterparty can demand payment.

OTHER COMMENTS

In Australia the instrument of monetary policy is the 'cash rate', which is the market interest rate on overnight funds. It is periodically adjusted by decisions of the Reserve Bank board (the central bank) and, when this occurs, the Reserve Bank makes a public statement announcing the change and explaining the reasons for it. The cash rate has a very strong influence on other interest rates, including the home loan rates and business loan rates offered by the retail banks (and those interest rates tend to move broadly in line with movements in the cash rate).

In the Australian environment, many loans are termed "variable" interest rate loans. We understand that in a "pure" variable interest rate environment a bank would not be exposed to changes in the fair value of its portfolio of variable interest rate loans and accordingly it would not contemplate hedging its net position (and even if the bank engages in hedging activities, fair value hedge accounting would not be available to a "pure" variable interest rate loan because the fair value of the loan would not change in response to changes in interest rates).

Despite being called "variable" interest rate loans, changes in the benchmark interest rate are often not passed on to the counterparty and repricing is at the discretion of the issuer. This means that in a changing interest rate environment a bank is exposed to changes in the fair value of the portfolio of "variable" interest rate loans, and accordingly, the portfolio of "variable" interest rate loans may qualify for portfolio fair value hedge accounting under the proposed amendments.

Given this, we believe that the application guidance, illustrative example and basis for conclusions should articulate that it is exposures to changes in fair value that is critical to qualifying for portfolio hedging, and not whether the loan is termed "fixed" or "variable". We believe that the references to a fixed rate item in the application guidance, illustrative example, and basis for conclusions (and the non-references to a variable rate item) might cause preparers to conclude that it is only "fixed" interest rate loans that qualify for fair value hedge accounting.