Bundesanstalt für
Finanzdienstleistungsaufsicht

BaFin

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30 Cannon Street
LONDON EC4M 6XH
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Head of
International/
Financial Markets
Department

Dr. Uwe Neumann

Contact:
Mr. Hanenberg
Q 14
Fon +49 (0)2 28 41 08-1582
Fax +49 (0)2 28 41 08-1550
poststelle@bafin.de
www.bafin.de

Official residence:
Georg-von-Boeselager-Str. 25
53117 Bonn
Germany

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

Dear Sirs,

In August 2002, the International Accounting Standards Board (IASB) issued the above-mentioned exposure draft for comments. I welcome the opportunity to respond to the exposure draft in hand. As a banking and insurance regulator, I would like to focus my statements on aspects which are primarily relevant from a supervisory perspective.

I followed with great interest the extensive discussions on certain IAS 39 rules and the dialogue of the IASB with the respective representatives of the financial industry following the roundtable meetings in March. This process reflects the efforts of all participants to take into account the existing concerns about the difficulties related to the current hedge accounting requirements, in particular regarding portfolio hedges. I understand that the current exposure draft is the result of this intensive exchange of information, which seems to be a very fruitful one.

From my point of view, the current proposal is an important step forward when it comes to developing a feasible solution regarding the hedge accounting issue on a portfolio level. Indeed, the draft has its merits, for example it allows the designation of hedged items in terms of amounts of financial assets or liabilities instead of individual assets or liabilities. Furthermore, the draft recognises explicitly the use of modern risk management procedures. Such a reference is a clear signal that appropriate risk management procedures will play a central role in the implementation of IAS/IFRS.

However, beyond my general support regarding the direction of the draft, I am adamant that a number of issues still remain. Indeed, these may impede the practical implementation of portfolio hedge accounting of interest rate risks. Within this context, several key problems have been identified regarding the proposed approach to reflect the ineffectiveness of the hedge and the proposed treatment of core deposits. These concerns will be explained in more detail by responding to the specific questions in the Exposure Draft. As a result of these concerns, I believe that the proposal regarding portfolio hedge accounting should be discussed in further detail with the financial sector, with the express purpose of finding a solution which is acceptable to all parties involved.

The following section is to be seen as a response to the questions of 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 (the repricing date is the date on which the item will be repaid or repriced to market rates). 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 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?

Answer

I agree with the proposal to designate the hedged items of assets or liabilities in a maturity time period rather than individual assets or liabilities. This would appear to be a feasible approach in terms of reconciling — to a certain extent - risk management practice which is based on the evaluation of a net risk position and IASB accounting requirements. Nevertheless, the proposal submitted does not fully reflect the current risk management practice of financial institutions.

Furthermore, I agree with the concept that any material (and not every) ineffectiveness of a hedge relationship should be measured and recognised. From this perspective, the IASB support of approach D (recognition of over- und underhedge situation) is perfectly understandable. Having said this, it is obvious that effectiveness within the meaning of the Exposure Draft is the consequence of the designation the standard allows. This means that the approaches of the draft are based on the effectiveness of the bank's expectations regarding the distribution of assets and liabilities to certain time buckets. But they did not refer on the substantial effectiveness of the hedge. The definition refers only to the adjustment of expectations deriving from the change of the customer's payment/prepayment behaviour and such adjustment is an indication of ineffectiveness. But this is a new definition compared with the current approach of IAS 39, which defines effectiveness of a hedge in the 80% to 125% range (IAS 39.149). Outside this range the hedge will not be recognised and inside this range the deviation of values of financial instruments must be recognised as ineffectiveness in the income statement. Therefore, it is questionable whether the approaches of the Exposure Draft are in line with the overall concept of IAS 39. Furthermore, it is open to discussion whether such ineffectiveness connected with a customer's prepayment behaviour should be recognised in the standard. If there is such a need, approach B or C are the most useful ones (because approach A allows - due to the large "cushion" - the recognition of ineffectiveness in rare cases only, and the recognition of the "upwards situation" in approach D is not necessary).

However, against the background of the conceptual uncertainties of the proposal put forward, the most appropriate strategy would be not to prescribe a specific method for the measurement of ineffectiveness but rather to formulate fundamental principles. For further elaboration of such a principle based approach additional discussions between Standardsetter and financial industry seems to be useful.

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?

I agree with the approach of the Exposure draft that demand/core deposits should be valued with their nominal value. However, I disagree with the conclusion of the IASB that demand/core deposits should not be included in a portfolio fair value hedge relationship. Such an inclusion must not necessarily lead to a gain in the case of the initial recognition of a demand/core deposit. For the purpose of the designation process as proposed in the Exposure Draft, assets and liabilities could be recognised at their carrying amount. Therefore, a value adjustment on inception of the hedge would not be necessary.

Furthermore, it is useful to take into account that demand/core deposits are part of the bank's ongoing risk management practice. They are usually recognised in portfolio hedging relationships according to their expected maturity. Within this context, it is important to notice that Bank's experience and statistical data indicates very clearly that a significant high amount of demand/core deposits - irrespective of the legal possibility that the counterparty can demand payment in relatively short period of time - will remain in the financial statement over a long period of time. The "empirical long duration" of demand/core deposits will often result in a situation in which deposits will have a low interest rate and such effect is recognised by risk management practices. Taking into account that the Exposure Draft refers to risk management practice, it is necessary to allow the inclusion of demand/core deposits as part of the designated amount.

Furthermore, such a treatment of deposits seems to be in line with the rules of the Exposure Draft due to the fact that they still permit the inclusion of demand/core deposits in respective time buckets according to their expected maturity. In order to remain consistent, one should allow the recognition of demand/core deposits as part of a designated amount.

<u>Other issue</u>

Within the context of the draft submitted, I would like to take the opportunity to refer again to the proposal of IAS 39 regarding the "fair value option". I would like to point out that the objections regarding this option, as expressed in my letter dated 14 October 2002, still remain. It is possible that the proposal will lead to fair value accounting for items within the banking book which, usually, are not traded on deep and liquid markets and where, therefore, no reliable fair value exists. The fair value designation renews the problems associated with an extensive application of fair values. The main problem, as mentioned during the discussion of the Exposure Draft of the Joint Working Group of Standardsetters, is that — for many financial instruments — an active or liquid market does not exist and a method of reliably measuring a fair value is not available. This means that the concerns expressed during the discussion of the Exposure Draft of the Joint Working Group of Standardsetters, i.e. whether the majority of financial instruments can be measured in a reliable and transparent manner, are still relevant. Furthermore, the problem of recognition of own creditworthiness and the reporting of increased profits in the case of an impairment of own creditworthiness will arise again.

In addition to this, I have serious concerns about the comparability of annual accounts in general if the fair value option enters IAS 39. One aspect is the creation of a new and artificial category "held for trading" not fulfilling the trading definition, which will not enhance transparency. We realise that you are trying to solve this problem under the heading "financial instruments at fair value" (IAS ED 39.18A), but this will further increase the complexity of financial information. Another, and perhaps more important aspect, is the possibility of "cherry picking". Every user of IAS 39 would be able to decide individually whether, and to what extent, financial instruments are measured at fair value or at cost. This can be used to manage the overall earnings of the company.

Yours faithfully,

Dr. Uwe Neumann