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Bundesverband deutscher Banken

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Amendments to IAS 39 Financial Instruments: Recognition and Measurement Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

Dear Sir David,

Thank you for the opportunity to comment on the exposure draft "Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk". We should like to begin by making some general remarks. These are followed by our replies to the questions.

General remarks

1. We welcome the fact that the Board has responded to the severe and broadly based criticism of the hedge accounting rules by revising the relevant provisions and publishing a new exposure draft. It is a starting point fin rectifying the major weaknesses and allowing companies to prepare financial statements which do not significantly distort their earnings.

2. Compared to the original rules on hedge accounting for interest bearing positions, the envisaged changes will go some way towards enabling a more appropriate accounting of the banks' risk management strategies. We therefore regard the draft as an important step in the right direction.

3. Nevertheless, we are critical of the fact that in some important respects the proposed changes fail to go far enough. The rules concerned continue to produce accounting

results that deviate from the economic results of the risk management strategies applied.

4. The shortcomings include the designation of the hedged positions. Although the balance of assets and liabilities from a maturity time period is to be recognised as a risk position, the designation of the net risk position will not be permitted. This runs counter to modern risk management methods. Another rule at odds with the true and fair view concept is the fact that it will not be possible to designate core deposits although the banks' risk management strategies take these positions into account with their expected maturities and hedge net liability positions. We believe it is absolutely essential on conceptual grounds to allow this designation. Otherwise, it will be impossible to avoid distortions in profit and loss, particularly in the event of net liability positions.

5. In addition, economically sound rules on hedge accounting require an adequate solution for the treatment of internal contracts. Despite their importance in hedge accounting, the draft fails to address the treatment of these contracts. It can be inferred from an IAS update, however, that they will continue not to qualify. We are highly critical of this point. In modern risk management, internal contracts are used to enhance efficiency (concentration of product know-how, better pricing and lower transaction costs) and to reduce counterparty risk. Their use has no impact on the profit and loss account, since otherwise external contracts would have to be concluded in their place, with corresponding efficiency losses. The rule whereby internal hedging transactions qualify for hedge accounting only if they are passed on to an external party on an individual basis completely undermines the advantages of these transactions. We therefore strongly advocate treating internal contracts in basically the same way as external contracts and allowing them to qualify for hedge accounting as long as the hedge relationship is documented and the conditions regarding effectiveness set out in ED IAS 39.142 are fulfilled.

6. Some of the intended improvements have not been worded sufficiently clearly. A 33, for example, deals with a key rule for implementing fair value hedge accounting and states that the calculation of changes in the fair value of a hedged item does not have to measure all the individual items involved, but may use statistical or other estimation techniques. We expressly welcome the possibility of using a simplified method. As we have learned from various accountants, however, the requirement also contained in A 33 that a simplified method must come to the same result as would be obtained from measuring all the individual assets and liabilities in the hedge gives rise to different

interpretations. These ultimately call the use of the simplified method totally into question. To avoid misunderstandings, the wording of the standard must be absolutely unequivocal.

7. The draft's illustrative examples give the impression that risk positions have to be calculated on the basis of nominal amounts. We would appreciate clarification that other methods, such as on the basis of cash flows, are also permissible.

8. We believe it is essential that entities continue to be permitted to document cash flow hedges as well as fair value hedges. Given their proximity to modern risk management strategies, we will see a preponderance of fair value hedges under revised and more workable rules. Nevertheless, economically sound hedging transactions will continue to be carried out that can only be documented as cash flow hedges. To allow the cash flow hedge to represent a real alternative to the fair value hedge, we ask you to eliminate its volatile impact on equity. This could be achieved by reporting the cash flow hedge reserve outside equity.

9. It is very important that companies already preparing IAS accounts should be able to start applying the improved fair value hedge accounting rules to their existing portfolios. The envisaged transitional arrangements require the new rules to be applied prospectively. The treatment of existing transactions is not specifically mentioned. Prospective application would mean that entities already using IAS 39 which, in the absence of viable fair value hedge accounting rules, have applied the cash flow approach up to now would have to continue the cash flow hedge until the existing transactions had matured. There is, however, no conceptual or practical justification for treating existing and new transactions separately. The management of assets and liabilities is based on controlling interest rate risk in the banking book as a whole. Contrary to the stated aims of the draft standard, the accounting treatment would be at odds with risk management practice.

Replies to the questions

Question 1: Designation and measuring effectiveness

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 of an item 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?

No, we do not agree with the proposed designation. Nor do we agree with the resulting effect on measuring ineffectiveness.

Designation

The portfolio management of interest rate risk is a dynamic process, which takes into consideration both assets and liabilities. In other words, it is the net position that risk management seeks to designate when hedging the interest rate risk as opposed to the gross designation advocated in the exposure draft. To apply fair value hedge accounting under the rules of the draft exposure, we must designate gross amounts. This focus on linking a portfolio of hedging derivatives to the gross amount of either assets or liabilities is not consistent with the hedging strategy of risk management and could lead to an "accounting" result that is vastly different from the economic intent of hedging the net risk exposure.

Furthermore, the designation of the hedged item should not be limited to the nominals of both assets and liabilities. Instead, the basis of designation should be allowed to follow the risk management techniques that are being used. An important consideration in this respect, for example, pertains to the designation of cash flows arising from the portfolio of assets and liabilities.

Measuring ineffectiveness

The alternative approaches for measuring ineffectiveness set out by the Board all have their limitations. It is therefore difficult to say which method should be selected. In consequence, and in light of the arguments outlined above under “designation”, we advocate a principles-based hedge accounting approach of measuring ineffectiveness that supports the dynamic nature of risk management on a portfolio basis and at the same time recognises the economic intent of its hedging strategy. Hedge accounting rules should therefore be streamlined and contribute to sound risk management practices by not restricting banks to a single method of measuring ineffectiveness. Instead, they should be given the opportunity of selecting the method that best fits their portfolio hedging techniques and the way they conduct their business. For example, early prepayment of a fixed rate loan is handled differently from one European country to another. In most countries, banks charge prepayment fees; in others, no prepayment fee is charged at all. Specifying one particular method as the benchmark for capturing ineffectiveness is therefore inappropriate and would have an adverse effect on the level playing field for international banks in terms of “accounting” results.

Once a method is selected, however, it must be applied consistently over time and included in the disclosure of the entity’s accounting policies.

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?

As mentioned above, the net position should be the designated hedged item. This would be in line with current risk management practices and therefore produce “accounting” results that better reflect the economic intent of risk strategies.

(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?

Yes, since all underlying items (assets and liabilities) in the portfolio would be revalued and therefore any ineffectiveness that arose would 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?***

It follows from (b) that since all underlying items would be revalued, their fair value adjustments in the balance sheet would automatically be removed from the balance sheet when they were derecognised due to maturity, prepayment, sale or impairment.

Question 2: Core deposits

Draft paragraph A 30(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 (i.e 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 ?

We are critical of the Board's intention not to allow core deposits to be designated as a hedged risk in a portfolio hedge. For German banks, these deposits are a key element of their funding strategy. Based on long experience with the underlying customer behaviour, core deposits are regarded as medium to long-term liabilities and handled accordingly in the banks' liquidity and interest rate risk management. This has a stabilising effect on the interest margin and reduces funding costs. Ignoring the role of core deposits in portfolio hedging would result in an economically unjustified volatility in profit and loss, especially for banks with substantial deposit-taking activities.

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 characterize the change in value of the hedged item?

We agree that, when core deposits are initially received, the balance sheet value must be the same as the nominal value. There can be no gain or loss recognition at this stage. This follows from the risk management approach to core deposits outlined below. Many banks currently apply models for core deposits which assume that a significant percentage of these deposits will remain at the bank's disposal over the medium to long term (deposit base). The remaining amount represents the cushion needed for short-term adjustments. On this assumption, the deposit base is invested on a medium to long-term basis and is thus subject to fair value fluctuations. The cushion, on the other hand, is regarded as a liability payable on demand which carries no fair value risk and is therefore always stated at nominal value. Since, based on the assumptions outlined above, any additionally generated amount increases the volume of the cushion only, this "new business" is also assigned a fair value identical to the nominal value.

However, this does not mean that the bank's total core deposits are not subject to market value fluctuations. We particularly disagree with the conclusions set out by the Board in BC 14 (ii) and BC 14 (d):

BC 14 (ii): Often the only observed market price, which is the best evidence of fair value, for a core deposit is the price at which demand deposits are originated between the customer and the deposit-taker — i.e. the amount payable at demand:

The Board's arguments do not reflect the treatment and measurement of core deposits in risk management. From the bank's point of view, these deposits in their entirety represent a medium to long-term position. An individual deposit is an item payable on demand only from the point of view of the depositing customer. From the bank's point of view, therefore, a demand deposit account cannot be interpreted as proof of a market price.

There are also empirical justifications for adopting a portfolio rather than an individual approach. While it is virtually impossible to predict the development of the balance of an individual account with any degree of accuracy, it is perfectly possible to make such a prediction about the balance of an average account and thus, if the total number of accounts remains relatively constant, about the aggregate balance of all accounts. This is because the random movements on individual accounts largely cancel each other out and

- assuming the total number of accounts is high enough - overall uncertainty is reduced. So while the high degree of uncertainty means it is not possible to calculate the fair value of an individual account, it is perfectly possible to determine the fair value of the total portfolio.

BC 14 (d): This is inconsistent with the Board's decision that the fair value of a core deposit is not less than the amount payable on demand, because the amount does not change with interest rates. Under the Board's view, if a core deposit whose fair value does not change with movements in interest rates is hedged by a derivative whose fair value does change with movements in interest rates, the hedge will be 100 % ineffective:

Under the risk management models recognised by banking regulators and applied by the banks in practice, changes in interest rates have a key influence on the value of core deposits. The margin from deposits varies with adjustments in market interest rates. This can be explained by the fact that the interest paid on deposit accounts adjusts more slowly than the short-term conditions on the money market. This lag is reflected in the models which are applied. The change in the economic value of a bank's core deposit portfolio as a result of the changes in interest rates is duplicated by the fair value fluctuations of the model. In order to quantify the fair value fluctuations, assumptions must be made about the maturity pattern of the core deposit portfolio. These assumptions have to satisfy banking supervisory requirements and must be validated by regular backtesting. Fledging strategies which duplicate the maturity fiction of core deposits as exactly as possible and thus help to stabilise net interest income can therefore certainly be regarded as effective hedges.

The Association of German Banks is hopeful that the ongoing discussions with the Board will lead to a viable solution.

Should you require any further information, please do not hesitate to contact us.

Yours sincerely,