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FBE COMMENTS ON THE PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS "RECOGNITION AND MEASUREMENT – FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF INTEREST RATE RISK"

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. 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 recognized 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?

FBE RESPONSE

- It needs to be reiterated, as a matter of principle, that banks, when managing interest rate risk in a banking book, intend to secure a margin, and not a portion of assets or liabilities. Banks would prefer to be allowed to designate the gross amount of assets <u>and</u> liabilities as hedged items. Therefore, they have difficulties to reason within the proposed framework and believe it to be highly artificial to implement fair value hedge accounting on the basis of a net assets and liabilities approach.

- The FBE agrees with a method according to which the hedged items would be designated in terms of amount of assets or liabilities in a maturity time period, rather than individual assets or liabilities.

- It should be borne in mind that the complexity and degree of difficulty in measuring effectiveness depends largely on how each bank has internally organized its hedging activity. This implies that there is no unique solution which would suit every bank. To enable entities to align the measurement of ineffectiveness to their risk management practices the standard should, therefore, be principles based and, more particularly, avoid prescribing into detail how ineffectiveness should be measured. Also it should be clear that the examples used in the Appendix as part of the Standard represent one of many different possible ways.

- The basic underlying principle should be that ineffectiveness would need to be recognized only when the net position in the portfolio has become over-hedged through earlier than expected prepayments for an asset sensitive time band. Adopting such an approach would be consistent with the treatment which is given in the Exposure Draft regarding revisions to the estimated repricing dates of existing positions from originating new assets (or liabilities) (see A 37). It would, moreover, be in line with the overall aim of risk management, which is not to eliminate risk but to bring the exposure within parameters that are tolerated.

- As stated in our technical meetings leading up to the Exposure Draft, we prefer Alternative C above the others. However, provided that the general view on ineffectiveness as expressed above can be upheld (i.e. only for over-hedging), we would be happy to consider proposals by the IASB to accommodate a percentage approach as indicated in Alternative D.

- It is important for European companies from outside the euro-zone to be allowed to use the fair value macro hedging proposal when they have interest rate risk positions in several currencies in their portfolios. They should be able to use cross-currency swaps when hedging interest rate risk within the proposed framework.

QUESTION 2

Draft paragraph A30 (b) proposes that all of the assets (or liabilities) from which the hedge 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? 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?

FBE RESPONSE

- The FBE fully agrees with the Board's decision that the carrying amount of a stand-alone deposit redeemable on demand cannot be less than the amount payable on demand (albeit for reasons other then those advanced by the Board).

  Core deposits collected by banks are recorded at their nominal value and no gain or loss is recognized on this event. This follows from the proposed procedure of designation according to which assets and liabilities enter into the designation at their carrying amount.

- Macro hedging strategies which banks use to manage their banking book's interest rate risk do not aim at protecting the fair value of core deposits or of any other asset or liability. Their objective is, instead, to monitor and reduce the effect of changes in interest rates on net interest income and, therefore, on banks' earnings.

  However, the exposure to movements in interest rates generated by a core deposit base needs to be hedged. It ought to be possible to achieve this within the approach to fair value hedging being proposed by the IASB.

  The FBE is prepared to accept the proposed practical compromise according to which the calculated value of assets, liabilities and off balance sheet items changes appropriately, with interest rate changes. Such a solution would be workable and acceptable only provided that the reality of banks' interest rate risk management strategies are accepted. Accounting theory should recognise that risk management strategy can only be effective when it encompasses all sources of interest rate risk arising from the full scope of banking book components, including core deposits. The key is to recognise that for core deposits the behavioural maturities differ significantly from the contractual maturities.

  If accounting theory were to ignore existing risk management policies and requirements and refuse to include such demand deposits with a view to measuring the interest rate risk gap, this would result in an erroneous view on the bank's true interest rate risk position. Risk management policies are accepted as a sound basis by banking supervisors and central bankers worldwide. As a consequence, the right thing to do from a risk management point of view may become the wrong thing from an accounting point of view. It is essential for such clashes between accounting theory and risk management policies to be avoided.

- Core deposits constitute a stable component of the liabilities of many banks in Europe. This is supported by statistical observations which demonstrate the core deposit base to be very stable over time. It is indeed a well applied banking practice to modelize deposit withdrawal behavior and to assign probabilities to various possible outcomes of the existing balances. It can be demonstrated on this basis that the existing liabilities balances will remain over a certain threshold for specific future maturities with a very high level of probability.

  It is true that each deposit, considered on an individual basis, may not be at the bank's disposal for an extended period as deposits are withdrawn regularly and replaced by new deposits. However, this is not relevant from a portfolio perspective. Demand deposits should therefore be slotted into the time-bands structure according to their assumed maturities.

  The use of expected behavioural patterns has been accepted by the IASB for assets that are subject to prepayment risk under IAS 39. It is also a key element of the approach upon which the portfolio hedging proposals have been based. Including core deposits in a portfolio hedge based on expected repayment dates would be consistent with the overall model for portfolio hedges as developed in the Exposure Draft.

The fact that deposits are withdrawn and replaced by new deposits on a regular basis does not imply that the liability being hedged would be the forecast receipt and rollover of new deposits.

- To exclude core deposits from fair value hedging strategies would mean that considerable differences would remain between accounting and risk management. Moreover, institutions with large core deposit bases could be severely impacted.

USE OF ESTIMATION TECHNIQUES

According to this paragraph a simplified method could be used only provided these statistical or estimation techniques come to *"the same result as would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item*". The wording used may be interpreted as implying that such techniques produce identical results – which would make the use of such techniques impossible. To avoid misunderstandings, the wording of the standard must be adapted and clarify that it is sufficient for such techniques to lead to a very similar result.

INTERNAL CONTRACTS

Despite the importance of internal contracts within the framework of hedge-accounting, the Exposure Draft fails to address their treatment. It can be inferred from an IASB Update, however, that they would not qualify. We strongly criticise this point. In modern risk management, internal transactions 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. A rule whereby internal hedging transactions would qualify for hedge accounting only if they are passed on to an external party on an individual basis completely undermines the advantages referred to above. 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. IAS 39 should restrict itself to an in principle statement that internal transactions must not generate gains or losses and should not include any further comment that may be interpreted as imposing additional, specific rules.

TRANSITION RULES

Entities which already prepare IAS accounts should be able to apply the new 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 have 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.

Therefore, entities already using IAS should be able to adopt the new rule on a retrospective basis.

OTHER SIGNIFICANT ISSUES

The IASB has been informed that the FBE has other major concerns with the existing standard (See our paper entitled "Other significant problems arising from IAS 32 and 39" which has been forwarded to Sir David Tweedie on 4 April 2003). These major concerns include the following issues:

- IAS 32 disclosures (changes in accounting policy)
- Other disclosure issues
- Scope (exclusion of insurance investment products)
- Financial guarantees
- Loan commitments
- Effective interest rate calculations
- Transactions costs Purchased loans
- Initial measurement of financial instruments
- Fair value hierarchy
- Impairment
- Internal contracts
- Derecognition
- Repurchase or induced early conversion of convertible debt
- Puttable instruments
- First-time adoption, including transition rules for entities that already apply IFRS
- Fair value option
- Debt/equity issues
- Offset
- Cash instruments as hedges of interest rate risk.
- Loan servicing rights

The FBE concludes from the Board's preliminary decisions on these issues that some progress would seem to have been made.

Because of the fundamental nature of the proposed changes and their potential impact, the FBE believes that the IASB should publish its proposed changes to IAS 32 and IAS 39 and provide the public with an opportunity to comment upon them, albeit within a short time-frame.