BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

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Basel Committee Comments on the IASB Exposure Draft of Proposed "Amendments to IAS 39, Financial Instruments: Recognition and Measurement – Fair Value Hedge for a Portfolio Hedge of Interest Rate Risk"

Introduction

For over a decade, the Basel Committee on Banking Supervision[1] (Committee) has been issuing extensive guidance and policy papers on risk management activities of banks. These releases have included guidance and research studies on sound practices for managing credit risk, market risk (including interest rate and foreign exchange risk) and other banking risks arising from trading and derivatives activities. In addition, in its work on the New Basel Capital Accord, the Committee is developing new rules and proposals for comprehensively relating capital adequacy to bank risk profiles. All of these efforts have involved extensive consultation with global banks and others, and have been designed to promote the adoption of sound risk management by banks around the world. In reviewing the proposal to amend IAS 39 to allow for portfolio hedges of interest rate risk using the fair value hedge accounting approach, the Committee has drawn upon its expertise in these areas.

In addition, the Committee has long held that the transparency of banks – facilitated by sound accounting and disclosure – is a very important objective, and this has been the topic of a number of the Committee's policy papers, surveys and supervisory guidance documents in support of this objective. Most notably, the enhanced capital framework that the Committee has proposed recognises the important role of transparency in effecting market discipline as a complement to effective banking supervision. In addition, since 1998 the Committee has been actively involved in important projects, with the IASB and its predecessor, to enhance financial instruments accounting and disclosure. In all of these efforts, the Committee has been actively seeking to improve the overall quality of financial reporting in ways that will enhance transparency and market discipline, and facilitate financial stability. Thus, the Committee has brought these perspectives to bear in reviewing the June 2002 exposure draft as well as the current proposal for portfolio hedging of interest rate risk using the fair value hedge accounting approach.

[1] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

This note presents our comments in two sections. The first section provides our main comments on the proposal. The second section provides summary answers to the specific questions raised by the IASB in the exposure draft. The answers in this second section should be read in the context of our overall comments in the first section.

Section 1 – Main Comments

In its previous comments to the IASB, the Committee has noted that hedge accounting remains one of the most challenging issues related to financial instrument accounting. On the one hand, it is not desirable to have standards that are so flexible that they open the door for companies to manipulate their reported financial results. On the other hand, it is similarly undesirable to have rules that are so complex that they stifle sound risk management. An approach to hedge accounting that strikes a better balance in terms of complexity and ease of application would be a welcome improvement to the current standards.

The Committee has also emphasised for many years that banks should manage their risk exposures on a comprehensive basis. The Committee has expressed concern in prior comment letters that burdensome rules for designation of derivatives as hedges of individual assets or liabilities or specific transactions and overly stringent requirements for correlation may deter banking organisations from undertaking prudent actions to manage risk exposures. In addition, it is well known that banks and other large companies seek to hedge net risk exposures, i.e. the remaining exposure when certain risks inherent in a group of assets are substantially offset naturally by the same risks embedded in a group of liabilities. In this regard, the Committee has been actively involved with the IASB and its predecessor in supporting efforts to develop hedge accounting approaches that support risk management on a portfolio basis in ways that are consistent with the intent of IAS 39. For example, these efforts resulted in IAS 39 Implementation Guidance (eg 121-1 and 121-2) that outlined how many of the interest rate risk management activities of financial institutions could qualify for hedge accounting treatment under IAS 39 using the cash flow hedge accounting approach. We believe that many aspects of the IASB's proposal in this exposure draft address our concerns by permitting more portfolio-based accounting approaches to better hedge interest rate risk exposures.

The Committee also notes that the proposal benefited from the IASB's extensive dialogue earlier this year with bank experts on risk management and derivatives accounting, and other experts. This process of dialogue led to a better understanding by the IASB of the banks' approaches to monitoring and managing risk and to a better understanding by banks of the IASB's objectives with respect to transparency and guidance on hedge accounting matters. We commend the IASB's efforts to involve banks and other interested parties in exploring issues and potential solutions as it seeks to enhance its accounting standards.

There are a number of other aspects of the proposal that we view as beneficial. In particular, the proposal would permit:

- The designation of hedged items in terms of amounts of financial assets or liabilities instead of individual assets or liabilities;
- Many types of derivatives, or portions thereof, to be viewed in combination and jointly designated as the hedging instrument when certain criteria are met;
- Greater recognition of risk management systems as providing sound inputs in the application of accounting approaches (eg scheduling on the basis of expected repayment dates); and

- Changes in the fair value of hedged items to be reported separately on the balance sheet instead of in the respective balance sheet captions for the hedged assets or liabilities.

As previously noted, the proposal has aspects that build upon the portfolio-based cash flow hedge accounting approach set forth in the IAS 39 implementation guidance (eg 121-1 and 121-2). Since the current proposal focuses solely on the use of the fair value hedge accounting approach, we recommend that the final IAS 39 standard include language that incorporates the above mentioned implementation guidance into the IAS 39 standard itself. We note that the possibility to choose between fair value hedge accounting and cash flow hedge accounting may create comparability problems. We recommend that further consideration should be given to the desirability of having a single accounting approach for hedging all assets and liabilities – including, in particular, demand deposit liabilities -- in order to promote comparability and in view of possible scope for manipulation under the current proposals.

A comment in the IASB's June Update concerning the proposed portfolio hedging indicates that the assets and liabilities contained in each maturity period should be reasonably homogenous with respect to the hedged risk, so that the fair value of each item will move by about the same proportionate amount. However, this notion has not been incorporated in the exposure draft. It would appear appropriate for this notion to be included in the final standard.

The proposal would allow for separate presentation of the value adjustments for the hedged items. We believe that it could be also useful to present or summarise the value adjustments in the same manner for "traditional" types of fair value hedges, perhaps in separate items in major financial instrument categories that are being hedged (eg loans, long term liabilities), as proposed in the ED for the macro-hedging. This approach would improve the comparability of the financial statements of banks and other companies, since the assets and liabilities would generally continue to be reported at amortised cost (eg with the exception of those instruments that are carried at fair value) but the valuation adjustments would show the effect of hedging. Reporting in this manner would make the impact of the hedging activities more transparent in the balance sheet. This could also be handled through enhanced disclosure.

We recommend, as a final general comment, that the IASB review the other IAS 39 paragraphs that apply to hedge accounting to determine whether the guidance fully applies to portfolio hedge accounting approaches or whether adjustments to the wording may be appropriate (eg paragraphs 142, 146 and 157).

Section 2 – Comments on Specific Questions in the Exposure Draft

Question 1 -- The measurement of ineffectiveness

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?

Our Response

While we lean toward approach C (whereby an entity hedges only a portion of the risk associated with the designated hedged amount), we see the merits and drawbacks in the arguments presented for all of the approaches in paragraph BC19. However, we believe these arguments need to be further explored. For example, the hedge accounting framework currently reflected in IAS 39 and in its June 2002 Exposure Draft reflects a number of issues which should be further considered in designing IAS 39's final guidance in the area of hedges of the risk of portfolios. These include the following:

- IAS 39 has long permitted companies to hedge the full risk or a portion of the risk as designated by management and to calculate the adjustments to the hedged items in a manner consistent with this principle. From this perspective, bank interest rate risk hedging approaches that focus on hedging a portfolio's net interest rate risk without including the impact of prepayments – when this is the companies' documented risk management strategy – would seem entirely consistent with the guidance in IAS 39. Further consideration of this could lead to an approach that does not penalise such targeted interest rate risk hedging strategies when they are effective in achieving the risk management strategy. The Basel Committee provided background and guidance for banks and supervisors in its recent consultative document "Sound Principles for the Management of Interest Rate Risk" (September 2003). While this supervisory guidance did not focus on hedging strategies, it recognised that interest rate risk in its entirety can arise from many different sources of risk, including repricing, yield curve, basis, and prepayment and other optionality risks. This proposed guidance indicates that the Committee expects banks to measure, monitor, and manage all of the sources of interest rate risk using sound approaches.
- While the Committee concurs with the underlying principle in IAS 39 that all material ineffectiveness within the hedge relationship should be identified and recognised in profit or loss, we note that IAS 39 does not define fully what the ineffectiveness is. We are not convinced that an approach that measures the ineffectiveness symmetrically, both in the case of an under-hedge and in the case of an over-hedge, is superior to an approach that measures ineffectiveness only in the case of an over-hedge, as there is no clear conceptual basis for measuring the effectiveness of a portfolio hedge of interest rate risk in a symmetrical manner. One could argue that

as long as the hedging derivative does not exceed the net position identified for risk management purposes, there is no need to recognise any ineffectiveness. From this point of view, the effectiveness of the hedge depends on the interest rate risk exposure identified within the time buckets and the extent to which this risk is hedged by a derivative. Thus, from this perspective ineffectiveness would be reflected automatically in the financial statements when over-hedging occurs because of the value adjustments of the item being hedged – the net exposure per time bucket (or portion of the gross assets or liabilities using the IASB terminology) – would be smaller than the recognised value adjustment of the hedging derivative.

- The IASB expressed concern about the possible need to require an arbitrary limit with respect to a minimum hedge ratio if approach C is reflected in the final IAS 39 guidance. However, the Committee notes that the IASB has already chosen to implement arbitrary limits in certain other aspects of its hedge accounting guidance (eg the 80-125 percent effectiveness rule in paragraph 142 of IAS 39). While we respect the IASB's desire to avoid unnecessary arbitrary rules, it is possible that reasonable approaches could be developed that would ensure that hedging activities pursuant to sound risk management policies can take place but at the same time ensure that hedge accounting is not subject to abuse.

Having considered the merits and drawbacks of each of the four approaches set forth in the exposure draft, the Committee has a leaning towards approach C, particularly because it is consistent with the notion of a partial hedge and with the notion already in IAS 39 that ineffectiveness should not arise from the unhedged risk exposure. However, we would urge the Board to continue to work closely with the various interested parties as it examines the issues we noted above to ensure that the accounting model leads to the most meaningful financial information. We understand that the proposal will create a number of challenges for preparers and their auditors. In particular, the reliable estimation of the value of each maturity time band will create some practical challenges. It is important that the approach required by the IASB is neutral and does not create incentives for banks or other entities to either overstate or understate the value of any particular time band.

Question 2 – Demand deposits

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 (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 characterise the change in value of the hedged item?

Our response

The Committee concurs with the IASB's decision, which confirms the existing requirement of IAS 32, that a demand or core deposit should not be valued in the financial statements at less than the amount payable on demand. However, the Committee also recognises that historical evidence clearly suggests that demand deposits of banks usually have actual lives that extend far beyond the shortest period in which the depositor can demand payment and that sound bank risk management systems are designed to reflect this historical evidence.

Part of the problem that the IASB is facing here is that the IAS 39 hedge accounting approaches are not fully consistent with the overall objective of most banks with respect to hedges of key banking book activities (ie, hedges not associated with trading activities), that is, to hedge their net interest margins over time. In order to comprehensively hedge their interest rate risk using IAS 39 approaches, banks must categorise their hedging activities as hedges of fair value or of cash flows and divide their underlying financial assets and liabilities into portfolios permitted under these two hedge accounting approaches (eg portfolios of fixed or floating rate assets or liabilities). Thus, in adopting IAS 39 for accounting purposes, bank risk management systems that seek to comprehensively manage interest rate risk will have to consider both the fair value hedges of fixed-rate financial assets and liabilities as well as cash flow hedges of variable-rate financial assets and liabilities. This leads some banks and other companies to see whether there is one hedge accounting method that can accomplish most of their risk management objectives, hence leading to much of the debate with respect to the current proposal and the demand deposit issue.

While we support the prohibition on valuing demand deposits at less than their face value, the Committee does not view the inclusion of deposits in the portfolio-based fair value hedge accounting framework as necessarily leading to the initial recognition of a gain on demand deposits for two main reasons. First, the demand deposits would be recognised at their historic cost at inception and the fair value hedge accounting framework would then focus on the change in their fair value with respect to the hedged risk from period to period and the corresponding change in the fair value of the derivative hedging instrument(s). Second, the proposed approach would then measure the change in the fair value with respect to the hedged risk from month to month for the hedged items and hedging instruments which would usually be a much smaller amount than the difference between the fair value of the deposit (considering their expected lives) and their historic cost at inception.

We believe that the IASB should further consider whether it is possible to design its final IAS 39 guidance on portfolio-based hedges of interest rate risk to explicitly prohibit the recognition of an initial gain on demand deposits. The prohibition on valuing demand deposits at less then their face value makes it difficult to fully hedge the interest rate risk associated with demand deposits using the fair value hedge accounting approach. Banks can however schedule the amount of demand deposits into the various time categories in accordance with their historic cost but also their expected payment dates as a means of determining the net interest rate risk exposure to be hedged using the fair value hedge accounting approach. At the same time, when this analysis determines that the bank is liability sensitive with respect to a particular time category, and the net risk exposure cannot be attributed to non-demand deposit liabilities, the guidance could point out that the bank could hedge that time category using the cash flow hedge accounting approach. Illustrations and other guidance in the final IAS 39 standard that would show how banks' risk management strategies can be achieved by more fully considering the combined effects of fair value and cash flow hedge accounting approaches for portfolio risk exposures, for example, in hedging net interest margins, may be beneficial in addressing many risk management concerns, including those with respect to the treatment of demand deposits.

However, we recommend that the IASB give further consideration to the desirability of having a single accounting approach to hedging all assets and liabilities – including, in particular, for the hedging of demand deposits -- and undertake further work in this area. The current proposals may provide scope for manipulation of the amounts in the various time categories in order to achieve the desired form of hedge accounting. A single approach would be easier to apply in practice and promote more comparable accounting by deposit-takers holding different levels of core deposits in relation to their total fixed rate liabilities.