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An association of Australia's senior Finance Executives
from the nation's business enterprises

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GROUP OF 100

24 November 2003

Ms Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
LONDON EC4M, 6XH
UNITED KINGDOM

Dear Ms Thompson

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

The Group of 100 is pleased to respond to the Invitation to Comment and acknowledges the response of the IASB to the concerns expressed about the impact of the hedging requirements in IAS 39 on certain classes of constituents. While broadly supporting the proposed approach to portfolio hedging as an important step in recognising the way in which entities conduct their businesses and manage risk exposures the Group of 100 believes that the IASB proposals are too narrow in that they focus only on the activities of financial institutions. Other groups of preparers, for example, those engaged in the extractive industries, also undertake what they believe to be portfolio hedges in managing their risk exposures. The proposals do not specify why special rules are proposed for portfolio hedges of interest rate risk and not for portfolio hedging of other types of risk. The Group of 100 believes that in a principle-based standards regime, the application of the principles identified should not be restricted to a particular type of transaction.

Our responses to the questions are attached.

Yours sincerely

John V Stanhope
National President

c.c. Mr D Boymal, AASB

GROUP OF 100 RESPONSES TO QUESTIONS

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 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?*

The G100 supports the approach to the designation of hedged items in terms of the amount/volume of assets or liabilities as a reflection of the way in which many entities, including those in the extractive industries, undertake hedging activities. The approach is also administratively efficient as the task of designation and ongoing monitoring and assessment is simplified.

The G100 supports the views expressed by the Australian Bankers' Association, in its submission of 14 November 2003, in respect of the preference for adoption of Approach A for the reasons set out in BC 20. In addition:

- **it more closely reflects the way in which economic risk is assessed and managed. As not all balance sheet fixed rate exposures are necessarily hedged faster prepayment should not automatically lead to hedge ineffectiveness. This does not occur under Approach A;**

- **it is consistent with the principles underlying cash flow hedging;**

- **adoption of Approach D will not necessarily result in recognition of the fair value of the over-under hedging in the current period. The profit and loss impact under (d) will depend on the hedge ratios at different parts of the 'gap' position and will introduce randomness in hedge effectiveness calculations that is inconsistent with the objectives for measuring and reporting effectiveness under IAS 39;**

- **it is difficult in practice to measure the expected rate of prepayments reliably. Prepayments may vary markedly in response to interest rate movements and other changes but typically revert to a long-run average over time. Marking to market in these circumstances if short-term fluctuations introduce unnecessary volatility to the profit and loss account which does not occur under Approach A.**

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?

   In 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?

   The G100 considers that demand (core) deposits are capable of fair value hedging. Entities exposed to interest rate risk and having products that, in substance, at least for a significant proportion of the amount, exhibit the characteristics of a fixed rate instrument may be significantly disadvantaged if they are unable to apply fair value hedge accounting.

Core deposits are a significant fixture of the Australian banking system. The inability to apply fair value hedging in respect of core deposits is likely to result in the use of cash flow hedging for core deposits. This will lead to the duplication of systems where these entities use portfolio hedging in respect of other activities, increases in transaction costs and potentially to changes in product design and pricing and funding arrangements.

Comments

a. **The G100 considers that the fair value of a core deposit can be less than the amount payable on demand. On a going concern basis the possibility that all depositors will withdraw all of their funds at the one time is remote. For these deposits the interest rate exposure is driven more from the fact that the maturity date is not known rather than being at call. From the point of view of a bank on a going concern basis the fair value of such deposits is determined as the present value of all the expected future income and expenses including movements in the interest rate margin and the cost of funds/reinvestment rate. To acknowledge that the fair value of core deposits may be less than the face value is a better reflection of the economic substance of the bank's arrangements than assuming the face amount should not be revalued.**

b. **The initial recognition of core deposits would be at their cost/fair value, which is the face value of the deposit funds accepted. Changes in the fair value would occur as a result of changes in market interest rates subsequent to the initial deposit.**