

November 14, 2003

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

Re: *ED Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive amendments to IAS 39 on the issues.

EFRAG appreciates the Board's efforts made in exploring whether and how IAS 39 can be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk and strongly encourages the IASB to issue amendments of IAS 39 in that respect. However, as explained in detail in appendix 1 of this letter, we question whether the proposals in the draft's paragraph A30(b) go far enough in acknowledging the (essential) difference between a portfolio approach versus an individual item approach. This becomes particularly important in those cases where entities have a net risk position of core deposits.

We believe that entities are hedging only interest rate risk, and are not hedging, but managing, prepayment risk. Since IAS 39 allows an entity to hedge an amount that is less than the amount of the net risk position, we consider approach C to be the preferred way of designating the hedged item. However, we consider there are also valid conceptual and practical arguments for method D (percentage approach) when prepayment is not being hedged. Therefore, we encourage the Board to perform further research on how method D can be applied without recognising ineffectiveness in the case of under hedging.

Appendix 1 sets out our answers to the questions raised in the draft standard.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman
EFRAG, Chairman

Q1. Hedge designation and the resulting effect on measuring 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?*

Response

Whilst we agree with the Board's proposal to designate the hedged item in terms of an amount of assets or liabilities in a maturity time period, rather than as individual assets or liabilities, we do not agree with the Board's proposed approach to the designation of the hedged item and the measurement of ineffectiveness.

As explained in more detail below, we believe that:

- entities are hedging only interest rate risk, and are not hedging, but managing, prepayment risk;
- IAS 39 allows an entity to hedge an amount that is less than the amount of the net risk position.

Based on these understandings, we consider Approach C to be the preferred way of designating the hedged item.

We further believe that – in the case of a partial hedge – prepayment does not lead to ineffectiveness as long as the amount prepaid does not exceed the amount that was initially unhedged. In the case of less than expected prepayments, we believe that a revision of repricing dates does not lead to

ineffectiveness because entities are not hedging interest rate risk after the expected repricing date.

Our position appears to be in line with the alternative view of the five dissenting Board members set out in AV2, which is that the approach to evaluate effectiveness should lead to the recognition of ineffectiveness only when the net position in the portfolio has become over-hedged. Set out below are the principal arguments that support EFRAG's view:

How should the hedged item be designated?

While the designation of the net risk position (instead of an amount of assets/liabilities) as the hedged item could be considered more consistent with the underlying risk management, we accept the Board's proposal to designate the hedged item in terms of an amount of assets or liabilities in a maturity time period. Such an approach is, within the currently existing hedge accounting models, an improvement of the present requirement to designate individual assets or liabilities.

In our view, the four alternative forms of designation described in BC19 represent only two basic approaches:

- i. designation of a layer of assets (or liabilities), and
- ii. designation of a percentage of assets (or liabilities).

The process of portfolio hedging requires certain steps to be followed, as described in A26. The example in A30 uses a portfolio of fixed rate assets of CU100 and fixed rate liabilities of CU80 within one particular maturity time period (steps A26(a) and (b)). The analysis (step A26(c)) leads to a net risk position of CU20, taking into account the "natural offset" of risk from CU80 fixed rate liabilities.

The next part of step A26(c) is the decision whether to hedge fully the risk of CU20 or whether to hedge partially the risk (i.e. an amount of less than CU20).

From a conceptual point of view, the difference between the two basic approaches (layer versus percentage) is based on the view whether an entity hedges prepayment risk or not.

Is prepayment risk being hedged in a portfolio hedge of interest rate risk ?

Answering this question answers the question whether a revision of repricing to dates later than previously expected impacts effectiveness.

We believe that the problem of later than expected prepayments is not a question of 'layers' and their designation, but of additional amounts of assets to be hedged in future periods that have not been considered for hedging so far. When entities use expected repricing dates, we believe that they hedge only the fair value of the assets that relate to the interest rate risk up to the chosen date (partial term fair value hedge). Within the periods up to that date, prepayment is highly unlikely and does not need to be considered.

We believe that the Board's conclusion that "many entities do not consider these two effects separately" (BC8/21(e)) may not be the right interpretation. Instead, we believe that the described risk management

strategy actually does exactly that: it separates the interest rate risk from the prepayment risk by applying a partial-term hedge strategy during the time when no prepayment is expected. The possibility that the asset may remain longer on the books than the designated period is disregarded and not hedged. In so doing, the entity effectively carves out the prepayment risk for the time periods after the expected date. This method designates only the portion of fair value that relates to the interest rate risk for the time up to the expected repricing date, which is permitted under IAS 39 (see paragraph 128).

Revisions of repricing dates to a date later than initially expected extends the time periods for which hedging may be required in future periods because they were not covered by the initial hedge. Such revision would create new assets in future periods to be analysed within the then increased risk position. However, they do not change retroactively the initially hedged position but should be considered as new assets as described in A37, sentence 1. It is important to note that new assets do not only arrive from origination, but also from including more assets than previously estimated for their remaining period until expected repricing date. In other words, prepayment risk is not hedged in the meaning of IAS 39, but is being managed by frequent reassessment of the expected prepayment dates and adjustment of the hedging instruments to match the changed assessment of prepayment dates.

Since there is no requirement in IAS 39 to be able to measure the portion that is **not** hedged, we believe that the BC21(e) argument that it is extremely difficult to measure interest rate risk and prepayment risk separately, should not preclude hedge accounting for interest rate risk hedges only.

We consider there are also valid conceptual and practical arguments for method D (percentage approach) when prepayment risk is not being hedged. Therefore, we encourage the Board to perform further research on how method D can be applied without recognising ineffectiveness in the case of under hedging.

Which layer approach do we prefer?

Within the layer approaches A – C, the question arises as to how to determine the impact on ineffectiveness of earlier than expected prepayment of some assets.

In example A30, the decision is to hedge fully the net risk position. Consequently, the entity designates assets of an amount of CU20. It appears to be a logical answer that, in case of a full hedge of the net risk position, any amount of earlier prepayment leads to ineffectiveness to the extent of the prepaid amount.

Approach A refers to the designation of CU20 as a 'bottom' layer of assets. It then assumes that any prepayment would be related first to the "unhedged portion of CU80". We do not agree with this approach because, in our view, there is no unhedged portion. The assets of CU80 are (naturally) hedged by the CU80 of fixed rate liabilities, as described in the example.

In our opinion, the layer (designated amount) of assets has to be related to

the net risk position that has determined the amount to be hedged by derivatives, instead of to the total amount of assets. Only such an approach would be consistent with the hedging process required by the risk management strategy, and as described in A27(a) – (c). Therefore, if the net risk position is fully hedged; i.e. the whole of the excess of assets has been hedged, any prepayment earlier than expected will lead to ineffectiveness of the hedge.

In effect, this is the result of Approach B which – without mentioning the term – correctly relates the hedged amount to the initial risk position to be hedged.

Does ineffectiveness occur in the case of a partial hedge?

As described above, step A26(c) requires an entity to make a decision about the amount that it wishes to hedge. If the hedged amount is less than the amount of the net risk position (for example, CU16 instead of CU20, as illustrated by the Board under approach C), the hedge is referred to as a partial hedge. In the Board's example of Approach C, there is an unhedged layer of CU4. We would call the CU16 the "derivative hedged layer".

As explained by the Board in BC19, Approach C is based on the same layer approach as Approach B, with the difference of being a partial hedge instead of a full hedge. In fact, Approach C encompasses Approach B. Under a "derivative-hedged layer" approach – following the risk management strategy as described by the given example – prepayments would be assumed to reduce first the unhedged layer of assets, that is, those assets that are neither hedged by derivatives nor by liabilities. As soon as prepayments exceed the unhedged amount of CU4, they would reduce the "derivative-hedged layer of assets" of CU16, and thereby cause ineffectiveness.

We support fully the arguments set out in BC20 and BC26, on the grounds that they are consistent with the described risk management strategy.

We do not believe that there is a need for an "arbitrary rule" to prevent a "cushion" becoming too large. Instead, we believe that, in view of the requirement of consistency with the documented risk management strategy to qualify for hedge accounting, draft IAS 39.142 (a) & (b) does not permit interpretations such as those used in BC23 – sentence 4. Referring to the example in BC23, we believe that it would not be compliant with the amended standard to hedge an amount larger than the net risk position. The maximum of an unhedged amount could be CU20, which would mean that no derivative is being used.

In our view, it is compatible with the current philosophy of IAS 39 that unhedged amounts should not to be related to derivatives that are designated to hedged amounts. Therefore, only prepayments beyond unhedged amounts can lead to ineffectiveness.

With regard to question 1(c), we agree with the Board's view as expressed in paragraph 154 that amounts included in the separate balance sheet line items shall be removed from the balance sheet date when the assets or liabilities to which they relate are derecognised. As far as the accounting for these items in subsequent periods is concerned, we recommend the Board to clarify how the requirements of paragraph 157 (amortisation of the fair value adjustment) shall be applied.

Q2. The treatment of core 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?

Response

While we recognise the progress made in the Board's proposals addressing existing concerns about portfolio hedging, we question whether the proposals in the draft's paragraph A30(b) go far enough in acknowledging the (essential) difference between a portfolio approach versus an individual item approach. This becomes particularly important in those cases where entities have a net risk position of core deposits, as further explained in detail below.

The benefit of a portfolio approach is that individual movements are not necessarily as important as under an item-by-item approach, because hedging risk can be successful as long as there are sufficient amounts to cover the impact of the hedge. In particular, it is not necessary to forecast the specific development of an individual item as long as there are sufficient amounts available within the portfolio. In fact, this is the precise logic that the Board applied in developing its basis for the portfolio approach to cash flow hedges. Therefore, we are concerned that the Board's arguments presented in support of the proposal set out in this draft run counter to the reason and justification for the adoption of any form of portfolio approach.

Certain financial institutions (such as savings banks in Europe) have a financing structure of stable, long-term low cost funds. Economic reality is that a layer of such liabilities is at the disposal of the entity, and the market value of that layer changes according to the movements in interest rates. Indeed, when interest rates go up, the value of a low carrying interest rate account will increase for the financial institution. This value component is economically linked with the core

deposits and underlies the commercial substance of the bank's business. We, therefore, can see good reason to recognise the economic value on the hedged position within a portfolio hedge of interest rate risk.

On the issue of the fair value of core deposits, we understand some of the reasoning behind the Board's view that the carrying amount of a core deposit redeemable on demand cannot be less than the amount payable on demand. However, we do not find all of the BC14 arguments convincing and have summarised our reservations as follows:

- BC14(a) *The deposits included in the balance sheet are unlikely to be outstanding for an extended period (e.g. several years).*

We strongly disagree with the Board's understanding that core deposits are unusually expected to be withdrawn within a short time (e.g. a few months or less). For instance, in certain countries specific savings products exist for children. While their outstanding balances are redeemable on demand, the normal pattern is that their outstanding balance will grow over the period of adolescence. As a result, the balances do remain outstanding for several years.

- BC14(b) *A portfolio of core deposits is similar to a portfolio of trade receivables*

The Board argues that similar to trade payables, core deposits are usually expected to be paid within a short time. As indicated in our comment to point (a) above, we believe this is not the case for all core deposits.

- BC14(c) and (d) *Measurement issues*

We do not believe that the amount agreed between the customer and the deposit taker is the relevant market price in the case of a fair value hedge accounting for a portfolio hedge of interest rate risk. We consider it to be the nominal amount of a financial contract at its origination and settlement rather than the selling price of an existing financial instrument. Selling would require a third party to be involved being different from the two parties to the initial contract.

We agree that a market price for a portfolio of demand deposits can only arise between two licensed deposit takers. However, it is undisputed that such sales occur at prices different to the nominal amounts of the obligations transferred. The fact that such prices may include other elements – as mentioned under BC14 (c) (iii) – does not exclude the possibility (some believe the reality) that this also includes payment for the consideration of expected demand dates.

- *EFrag's alternative proposal: a pragmatic solution to ensure consistent accounting*

We do not propose that core deposits should be accounted for at fair value. Instead, we recognise that hedging the risk involved with core deposits is possible under the provisions of the draft in the form of cash flow hedge accounting. Part of the progress made in the discussions so far is that core deposits can be part of the portfolio that determines the amount to be hedged as part of the "natural offset".

However, the issue of fair valuing core deposits arises because the Board is attempting to fit the described hedging activity within the current cash flow/fair value hedging classifications of the standard to accommodate the rule of measuring all derivatives at fair value. There are legitimate arguments to support the view that there is sufficient change in the economic value of the deposits that is related to the value change in the hedging derivatives that ought to be recognised.

Under our alternative proposal, there should not be an immediate gain or loss on initial recognition when core deposits are included in fair value hedges because the changes in fair value to be recognised should be limited to the corresponding changes in fair value of the hedging instrument. The inclusion of core deposits in the hedge portfolio with their expected repricing dates should not affect the recognised amount (at their nominal value) in the balance sheet. Instead, we propose that, as an exception, a “valuation adjustment” on core deposits would be recognised. It should be noted that the subsequent changes in value due to changes of the respective yield curve do not correspond with the difference in value between a short term demand deposit of for instance one week and a five year deposit, which could be a substantial amount. They represent only the changes in value between the current and previous measurement date (e.g. one month ago) of for instance a five year deposit. Therefore, the fair value of the hedged core deposits should be determined at inception of the hedge as a memorandum item only. Any subsequent value change recognised should correspond with the change in fair value of the hedging instrument for that time period. As a result, both would be balanced off against each other in the income statement.

In conclusion, therefore, EFRAG believes that the outcome of the draft's proposal on one consistent single hedging activity – as it stands – remains unsatisfactory because investors will find volatility in equity for some “time periods” whilst offsetting gains and losses through profit and loss – for other “time periods”. This outcome puts entities that have access to long-term, stable low cost funding at a competitive disadvantage over institutions that are required to fund themselves – at least in part – at a more volatile, higher cost level. A pragmatic solution to this problem could be the acceptance by the Board of a net position of core deposits for portfolio hedging by way of exception in order to meet the need for a consistent accounting solution.

Other comments

1. Interaction with requirements of paragraphs 142 and 146 (prospective and retrospective hedge effectiveness)

We invite the Board to clarify how the prospective and retrospective effectiveness tests shall be applied when an entity adopts portfolio hedging.

2. Transitional provisions

Some entities that are currently adopting cash flow hedge accounting for portfolios will want to redesignate these hedges as fair value hedges under the revised IAS 39. It would be helpful if transitional provisions on this issue could be included in the standard to avoid inconsistent accounting.