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International Accounting Standards Board  
30 Cannon Street  
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Attention: Ms Sandra Thompson, Senior Project Manager

Dear Sirs,

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

I am writing to respond to your invitation to comment on the above exposure draft in my personal capacity. The views provided in this letter are a result of intensive discussions with colleagues in the banking industry and accounting profession. Therefore I have generally used the word "we" in place of "I" in this letter. I should however state that any inaccuracies and errors remain my responsibility. The comments herein also do not necessarily reflect those held by the firm in which I am a partner or the professional bodies of which I am a member.

Throughout this letter we would use "\$" in place of "CU" as written in this way the amounts stand out more neatly from the text and for no other reason. Any other currency sign could have been used.

We set out below our response to the specific questions raised in the Exposure Draft ("ED").

**Q1                    Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness?**

We would use the same example given in the ED whereby we have fixed-rate assets of \$100 and fixed-rate liabilities of \$80 in a particular repricing time band, together with a risk management action to hedge the net position with an IRS of a notional principal of \$20 to pay a fixed rate against LIBOR. The ED has proposed that in this case an asset amount of \$20 be designated as the hedged item and the change in fair value of the hedged item attributable to the change in interest rate be designated as the risk being hedged.

From our discussions with senior executives responsible for managing interest rate risk at large banks, designating the asset amount of \$20 out of the total assets of \$100 as the hedged item is not consistent with normal risk management concept and practice. This method of hedged item designation also leads to the various difficult issues for measuring ineffectiveness.

Hence we do **not** agree with the proposed method of designation. Our alternative designation method and our comments on the resulting effect on measuring ineffectiveness are provided below in our response to Q1(a).

**Q1(a) In your view how should the hedged item be designated and why?**

We would use the same example above to illustrate an alternative way of designation. When we have fixed-rate assets of \$100 and fixed-rate liabilities of \$80 in the same time band, the most **basic and direct** way of hedging is to undertake \$100 IRS-pay fixed and \$80 IRS-receive fixed. In practice, to minimise transaction cost, the bank would do \$20 IRS-pay fixed instead.

We propose that the IRS of \$20 be, upon inception, "grossed up" to a \$100 IRS-pay fixed rate and a \$80 IRS-receive fixed. This is easily achieved in the accounting system by raising an equal and opposite IRS of \$20 to offset against the external IRS and setting up two interest rate swaps of \$100 (pay fixed) and \$80 (receive fixed) as the hedging instruments. These two interest rate swaps, although giving an appearance of internal deals, are in fact an external deal being divided into two deals for capturing in the accounting system.

We next designate an amount of \$100 in assets and an amount of \$80 in liabilities as the hedged items, which in this case means full hedging of all fair value exposures within this repricing time band.

We will now use this method of designation to test the validity of the four approaches considered by the Board in dealing with hedge ineffectiveness.

Under **approach A**, any reduction in assets is assumed to come from the unhedged portion of \$80. This is not consistent with how the risk manager has hedged the exposure. With the IRS of \$20, he has fully hedged both the fixed-rate assets of \$100 and the fixed-rate liabilities of \$80. Hence any change in assets or liabilities in the

repricing time band will immediately lead to hedge ineffectiveness. There is no room for an unhedged component, either within assets or liabilities, contrary to the notion under approach A that no ineffectiveness arises so long as at least \$20 of assets remain in this repricing time band. We note the Board has also rejected approach A, but for a number of different reasons.

Under **approach B**, any reduction in assets is assumed to come from the hedged portion of \$20 and ineffectiveness arises on any decrease up to \$20 and the Board has similarly rejected this approach.

**We wish to suggest that approach B can be modified to provide a generalised solution to for measuring hedge ineffectiveness and this is explained below.**

Under our proposed method of designation, both assets of \$100 and liabilities of \$80 are hedged by IRS. Any unexpected reduction in assets immediately leads to hedge ineffectiveness as does any unexpected reduction in liabilities. Although the gain or loss arising from the IRS which is not offset by a corresponding loss or gain on the portion of assets unexpectedly reduced is computed separately from the amount arising from applying the same requirement to the unexpected reduction in liabilities, there is a natural offsetting effect to the extent that the reduction in assets is matched by a reduction in liabilities [of the same or smaller quantum]. Hence the hedge ineffectiveness measured in this way will capture both changes in assets and liabilities.

We now consider whether this argument will work if we remove the word "of the same or smaller quantum" from the above scenario. If the unexpected reduction in assets is \$10 and the unexpected reduction in liabilities is larger, say \$20, the initial gap of \$20 widens to \$30. If the gap is managed by an asset liability management (**ALM**) function on a portfolio basis, the ALM can in practice choose to do nothing as it is acceptable to hedge only \$20 when the gap is \$30.

However, if the risk management practice of the bank is such that the asset portfolio is managed by an asset management (**AM**) unit and the liability portfolio is managed by a liability management (**LM**) unit, separately, then any reduction in either assets or liabilities will immediately trigger a close-out of a certain amount of IRS either externally or with the trading desk (that is, transfer of a position to the trading portfolio for the portion no longer used for hedging). In a large bank, it is possible that a portfolio of assets such as credit card receivables are managed separately from a portfolio of liabilities such as retail deposits.

Henceforth we will use ALM to refer to the practice of managing the assets and liabilities jointly, and AM and LM to refer to the practice of managing the assets and liabilities separately.

Now let us return to the scenario where the portfolio risk is managed by ALM. The ALM manager sees the gap widening to \$30 and chooses not to adjust the hedge. However, if the accounting standard only caters to the AM and LM practices but not ALM practice,

the ALM manager will be compelled to adjust the hedge for the unexpected reduction of assets of \$10 and the unexpected reduction in liabilities of \$20. This means he will be driven by accounting standard to undertake an external deal to increase the IRS-pay fixed by \$10. In our view, the accounting standard would be deficient if it is not sufficiently general to allow ALM as an alternative hedging practice.

In any case, he should be allowed to rebalance the existing IRS by "liquidating" \$10 IRS-pay fixed against \$10 IRS-receive fixed.

To prevent accounting from driving risk management decisions, we propose that IAS 39 be modified to permit different accounting treatments for different risk management practices/strategies, provided they are clearly documented. In our example, an ALM arrangement is considered a different strategy from either an AM or a LM strategy.

How do we handle the above scenario when the gap widens to \$30 and ALM has decided to under-hedge, that is, to maintain the \$20 IRS? The \$20 can now be viewed as \$80 IRS-pay fixed and **\$60** IRS-receive fixed, against the revised total assets of \$90 and total liabilities of **\$60**. Compared with the original position, the ALM manager should be allowed to re-balance (or re-arrange) the existing IRS by "liquidating" \$20 IRS-pay fixed against \$20 IRS-receive fixed. The rebalancing does not produce any financial impact; it merely gives a better fit between quantum of the hedging instruments and the portfolio size of the hedged items.

Under **approach C**, and using the same numerical example provided in "Basis for Conclusion", we would designate the amount of assets hedged to be \$96 and the amount of liabilities hedged to be \$80, corresponding to the net amount of \$16 for the IRS. This may reflect the AM manager's assessment that there is a likelihood of unexpected prepayment of assets of \$4 and hence this amount is left unhedged. If the documented hedge strategy is that of **AM**, no ineffectiveness should arise from any unexpected reduction in assets to the extent of \$4.

On the other hand, if the hedge strategy is documented to be **ALM**, both the reduction in assets and reduction in liabilities must be considered **jointly**. If the gap widens, the ALM manager can choose to do nothing, as in approach B, and no hedge ineffectiveness should arise from not hedging. If the gap narrows to less than \$16, the ALM manager must close out a portion of the reduction either by entering into an offsetting IRS with the market or with the trading desk (that is, effectively transferring the portion of the IRS not used for hedging to the trading portfolio).

Under our proposed method of designation and allowing for different hedging strategies (ALM, AM or LM), approach C is merely a special case of approach B. The techniques proposed by us under approach B for rearranging the gross amounts of IRS to fit the new asset portfolio size liability portfolio size are also applicable to approach C.

Under **approach D**, the amount hedged is expressed as 20 per cent of the assets of \$100. If the assets are reduced to \$90 due to earlier than expected prepayment, ineffectiveness arises on \$2. The approach described in the ED views assets separately (an AM hedging strategy) and ignores any unexpected reduction in liabilities.

Under the AM hedging strategy, the risk manager need not adjust the hedge since the position was so under-hedged in the first place. It would indeed be unfortunate if the accounting standard dictates otherwise and even prescribes the quantum of hedge reduction to be \$2, as illustrated.

On the other hand, if the bank applies an ALM hedging strategy, in the absence of any unexpected reduction in liabilities, the risk manager would close out IRS to the extent of \$10 (as this amount is no longer required as a hedge) contrary to approach D which assumes that the ineffectiveness arises on only \$2. In our view, approach D is not consistent with the risk management practice, although it is thought to be most consistent with IAS 39 by the ED.

**Q1(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?**

Yes, if there is over-hedging, the bank will either close out the portion of the hedging instrument no longer used for hedging or transfer the position to its trading portfolio. The close-out can be achieved by entering into offsetting IRS either with the market or with the trading desk, with immediate recognition of the resulting gain or loss.

Under-hedging can occur either intentionally or unintentionally. Under IAS 39, as well as under normal risk management practice, there is no compulsion that all risk exposure arising from a banking business position must be hedged. It is therefore logical that intentional under-hedging should not lead to immediate recognition of hedge ineffectiveness. (If there is no hedging in the first place, how can there ever be hedge ineffectiveness?)

Unintentional under-hedging can occur from prepayments of either assets or liabilities over and above the original expectations or from any form of error in information compilation. If the position unhedged is a banking business position, we are of the view that there should be no hedge ineffectiveness even if failure to hedge is unintentional.

**Q1(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?**

First we support the idea of allowing the adjustments to hedged items to be presented as a single line item in the balance sheet. This is entirely consistent with a long-

standing bank accounting practice of presenting accrued interest receivable (or payable) as a single line item. There are two different situations when we have to deal with the balance sheet line items, and they call for different solutions.

The first is where unexpected reduction in assets or liabilities within a repricing time band occurs. The second is where a hedge is terminated half-way through its term, leaving the existing adjustment to the hedged item to be dealt with for the remaining life of the hedged item.

A customer normally prepays a fixed rate loan when interest rate has declined. If the loan is part of a hedged item, at the time of prepayment the bank would have recorded a fair value gain in a separate line item within assets, as proposed by the ED. The customer settles either the face value of the loan only or the face value of the loan plus a penalty for early settlement, in accordance with agreement with the bank. The penalty, if any, enables the bank to realise the fair value gain fully or partially. In standard bank accounting methodology, the penalty received is recorded as interest income upon receipt and the fair value gain previously recorded is removed from the balance sheet (that is, written off as an expense). Mechanically, that amount disappears from the balance sheet and flows into the income statement as it is no longer derived from an item (or an amount) remaining on the listing of hedged items at a balance sheet date.

[As there is an assumption that all items within the repricing time band are homogeneous, it is no necessary to have specific identification of the relevant hedged items.]

The amount to be removed from the balance sheet is tracked by focusing on the items (or an amount) still remaining on the hedged item listing. It is not tracked by focusing on the items (or an amount) that ceased to be hedged items during a financial period as this would be a tedious process. This accounting mechanism considerably simplifies the tracking process.

The second situation is more complex for accounting. An IRS effectively converts a fixed rate financial asset (or liability) into a variable-rate asset. Periodic cash settlement (or if not settled, then proper interest accrual at balance sheet date) of interest differentials under the IRS serves to adjust the fixed interest income to a variable interest income. An action to early terminate the IRS converts the synthetic variable-rate asset back to fixed-rate. Amortisation of the fair value adjustment to the hedged item from the date of cessation of the hedge to the next repricing date or maturity date adjusts the interest income for the remaining life of the fixed-rate asset to the new locked-in effective interest rate.

At the date of closing out the IRS, the fair value of the IRS at that date is either realised in cash or be locked in by an offsetting IRS. This has no income statement impact as the new deal has a zero fair value at inception and any subsequent change in its fair value will be offset by an equal and opposite change in fair value of the old IRS.

We can similarly derive a new amount of adjustment to the hedged items (or amount) based on the remaining hedged items (or amount) but the resulting change in the single line item in the balance sheet should not be allowed to flow into the income statement in one go. Instead the amount should be deferred for amortisation during the remaining period. This amount may be slightly different from what the fair value of the terminated IRS suggests due to the existence of hedge ineffectiveness.

Hence to answer how and when the amounts presented in the balance sheet line items are removed from the balance sheet, in the first situation, a fair value adjustment will drop out of that line item when the hedged item from which it is derived ceases to exist due to prepayment. In the second situation, the fair value adjustment to the hedged item will be amortised from the date the related hedging instrument ceases to exist and be removed through full amortisation.

**Q2                    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?**

No, we do not agree. The ED has made significant improvements to IAS 39 by allowing the financial assets to be scheduled based on their expected, instead of contractual, repricing dates. This aligns IAS 39 closer to the prevailing risk management practice.

In scheduling deposits payable on demand, any bank with a well established risk management framework will schedule the demand deposits based on their expected, instead of contractual, repayment dates. In practice, the bank is unlikely to schedule a large proportion of core deposits as very long-dated liabilities, even if supported by behaviour, to avoid the consequence of not hedging very long-dated fixed-rate assets. In other words, it is not good risk management practice to use core deposits to fund very long-dated assets.

If IAS 39 allows assets to be scheduled based on expected repayment dates but requires liabilities (demand deposits) based on contractual dates, the gap between accounting rules and risk management practices will be widened. There will be derivative contracts undertaken as hedging instruments legitimately for which the hedged items cannot be identified as the interest repricing gap report for accounting purposes is significantly different from the interest repricing gap report used for risk management purposes.

BC14(a) of the ED equates the roll-over of demand deposits as the occurrence of prior forecast transaction and proposes that “such a forecast transaction cannot qualify for fair value hedge accounting”. This is inconsistent with the prevailing risk management practice which treats a portion of the total demand deposits as *de facto* fixed-rate term deposits. Although it seems correct to state in BC14(a) that the liabilities concerned are forecast transactions and therefore cannot qualify for fair value hedge accounting, it is a

fallacy in this context as no risk manager would ever think of executing a cash flow hedge for core deposits. A cash flow hedge in the context of interest rate risk management is typically to convert variable interest flows into fixed interest flows.

**Q2(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?**

No, we do not agree. A non-interest bearing demand deposit of \$100 expected to remain outstanding for a year will have a fair value of \$95.23 at inception if a new one-year time deposit now bears interest at 5%. If a **non-interest bearing** demand deposit is scheduled into the one year repricing time band as \$100 and another **interest-bearing** deposit is scheduled into the same time period as \$105 (principal \$100 plus interest \$5), the two deposits have implicit present value (or fair value) of \$95.23 and \$100, respectively, in that schedule.

**Q2(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?**

Yes, our view would result in the demand deposit being recognised initially at \$95 (rounding from \$95.23 in the example in Q2(a)) and no, this need not give rise to a gain on initial recognition. We propose that the difference of \$5 be deferred as a prepayment of service fee by the depositor for services to be provided by the bank during the life of the demand deposit. For example, the depositor may write many small cheques or come to the counter from time to time to withdraw cash, all of which involve substantial costs to the bank.

In this case, the \$5 should be amortised as fee income over one year, to match with the operating expenses incurred by the bank in servicing the demand deposit account.

It is true that a lower interest rate (assuming positive-sloping yield curve) would be used to present value the demand deposit if it is estimated to have a shorter duration. While this results in a lower imputed interest expense and imputed service fee income, there is no impact on the net profit of the bank.

The demand deposit, initially recognised as \$95, accrues at 5% interest to reach \$100 in 12 months. If there is unexpected withdrawal at the end of six months, the deposit will have accrued up to \$97.5 and the deferred fee income will have amortised down to \$2.5. The bank pays \$100 as repayment of \$97.5 and "refund" of \$2.5 for the unused portion of the service fee. The income statement effect, if any, due to unexpected withdrawal is nil. In practice, there may be a small income statement impact as the imputed interest is accrued using the effective interest rate method while the imputed service fee income is amortised on a straight-line basis.



We also wish to comment specifically on BC14(d) of the ED. There is no doubt that the banking industry, by not paying interest on demand deposits and simultaneously not charging the full cost of servicing, has for a long time obscured the true nature of a core deposit, at least from the public's perspective. The ALM manager, by scheduling \$100 in the 12 month repricing time band, implicitly treats the core deposit as one with a fair value of \$95 accruing at 5% to \$100 in 12 months. His way of managing the fair value exposure of the core deposit in the same way as other interest-bearing deposits reveals the true economic nature of the core deposit. The core deposit is managed as a fixed-rate deposit, whose fair value **does** change with movements in interest rates. Economically, the bank does incur an interest cost on demand deposits, but retains the interest to defray operating expenses.

A bank with sophisticated management accounting may split account for the core deposit at \$96 upon inception (compared with \$95 above) and a service fee prepaid by customer of \$4 (compared to \$5 above), based on negotiation between branch banking and group treasury. Should there be an immediate recognition of a gain of \$1 when the core deposit is fair valued to \$95 based on the prevailing one-year swap rate of 5%? We are of the view that no immediate gain should be recognised as group accounting should set up a financial liability of \$1 as the value of the customer's option to withdraw the deposit any time or at short notice.

This option is conveniently embedded in the deferral of \$5 if the service fee deferred is recorded as \$5 (see the first paragraph under Q2(b)).

By viewing core deposits as economically interest-bearing deposits with an estimated term to maturity (subject to an option to withdraw early), we can avoid treating core deposits as an anomaly within the overall IAS 39 framework. The example above also illustrates that withdrawal earlier than scheduled does not produce a material income statement impact as the repayment amount is made up of two components, the amortised cost of the deposit and the unused portion of the service fee paid by the depositor.

If you require any clarification of any comments made in this letter, please do not hesitate to contact me at [kim.chiu.chua@sg.pwc.com](mailto:kim.chiu.chua@sg.pwc.com).

Yours faithfully,

Kim Chiu Chua

