The South African Institute of Chartered Accountants

CL 37

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Dear Ms Thompson

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

In response to your request for comments on the above Exposure Draft, attached please find the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but is also secretariat to the Accounting Practices Board (APB), the official accounting standard setting body in South Africa.

We thank you for the opportunity to provide comments on this document. We have, in addition to our response to the questions raised, also included general comments on aspects not specifically dealt with in the questions.

Please do not hesitate to contact me should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director - Standards

cc: Peter Wilmot (Chairman of the Accounting Practices Board)
Pat Smit (Chairman of the Accounting Practices Committee)

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GENERAL COMMENTS

We commend the International Accounting Standards Board (IASB) on addressing the issue of fair value hedge accounting for a portfolio of interest rate risk.

Given that entities across jurisdictions manage interest rate risk in their portfolios in varying ways, we are of the opinion that the Exposure Draft should provide broad guidance only, which will allow entities to apply a hedge accounting methodology that is in line with their risk management policies and practices provided these remain within the broad principles of IAS 39 – *Financial Instruments: Recognition and Measurement* (reiterated in BC6). The Exposure Draft should not attempt to prescribe designation principles in respect of a single risk management approach, as in practice, different hedging strategies may be followed by different entities.

We believe that the proposals suggested in the Exposure Draft may be too prescriptive and we are concerned that they may not be universally workable in practice.

ISSUES DEALT WITH IN THE EXPOSURE DRAFT, NOT DEALT WITH IN THE ANSWERS TO OUR QUESTIONS

Contractual versus expected cashflows

Many of the entities in South Africa managing interest rate risk within portfolios base their risk management processes and systems on contractual maturity rather than expected maturity. Practically in South Africa there would appear to be little difference given that asset prepayment options are seldom granted for free. In other words, any prepayments generally attract penalties that place the asset originator in a similar position to the position the asset originator would have been in, but for the prepayment. Furthermore, as hedge effectiveness is regularly measured, it is considered unlikely that there will be any significant differences between expected maturity and contractual maturity. We therefore recommend that the Board make it clear that where contractual cashflows approximate expected cashflows, contractual cashflows may be used in the hedging calculation.

Offsetting derivatives

The amendments to paragraph 126F extend its scope to apply to all hedge accounting relationships, not only those relating to a fair value portfolio hedge of interest rate risk. The amendments will allow an entity to designate derivatives with offsetting positions as a hedging instrument. Paragraph BC35 in the Basis of Conclusions states that allowing offsetting derivatives that would have previously been recorded in net income has substantially the same effect whether they are designated as a hedging instrument or not. However, the rationale in the Basis of Conclusion is only relevant in the case of fair value hedges, where fair value movements in the derivatives are recorded in net income prior and following hedge accounting. The rationale does not apply in the case of cash flow hedging or a hedge of a net investment in a foreign operation where as a result of hedge accounting the movements in fair value of the derivative are recorded in equity. Such offsetting is further prohibited in the case of cash flow hedges in IGC 121–2. Whilst we support the amendment and the rationale inherent in the Basis of Conclusions, we believe the allowance of netting offsetting derivatives should be restricted to fair value hedges only.

ISSUES NOT DEALT WITH IN THE EXPOSURE DRAFT

Although not specifically dealt with in the Exposure Draft, we would like to raise an additional comment from the South African banking industry.

Internal hedging positions

So called internal hedges appear to be a widely used practice in gathering the risks to be hedged in a central treasury function. This central treasury function then typically aggregates the risks, assesses the degree of offsetting risks and hedges the exposures with external counterparties based on their limits, directional views and offsetting positions. The internal hedges therefore provide a mechanism to centralise interest rate risk existing in various divisions of a bank. These risks are combined with interest rate positions in the trading desk to determine the net interest rate risk to be hedged for the organisation. The exclusion of internal hedges from macro hedging could lead to an artificial hedged position for accounting purposes that is not aligned with the risk management strategy of the entity.

Provided the exposures that have arisen in the central treasury from internal hedges can be traced through internal hedges to hedging transactions with external counterparties and that appropriate rules are instituted to prevent mismatches in the measurement basis between the hedged item and the designated hedging instrument, it is suggested that entities might be permitted to use internal derivative transactions as part of their hedge accounting documentation without the need to redesignate hedging relationships at the group level. Such an approach would recognise that internal derivative transactions may be valid components of an entity's hedge accounting documentation, even at the group level, because they evidence the transfer of risk from hedged items within a group into a central risk management function.

SPECIFIC COMMENTS

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 (eg 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?

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. However, we do not agree with the Board's restriction of acceptable hedging approaches to measure ineffectiveness to approach D. As explained in the General Comments, we would expect the method used for effectiveness testing to be based on an entity's specific risk management strategy rather than having a prescriptive, rules-based methodology.

If not,

(a) in your view how should the hedged item be designated and why?

In providing an understanding of our views of why one particular approach should not be prescribed, it is necessary to indicate our position on each of the approaches A to D as detailed in BC19.

In our view the Board should not specify a single method for designating the hedging relationship and assessing hedge effectiveness, but rather allow the entity to choose the one that most closely reflects the risk management strategy currently adopted. We recognise that there are strong arguments for and against each of the proposed approaches as set out in the Basis of Conclusions, but believe that the merits of each can only be finally assessed in the context of the reporting entity's own circumstances. Linking the risk management strategy with the method of assessing effectiveness in this way will also meet the Board's stated objective of minimising the need for systems changes.

We note that the Board's primary argument against approaches A to C depends on the inseparability of interest rate risk and prepayment risk. However, in the context of hedging interest rate risk on a portfolio basis, many banks deliberately adopt a policy of underhedging their exposure in order to avoid ineffectiveness arising as a result of prepayments that do not occur in accordance with expectations. This approach is a valid risk management strategy that addresses the practical difficulties of assessing accurately the behavioural risk associated with prepayments of financial assets such as mortgages. Approaches A, B and C all appear to reflect such a risk management strategy whereas approach D assumes that ineffectiveness will arise from underhedging as well as overhedging, without recognition of the risk management strategy adopted by the entity. In our view approaches A to C are more likely to align with management's risk management practices and to be consistent with the underlying systems currently in place.

Approach A has the most merit in that it:

- is the simplest approach;
- will achieve the overall objective of the Board, of a workable solution;
- will not be inconsistent with the banks current methodology of hedging prepayment risk.

Approach D has more conceptual merit than the other approaches that were described in the Basis of Conclusions, but there are practical problems with this approach. The initial recognition principles of approach D make sense, however, it is on subsequent recognition that problems arise. Approach D is the most complex of the approaches considered and it is likely to be the most difficult to apply without significant systems changes. Examples where clarity is required for this approach, is:

- how impairment should be applied across time buckets, and whether in fact impairment should result in ineffectiveness where specific balances have not yet been identified as impaired (i.e. a portfolio impairment evaluation);
- how ineffectiveness is measured and allocated across time buckets for partial derecognition transactions, for example where some risks and rewards have been retained (whilst some have been transferred), and the transferor retains a residual interest in the assets that have been subject to the transfer;
- paragraph 151 of the current standard states that hedge ineffectiveness measurement need only be calculated at a minimum at every reporting period. We are concerned that this may no longer be the case as practically an entity would be required to test ineffectiveness as frequently as the duration of each time bucket changes over time. This is because the Exposure Draft requires expected cash flows rather than contracted cash flows to be hedged and therefore there is a corresponding requirement to report ineffectiveness more frequently as these expected cash flows change. If applying the Exposure Draft will result in increased frequency of hedge ineffectiveness measurement, the standard should state this.

(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?*

In terms of measuring hedge effectiveness, if the change in the fair value of the surplus asset or liability position for the hedged risk vs. the change in the fair value of the derivatives are measured, and this ratio falls within the 80% - 125% rule, we can conclude that hedge effectiveness has been achieved.

The fair value adjustment relating to interest rate risk of both the surplus asset or liability position and the derivatives should be processed to the income statement. As a result, all material ineffectiveness will be identified and recognised in profit and loss. However, that ineffectiveness as a result of prepayment risk need not arise from an underhedging strategy.

(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?*

In our view it is inappropriate, under any of the proposed designation approaches, to leave the fair value adjustment to the hedged item in a separate line in the balance sheet until the hedged asset is derecognised. Theoretically, IAS 39 requires amortisation to start as soon as a fair value adjustment exists since the adjustment of the carrying amount affects the calculation of the effective interest of the hedged item. However, an entity may defer amortising the adjustment until the hedged item ceases to be adjusted. This is because it may be administratively burdensome to amortise the adjustment at the same time as the carrying amount is being adjusted for changes in its fair value that are attributable to interest rate risk (the risk being hedged). Additional clarity is needed to specify how fair value adjustments are amortised in circumstances where a particular time bucket is designated or when the hedge ceases to be effective.

Question 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 (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?

We do agree that, with regards to a financial liability, a counter party who can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counter party can demand payment notwithstanding that historical empirical evidence may suggest that expected maturity exceeds contractual maturity. It is for this reason that we favour using contractual maturity rather than expected maturity for both liabilities and assets. We note, however, that there remains no practicable hedge accounting solution for banks that hedge their net margin where demand deposits constitute a significant component of the hedged position. We recommend that the Board continue to research alternatives to achieve this within the framework of the existing principles.