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IDW

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

Düsseldorf, 14 November 2003
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Dear Sir David

**Re.: 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**

We appreciate the opportunity to comment on the Exposure Draft mentioned above and would like to submit our comments as follows:

General Remarks

Basically, we acknowledge the Board's intention to allow fair value hedge accounting more readily for a portfolio hedge of interest rate risk. Furthermore, we agree that the proposed approach should be workable in practice without violating the principles underlying IAS 39's requirements on derivatives and hedge accounting.

Despite being a great step forward we believe that the proposals should be aligned more closely with the manner in which a financial institution hedges its interest rate risk. In particular, concerning the mapping of the designated amounts into maturity time buckets we are aware that only few possible risk management techniques are being addressed by the Exposure Draft. Banks which apply sophisticated solutions for risk management purposes (e.g. duration or cash flow models) would only be able

Institut der Wirtschaftsprüfer
in Deutschland e.V.
Tersteegenstr. 14
40474 Düsseldorf
Postfach 320580
40420 Düsseldorf

Telefonzentrale 0211/4561-0
Fax Geschäftsleitung 0211/4541097
Fax Fachabteilung 0211/4561233
Fax Bibliothek 0211/4561204
Internet http://www.idw.de
E-Mail info@idw.de

Geschäftsführender Vorstand:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands
Dr. Gerhard Gross
Dipl.-Kfm. Peter Marks, WP StB

Bankverbindung:
Deutsche Bank AG
Düsseldorf
BLZ 300 700 10
Kto. Nr. 7 480 213

to apply the proposed macro hedge accounting with the incurrence of major effort in systems changes.

With regard to macro hedge accounting the treatment of internal contracts is an important issue. We concur with the Board's opinion that intra-group or intra-entity hedging transactions should be subject to consolidation. However, since appropriateness and practicality of hedge accounting could be hindered significantly if internal contracts are ignored totally, the Board should consider permitting the use of internal hedge accounting transactions for documentation and effectiveness testing purposes.

In order to narrow the gap between risk management and accounting treatment we would like to suggest an alternative approach based on the Board's proposal concerning the implementation of a new category of financial instruments as outlined in the Exposure Draft of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement. In our view, the alternative approach is both more consistent and understandable. It would also be easier to implement, thereby aligning hedging and accounting. We have included the alternative approach in the Appendix to this letter.

Many requirements of the current Exposure Draft are ambiguous and, therefore, need further clarification to avoid different interpretations being applied in practice and to achieve comparability. In particular, additional guidance should be given with regard to debt instruments that are classified as available-for-sale.

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 (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?*

As mentioned in our general remarks we would like to submit an alternative proposal in this area (see Appendix). Limited to the approaches discussed in the Basis for Conclusions which, in our opinion, are not sufficiently aligned with risk management strategies in practice, we would like to submit our views as follows:

Whilst we support the proposal that the hedged item may be designated in terms of an amount of currency in a maturity time period rather than as individual assets or liabilities we do not agree with the Board's decision concerning the alternative methods of designation set out in paragraphs BC18-BC29 and their effect on measuring ineffectiveness. In weighing the pros and cons of the 'layer' approaches (A, B and C) and the 'percentage' approach (D) the risk management strategies of financial institutions should be given greater consideration. Such strategies are generally focused on the net risk position.

In accordance with risk management practice the Exposure Draft (reflecting approach D) allows the hedged amount to be determined from the identified portfolio of items whose interest rate the entity wishes to hedge. We acknowledge that, with a view to conceptual consistency, such an amount may be either an amount of assets or an amount of liabilities, but not a net amount reflecting assets and liabilities. However, in contradiction to risk management practice this amount is, in the next step, used to calculate a percentage of the initial estimate of the total assets or liabilities in the time period that was hedged. This percentage is later applied in measuring ineffectiveness. Instead of relating the designated amount to total assets or liabilities with a view to measuring ineffectiveness, as proposed under approach D, we propose that the designated amount should still/again be related, as closely as possible, to the net risk position when ineffectiveness is measured.

In order to achieve the maximum consistency with the manner in which a financial institution hedges its interest rate risk on a portfolio of fixed rate assets and liabilities without violating the concept of IAS 39 we prefer approach B. In particular, we favour the following persuasive arguments for this approach:

Designating the 'top' layer as the hedged amount appropriately reflects the fact that risk management, in practice, relates to the initial net risk position as a hedged item.

Approach B captures all ineffectiveness: If the entity revises downwards its estimate of the amounts of, for instance, assets in the respective maturity time period (over-hedging), these reductions lead to immediate ineffectiveness. However, if the entity revises upwards its estimate of the amounts of assets in the respective maturity time period (under-hedging), no ineffectiveness arises on the grounds that the 'top' layer is still untouched and the 'top' layer was all that was being hedged. Such upward revisions were not covered by the initial hedge and result in 'new assets' to be hedged. Therefore, we believe that this approach accords with the underlying principle of IAS 39 that all material ineffectiveness should be identified and recognised in profit or loss. In contrast, approach D reduces the amount of ineffectiveness inappropriately in the case of over-hedging as the hedged amount is based only on a proportion of the assets and not a layer.

Approach B avoids the large 'cushion' against ineffectiveness which is created using approach A. Such a cushion implies that there is an unhedged portion. Bearing in mind that hedged amounts are initially related to net risk positions, thus leading to a 'natural hedge' of assets and liabilities, we doubt the existence of unhedged portions.

Derecognition under approach B is not conceptually different from the proposed treatment under approach D (see paragraphs A38 and A39), i.e. items included in the separate line items are removed from the balance sheet when the corresponding items that were originally scheduled into time periods are derecognised because of prepayment, maturity, write-offs due to impairment or sale. Nevertheless, in any case additional guidance would be helpful with regard to the details of the concept.

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 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, despite the fact that many entities, when managing interest rate risk, include such core deposits in a portfolio hedge by scheduling them to the date when they expect the total amount of core deposits in the portfolio to be due because of net withdrawals from the accounts in the portfolio (paragraph BC13).

In general, we were persuaded by the majority of arguments set out in paragraph BC14. Nevertheless, not all arguments are convincing. We doubt, for instance, the Board's statement that it would be inconsistent to permit fair value hedge accounting based on the expected repayment dates, but to measure the fair value of the deposit on initial recognition on a different basis (paragraph BC14(c)). In our opinion, differences between cost, which is used on initial measurement, and the respective fair value are not unusual for financial instruments, e.g. in case of originated loans. Such financial assets can be hedged items with respect to interest rate risk.

Moreover, under the approach rejected by the Board the valuation adjustment that would be recognised in the first period equals the difference between the fair value that is attributable to the hedged risk on designation and the respective fair value when effectiveness is assessed for the period. To put it another way, the difference between cost and fair value would not be charged immediately to the income statement on the inception of the hedge.

We do however consider the additional reasons set out in the Basis for Conclusions sufficiently valid to support the Board's decision. Furthermore, we would like to point out that the fair value of core deposits is not less than the amount payable on demand because measuring core deposits based on expected, rather than contractual, repayment dates implies the existence of a combination of two separate items: a liability based on contractual repayment dates and another item representing the difference between contractual and expected cash flows. In our view, the difference does not meet the recognition criteria for financial instruments because the financial institution has no contractual right to receive cash or another financial asset (IAS 32.5). Therefore, the difference is part of the bank's internally generated goodwill.

Other Comments:

Due to concerns raised by bank representatives the proposed amendments to IAS 39 are limited to portfolio hedges of interest rate risk. Other risks, e.g. price risks of precious metals and other traded commodities, are not included. For the sake of consistency we suggest the Board consider whether macro hedge accounting could not also be allowed in these areas.

With respect to bank's risk management in practice we suggest a clarification that the portfolio hedge of interest rate risk is not restricted to one portfolio of items, but allows for several portfolios to be used by an entity.

It is not clear to us whether some risk management strategies that are effectively used in practice are allowed under the proposed treatment: Paragraph 128A states that, in the case of a hedge of a portfolio containing prepayable assets, the entity 'may' hedge the change in fair value that is attributable to a change in the hedged interest rate based on expected, rather than contractual, repricing dates. While the Exposure Draft seems to allow the use of either expected or contractual repricing dates, the Application Guidance is more restrictive: According to paragraph A26(b) an entity analyses the portfolio into maturity time periods based on expected, rather than contractual, repricing dates. As a consequence the entity measures the change in the fair value of the hedged item excluding the effect that the change in interest rates has had on expected prepayments. If an entity buys, among other instruments, a swaption in order to hedge a prepayment risk, i.e. the entity has the right to enter into an interest rate swap agreement by some specified date in the future, the change in fair value of the hedging instrument includes the change in fair value of the option, thus resulting in ineffectiveness. Because we feel that such risk management strategies should be properly reflected in accounting treatment we recommend a clarification that the use of contractual, in addition to expected, repricing dates is to be allowed when an entity analyses the portfolio into maturity time periods. Accordingly, we are of the opinion that changes in the fair value of the prepayment risk should, in this case, be accounted for as a part of the change in fair value of the hedged item.

Furthermore, we suggest that the new requirement of paragraph A31 stipulating that a portfolio of derivatives used as hedging instrument is limited to 'similar' derivatives should be abolished so as to enable the entity to combine, for example, a swap and a swaption as a hedging instrument.

Pursuant to paragraph IE2, a company analyses the 'principal amount' of all items in the portfolio into maturity time periods based on expected repricing dates, i.e. interest payments are not subject to such an analysis. However, most risk management systems of German banks do not distinguish between principal or interest payments. They split all transactions into cash inflows, or outflows, respectively, for a given time bucket. The use of cash flows seems to be appropriate in many cases because two financial assets may have the same principal amount, but different cash flows, e.g. interest-bearing loan vs. zero bond. Therefore, we believe that both treatments should be allowed with respect to hedged items. Additionally, we suggest the Board clarify that hedging instruments should also be split into cash flows and analysed into maturity time periods.

Uncertainty exists concerning the interrelation between the Exposure Draft and the existing guidance on assessing hedge effectiveness, in particular whether and how the existing requirements (IAS 39.142/146) are to be applied with respect to fair value hedge accounting for a portfolio hedge of interest rate risk. Since the Board, at its meeting on 20-24 October 2003, rejected a proposal specifying that 'the highly effective' prospective effectiveness test is passed if expected effectiveness is in the range of 80 to 125 per cent (that is, the same test that IAS 39 requires for assessing whether a hedge has been effective retrospectively), we suggest that for portfolio hedges of interest rate risk the assumption that such a hedge can be regarded as highly effective at inception can be applied. Moreover, we believe that future hedge effectiveness should only be assessed for the time period ending when the entity next tests for effectiveness.

In our opinion, clarification is also needed regarding the consequences of a hedge that no longer meets the criteria for qualification for hedge accounting pursuing to paragraph 142 of IAS 39. In our opinion, IAS 39.156(b) must be applied, i.e. the entity should discontinue the hedge accounting prospectively. Additionally, we suggest that the Board specify that actual assessments of hedge effectiveness should be based on the time period since the entity last tested for ineffectiveness, i.e. not on a cumulative basis.

The Exposure Draft discusses the effectiveness test in detail mixed up with the issue of derecognition of assets. We would appreciate additional guidance concerning the derecognition of assets.

The Exposure Draft is silent on the amortisation of the amounts included in the separate line items within financial assets and liabilities. IAS 39.157 stipulates that an adjustment to the carrying amount of a hedged interest-bearing financial instrument should be amortised to net profit or loss. Amortisation should begin no later than the point at which the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. According to IGC 157-1 amortisation can start as soon as a fair value adjustment exists. Since amortisation of amounts included in the separate line items, especially by application of the effective interest method, seems to be very burdensome and often not essential under the circumstances of macro hedging, we suggest the Board make an explicit statement in the final Standard that amortisation is not necessary in this area.

In our view, it should be made clear whether fair value hedge accounting for a portfolio hedge of interest rate risk is applicable to debt instruments that are classified as available-for-sale, bearing in mind the proposed separate presentation of the gain or loss on the hedged item attributable to the hedged risk. If macro hedging is applicable to debt instruments that are classified as available-for-sale, practical problems arise as a result of recognising the change in fair value

- in net profit or loss for the period as far as macro hedging is concerned and
- directly in equity regarding the remainder of the change in fair value.

Since many portfolio hedges that meet the proposed criteria for fair value hedge accounting often have not qualified for fair value hedge accounting under the current provisions of IAS 39, instead qualifying for cash flow hedge accounting, we consider it necessary that additional guidance on the transition from former cash flow hedge accounting to future fair value hedge accounting be provided.

Finally, we would appreciate an Illustrative Example which adequately reflects the complexity of macro hedge accounting and considers the items mentioned above. The example that currently accompanies the Exposure Draft tends to simplify the problems inappropriately.

Yours sincerely

Gerhard Gross
Executive Officer

Norber Breker
Technical Director
Accounting and Auditing

<u>Appendix: Alternative Approach</u>

APPENDIX

Alternative Approach:

Our suggested approach is based on the introduction of the new measurement category envisaged by the Board in the Exposure Draft of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement (June 2002): According to the proposals an entity is permitted to measure any financial asset or financial liability at fair value, with changes in fair value recognised in profit or loss, by designating it at initial recognition as held for trading. An entity is precluded from reclassifying financial instruments into or out of the category while they are held.

The principal objective of this proposal is to simplify the application of IAS 39 for entities with matched asset/liability positions. In particular, it eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets and thereby eliminates the relative burden of designating, tracking, and analysing hedge effectiveness (paragraph C58).

A brief survey among financial institutions suggests that many of them would be interested in using the new category in order to avoid the burden of (what they regard as artificial) documentation. However, we perceive a practical hindrance given the delayed implementation of the new Basle accord. Most German banks currently do not track changes in credit ratings or spreads in a way that would be necessary in order to account for them. System changes are underway, but they will need more time to be completed. Once the Basle proposals are implemented (which is likely to be the case by 2007), banks should be able to track the entire change in fair value appropriately.

We are aware of the Board’s intention to move into the direction of full fair value accounting for all financial instruments. Recording financial assets and liabilities at fair value would mean that any change in fair value would have to be accounted for, regardless of the risk factor which caused the change. In contrast, present day hedge accounting would only take into account those changes in fair value which can be attributed to the risk being hedged. Thus, if interest rate risk is hedged, changes in credit ratings and/or credit spreads are not taken into consideration.

Our proposal, being a step towards measurement at fair value, is in line with such risk management practice and accurately reflects the principles that underlie IAS 39's requirements for derivatives and hedge accounting (as set out in the Appendix to the Exposure Draft). We would like to describe our approach in more detail as follows:

1. Designate at initial recognition all items that are intended to be hedged by derivatives. The respective portfolio may comprise both assets and liabilities.
2. Measure all items within this portfolio at risk-adjusted value and recognise any changes in the income statement. Risk-adjusted value means recording only those changes in fair value that are attributable to the hedged risk, e.g. interest rate risk. This aligns the rules for macro hedging with those for micro hedge accounting.
3. Assess whether there is evidence that the items within this portfolio are impaired/uncollectable as a result of a change in credit risk and account for the impairment according to the requirements of IAS 39.
4. Record all derivatives at fair value in the balance sheet with changes in fair value included in the income statement.
5. The difference between the effects on net income of 2., 3. and 4. represents ineffectiveness that is recorded in the income statement (for both over- and under-hedges).
6. An entity is precluded from reclassifying financial instruments out of the portfolio while they are held. Therefore, the question of amortisation will not have to be addressed.
7. Since measurement of all hedged individual items includes changes in fair value attributable to the risk being hedged, there will be no need to record separate line items.

The necessary documentation of transactions included in hedging activities could usually be derived from the treasury department. In most cases, risk management activities are already being documented, audited, and supervised by regulatory authorities. Thus, we do not see any need for additional documentation. This would similarly apply to the assessment of hedge effectiveness.