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

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The Irish Bankers' Federation welcomes the opportunity to comment on the Boards exposure draft of fair value hedge accounting for a portfolio hedge of interest rate risk. We also welcome the continuing and constructive dialogue that is taking place with the industry through the Federation Bancaire De L'Union Europeenne. While we welcome many aspects of the approach suggested in the exposure draft, we remain concerned about key elements of the proposals as set out in our responses to the questions below.

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 decision 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 you 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.

<u>IBF response</u>

We understand that the proposals in the ED are a compromise resulting from the numerous debates that have been held on this topic. Therefore, although, in principle, we feel that many of the proposals are artificial and do not reflect the reality and dynamism of modern risk management techniques, we are willing to accept aspects of the overall suggested approach. While we agree with the Board's proposal to designate the hedged item in terms of an amount of assets or liabilities, rather than individual assets or liabilities, we do not agree with Approach D for designation.

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

In our view, the designation of the hedged item is the critical decision as it drives if and when ineffectiveness arises. The approach to measuring ineffectiveness must be consistent between cash flow hedges and fair value hedges. The 'layer approach' is therefore the more appropriate method.

Approach D does not reflect the reality of how hedging is executed. In particular, it fails to recognise the 'natural hedge' between assets and liabilities in the portfolio. It would also be extremely complex to implement operationally.

Although not ideal, our view is that a combination of Approaches B and C most closely mirrors economic reality of portfolio hedging. We would therefore support the arguments set out in BC20 and BC26 of the exposure draft.

It is important to note however that the complexity of implementing any of the approaches will vary substantially across institutions and the basic principles are open to differing interpretations depending on the scenario. For these reasons, detailed implementation guidance notes will be critical to a smooth and consistent implementation.

(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?

While we agree with the requirement that all material ineffectiveness should be identified and recognised in the profit and loss account, we do not agree that ineffectiveness arises as the result of an underhedge. Such 'ineffectiveness' is a result of the designation method set out in the standard rather than any underlying economic event. The result of later than expected prepayments is that items have moved time period and were previously not considered for hedging. Therefore ineffectiveness cannot arise.
Under Approach B and C all material ineffectiveness arising as a result of overhedging would be recognised immediately.

(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.?

We do not feel that the answer to this question changes based on the designation method. An item will be derecognised on remeasurement or when the hedged item is derecognised.

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 has 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?

IBF response

We agree with the Board's decision that the carrying value of a deposit redeemable on demand cannot be less than the amount payable on demand.

While we welcome much of the progress made in this area, we strongly disagree with the Board's conclusions in relation to core deposits. In particular, it should be noted that excluding core deposits from the portfolio-hedge model means that a number of our member institutions will not be able to use fair value hedge accounting consistently.

Many European financial institutions 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 accounts 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.

Risk management strategies aim to monitor and minimise the effect of interest rate change on net interest income rather than protecting the value of any particular assets or liabilities. It should be possible within the current model to hedge the exposure of core deposits to interest rate changes. Accounting theory should not preclude an activity, which is fundamental to the banking business.

IAS 39 must produce a consistent result for all assets and liabilities. The use of expected behavioural patterns has been accepted for assets that are subject to prepayment risk. A key element of this approach is the assignment of assets and liabilities into time buckets. Demand deposits should, therefore, be slotted into time bands based on their expected maturities.

We are also concerned that the proposals will put institutions that have access to long-term stable funding at a competitive disadvantage over those institutions that use alternative funding sources. It will almost certainly lead to a lack of comparability between such institutions.

Other Concerns:

We remain concerned that while many of the other issues, which were raised during the last consultation period, have been discussed by the Board, no definitive position will be available until the final standard is published. This situation causes extreme difficulties for those institutions that are currently in the midst of implementation projects. We would therefore suggest that all tentative decisions taken by the Board are briefly re-exposed prior to the publication of the final standard.

In conclusion, we welcome many of the proposed changes to IAS 39 but serious issues remain unresolved as discussed above. We trust that the constructive dialogue with the banking industry will continue to ensure that these issues are resolved in advance of implementation.

Yours sincerely

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