DEUTSCHER STANDARDISIERUNGSRAT (DSR)

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Berlin, 13. November 2003

Dear Sir David,

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

The German Accounting Standard Board is pleased to comment on the International Accounting Standards Board's exposure draft of proposed amendments to IAS 39 - Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk.

We welcome and appreciate the efforts made by IASB in addressing existing concerns about the difficulties with and unsatisfactory results of the current hedge accounting requirements with regard to portfolio hedges. We believe that the Exposure Draft represents a considerable step in the direction of the IASB's current aim of developing a solution that is both consistent with the principles that underlie IAS 39's requirements and workable in practice.

However, we disagree with the proposals of the Exposure Draft in two main points: (a) the proposed approach to reflect the ineffectiveness of the hedge (approach D) and (b) the treatment of the core deposits. With regard to measuring effectiveness we believe that among the solutions presented the approaches B and C represent the models the most consistent with the inherent logic and basic requirements of existing IAS 39 and related IGC. Further, we disagree with the Board's position that core deposits cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. We do not believe that including core deposits in the fair value hedge has the same effect as the measurement of core deposits at fair value. For practical and also conceptual reasons we recommend to permit the fair value hedge accounting for portfolios with demand feature based on expected prepayment days.

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Please find our detailed comments in the appendix.

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

Yours sincerely

Klaus Pohle

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Appendix

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?

GASB agrees with the proposed method to designate the hedged items in terms of amount rather than individual assets or liabilities. GASB realizes that this treatment does not fully reflect risk management practice based on evaluating the net risk position both ex ante and ex post. However, bearing in mind the difficulties to accommodate hedge accounting of net risk positions without changing the basic requirements and concept of IAS 39, GASB sees the proposed designation as a practical solution in the current stage of discussion.

Nevertheless, GASB would like to point out that selecting an appropriate approach for measuring the ineffectiveness turns out to be a problem as a direct consequence of not accepting the net risk position as a hedged item. The designation in terms of amount requires allocating what was hedged when revised expectations of repayment or repricing cause a change in the volume of assets or liabilities in a time bucket. In GASB's opinion, the ineffectiveness is not a natural phenomenon but rather a consequence of the designation the standard permits. The standard states that all material ineffectiveness must be identified and recognised in net profit or loss. GASB believes that an approach that measures the ineffectiveness symmetrically, both in case of under-hedge and in case of over-hedge, is not superior to an approach that measures ineffectiveness only in case of an over-hedge, as there is no conceptual argument for requiring measuring the ineffectiveness symmetrically. As the ineffectiveness is a consequence of a designation, GASB believes that the most important criteria for selecting an ap-

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propriate approach for designation must be that the approach chosen is in line with the basic concept and requirements for hedge accounting in IAS 39. In GASB's opinion, approaches B and C meet this requirement. This is elaborated further below.

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

GASB understands that the four alternative models of designation discussed in the Basis for Conclusions are based on two approaches, the "layer"-approach (alternatives A, B, C) and the "percentage"- approach (alternative D). The approaches B and C both are based on the notion of "top layer", with approach C representing a modification of the approach B for a situation of a partial hedge.

GASB supports the view of the five dissenting IASB Members that the approach for measuring ineffectiveness should be consistent with the approach applied to cash flow hedging, i.e. the "layer"-approach outlined in IGC 121 -2. The hedging of interest rate risk on a portfolio basis in the banking practice does not represent fair value hedging or cash flow hedging in terms of IAS 39, as the aim of this risk management procedure is converting fixed rate cash flows into variable ones. As IAS 39 does not permit an accounting model for the procedure of "locking in a margin", the model of cash flow hedge accounting or the model of fair value hedge accounting has to be applied. When hedging the interest rate risk on a portfolio basis, the fair value hedging or cash flow hedging represent the alternatives available for the accounting treatment, but the underlying economic substance of the hedge is different. GASB does not agree that the designation procedure when applying fair value hedge accounting to a portfolio hedge of interest rate risk should differ from the designation procedure when applying cash flow hedging to a portfolio hedge of interest rate risk. While GASB agrees in general with the statement in the BC 21(a) that the considerations applying to a fair value hedge are different from those applying to a cash flow hedge, the Board believes that the "layer"-approach for the designation of hedged items outlined in IGC 121 is the most appropriate for portfolio hedges of interest rate risk and should be applied regardless of whether fair value hedge accounting or cash flow hedge accounting is chosen.

However, while three approaches A, B and C are all based on the "layer" notion of IGC 121, GASB does not support approach A ("bottom layer" approach) favoured by five dissenting IASB members. Due to the large "cushion" this approach provides, there is only a very loose link to the changes in expected prepayments and in most cases the change in the prepayments will not cause any ineffectiveness at all. This approach is the most remote from the net position underlying the risk management procedure as practiced. GASB favours the approaches B and C, which also are based on the "layer"-approach and which will produce ineffectiveness in case of over-hedging. GASB sees this as being consistent with applying the general hedging and designation requirements of IAS 39 to portfolio hedges. Under the current requirements of IAS 39 only risks attributable to the hedged item give rise to ineffectiveness. In case of prepayments earlier than expected, the cash flows are revised downwards so that the hedged item will shrink. Therefore, a prepayment earlier than expected would give rise to ineffectiveness. Extensions of expected repricing dates lead to a cash flow

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revision upwards which is reflected by showing more assets or liabilities in a time bucket. These extensions of repricing periods were not designated and therefore are not part of a hedge and do not change ex post the initially hedged position. They therefore should not produce any ineffectiveness. This treatment would be consistent with the approach chosen in the Exposure Draft for the treatment of the new originated assets and liabilities (see A 37).

(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 GASB agrees to and supports the requirement of IAS 39 that all material ineffectiveness within the hedge relationship should be identified and recognised in profit or loss, the Board does not think that this principle implies or leads to the consequence that both over- and under-hedge produce ineffectiveness. GASB would support this conclusion if the designation approach was linked to a net risk position. But this is not the case; not one of the proposed approaches considers the net risk position by ex-post evaluation of the ineffectiveness. It could be equally argued that the proposed approach D does not capture all ineffectiveness: if an amount of assets is designated as a hedged item and in the following periods the amount of assets remains unchanged, whereas the amount of liabilities changes, there will be no ineffectiveness under the proposed approach D.

Under the current IAS 39 the ineffectiveness does not reflect consistently an underlying economical constellation, but rather is the result of designation as explained above. Therefore GASB is not convinced by the argument presented in BC 21 (c).

Furthermore GASB does not agree that the result of applying fair value hedge accounting to a hedged portfolio should be the same as when designating individual assets or liabilities as the hedged items. GASB believes that the risk profile of a portfolio is different from the separate evaluation of risk profiles of its components. Even the proposed scheduling of assets and liabilities into the time buckets is based on the behavioural assumptions regarding large number of items. Such a scheduling cannot be implemented for individual and separate items.

(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?

GASB does not view the problem of “derecognition” under the approach B/C different from when applying approach D. An item will be removed when the hedged item is derecognised.

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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?

GASB supports IASB's decision that a demand deposit (or a core deposit) should not be valued at less than the amount payable on demand. But the Board does not agree with the conclusion that the demand (core) deposits should not be included in a fair value hedge on a portfolio basis.
GASB does not see this inclusion leading to a gain on initial recognition of demand deposits. According to the proposed procedure of designation, assets and liabilities enter into the designation at their carrying amount. There would not be any adjustment to the carrying amount or any gain on the inception of the hedge.
GASB understands IASB's concern regarding the fair value measurement of core deposits; but the Board believes that the valuation adjustment done for the hedged item including demand deposits should not be equated with a one-to-one fair value measurement of a number of demand deposits. First, a one-to-one designation would not take into account the effect of a portfolio. Financial institutions have a permanent layer of such deposits and its value is affected by the changes of the interest rates. In the practice of risk management, core deposits are an integral part of portfolio hedging of interest rate risk. Second, the valuation adjustment required within the proposed model of portfolio hedge would not be equal to the present value of the margin between a short time deposit (e.g. one month deposit) and a long time deposit (e.g. seven years), which would be a considerable amount. The adjustment would only reflect the impact of movements of the interest rate of the value of core deposits for the period passed after the last assessment of effectiveness, which would be considerably shorter (e.g. one month).

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Furthermore, it should be considered that excluding core deposits from the portfolio-hedge model means that a number of financial institutions will not be able to use fair value hedge accounting consistently.

Other comments

1. Transition from the Cash Flow Hedge to the Fair Value Hedge

Under the current requirements of IAS 39 some financial institutions have implemented cash flow hedges for their hedging of interest rate risk. It is probable that these entities will be interested in treating these hedging relationships as fair value hedges according to the new requirements outlined in the Exposure Draft. Transition requirements for such transition will be needed.

The solution could be elaborated analogous to the planned transition requirements for firm commitments.

2. Time buckets

The example given in the Exposure Draft is based on monthly periods, but the Exposure Draft does not specify how narrow the time buckets should be. IASB's June Update includes a comment that the assets and liabilities contained in each maturity period should be reasonably homogenous with respect to the hedged risk. GASB suggests that this notion should be incorporated into the Standard.

3. Measurement of the change in the fair value of the hedged item attributable to the hedged risk

The ED does not specify how the change in the fair value of the hedged item attributable to the hedged risk is measured. However, it states that whatever techniques are used, "management must expect the same result as would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item". In particular, the ED does not permit the assumption that the value of the hedged item will have changed by the same amount as the change in fair value of the hedging instrument.

As the hedged item is an amount and does not represent an individual financial instrument or financial instruments, some more guidance on valuation issues would be helpful. GASB thinks that it would be neither reasonable nor supportive to prescribe selected techniques. But a description of some possible examples of valuation (e.g. an extrapolation of the valuation of a sample of assets/liabilities across the portfolio) would be helpful.

Furthermore, the notion of the same result that would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item could be misunderstood as a requirement to measure all individual assets and liabilities. The Exposure Draft should state clearly that the individual measurement of all assets and liabilities included in portfolio is not required.

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4. Effectiveness test

It is not clear how the proposed approach interacts with the requirements of IAS 39.142 and IAS 39.146. Due to prepayment risk a high probability of partial ineffectiveness for each maturity period could always be expected (ex ante and ex post). The proposals will only be practicable if they are understood as an alternative to the general rules of IAS 39 for assessing ineffectiveness (at least ex ante). This matter should be clarified.

5. Illustrative Example

Regarding the Illustrative Example it seems to be preferable to elaborate a more extensive example that would give more support for the implementation of the approach in practice. GASB consider it specifically important to extend the number of time buckets considered. Such an example should include an ex-post and ex-ante consideration of more than one time bucket (e.g. three time buckets are sufficiently illustrative) and show the interaction of prepayments and effects of recognition and amortisation of adjustments made to the hedged item. IAS 39.157 states that an adjustment of the carrying amount of a hedged interest-bearing financial instrument should be amortised to net profit or loss. This difficult issue should be sufficiently illustrated in the implementation guidance and in the illustrative example.

6. Portfolio Hedges of Price Risk

The Exposure Draft proposes a macro hedge model for hedging of interest rate risk. GASB suggests considering whether to allow macro hedge accounting for other risks, especially the price risks of commodities.

7. Internal contracts

We support the IASB's position that internal hedging transactions must be subject to consolidation. In order to facilitate the application of hedge accounting we ask the IASB consider permitting the internal transaction for documentation and effectiveness testing purposes.

8. Principle amounts and interest payments

The Exposure Draft mentions only "principle amounts" which should be considered when analysing the expected maturity of a hedged portfolio. Our understanding is that the Exposure Draft does not preclude analysing the expected maturity based on cash flows including interest payments. We suggest that the IASB should clarify this issue.