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**CL 36**

**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***

Finnish Financial Supervision Authority has reviewed Exposure Draft on the amendment to hedge accounting and our comments on the proposal are as follows:

This ED represents a step towards converging banks' sound risk management practices and accounting and thereby facilitating the application of IAS standards and fulfilment of the hedge accounting requirements. In our comments we emphasise the main target of financial statements: to present fairly an entity's financial position, performance and cash flows. We interpret this main requirement for financial reporting to mean that financial information fairly presents the business and not vice versa, that financial accounting requirements steer business decisions.

Our comments are presented from the point of view of a financial supervision authority. In forming our position we have held discussions with different parties in the banking sector (auditors, financial executives of banks, financial experts). We underline that the approach for management of interest rate risk in accounting cannot differ too much from the requirements of BASEL.[1]

## General comments

The hedge accounting requirements of the IAS 39 Financial Instrument standard currently in force are based on the designated hedge relationships of transactions. The net position of assets and liabilities cannot itself be designated as the item to be hedged; instead, the sum indicated by the net position can be replaced by designating a specific part of the underlying individual items as a hedged item. The designated relationship enables the effectiveness to be measured precisely in order to recognise all material under- and over-effectiveness of hedging in profit and loss. Thus current IAS 39 makes possible to hedge interest rate risk as transaction based. Ineffectiveness can then be measured based on the maturity schedule for individual financial assets and liabilities.

[1] Basel Committee on Banking Supervision: Consultative Document on Principles for the Management and Supervision of Interest Rate Risk, September, 2003.

However, in the banking business, entities are hedging the interest rates margin received from assets and paid for liabilities. Following the current IAS 39 hedge accounting requirements can cause distorted hedging decisions and so hamper sound risk management.

One could argue that banks are not compelled to follow the hedge accounting requirements, but on the other hand banks hedge their assets and liabilities, and in so doing they use hedging instruments, derivatives. Derivatives must be measured at fair value in the balance sheet, and, if banks do not apply hedge accounting for interest rate risk, the hedged items (or hedged risk component) are measured at amortised cost: this increases earnings volatility and reduces the financial stability both of individual institutions and of the financial sector as a whole. Because the aim of financial supervision is to maintain financial stability, it is very important that banks can use hedge accounting rules effectively when applying IFRS standards as long as a mixed fair-value model is used in valuation.

The IASB considered the hedging of net-based interest rate risk in more detail in Q&A 121-1 and 121-2 (including appendix). In this Q&A, the IASB preferred cash flow hedges over fair value hedges because of the difficulties involved in considering prepayment risk. Moreover, the IASB stated that current IT technology and programs support the use of a cash flow hedge. In this context the IASB allows partial hedging (ie the bank does not hedge the whole amount of 'net' future cash flow). However, cash flow hedging causes variation in the amount of equity because changes in the fair value of efficient hedging derivatives are recognised in equity. As, in the banking business, the amount of equity related to debt is relatively low, negative changes in derivative fair values further decrease the amount of equity. Again, from the point of view financial stability the sensitivity of equity is critical.

In the revised IAS 39, the IASB proposes that the entity may designate any financial instrument as held for trading when it is initially recognised. Option for fair value measurement will reduce the need for hedge accounting, but only full fair value accounting will remove the need for hedge accounting.

The amendment to IAS 39 now proposed represents a very welcome step forwards compared with what is presented above. However, we believe this step does not go far enough as far as sound risk management practices are concerned, particularly in the banking sector. Moreover, the solution, especially concerning the recognising of ineffectiveness in profit and loss, is too technical.

*Question 1*

**Ineffectiveness**

*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 to 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 and 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?*

**Finnish FSA**

Prepayment risk has not recently been considered a substantial risk element concerning risk management in Finnish banks, because assets are mainly floating-rate loans. However, from the point of view of ordinary ALM we comment as follows:

a) We agree that the proposed hedged item should be the amount of currency rather than specific individual assets or liabilities. In measuring ineffectiveness we support model C, because it best matches ALM in the banking business. It also allows partial hedging, and we assume that C, too, does not prevent full hedging.

b) When the 'net position' is hedged, ineffectiveness arises only in case of over-hedging. The solutions concerning net position fair value hedging must be in line with those solutions the IASB has made concerning cash flow hedging.

c) In over-hedging situations: the amounts are removed from the balance sheet when the time period of maturity has expired. In under-hedging situations: the amounts are removed from the balance sheet for the hedged part, when the time period of maturity has expired; for the unhedged part, the amounts will either remain unhedged or will be designated for hedge again.

*Question 2*

**Fair value of core deposits in fair value hedging**

*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?*

a) *Do you agree with the Board's decision (which confirms an existing requirement in IAS 32) that the fair value of such 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?*

**Finnish FSA**

We are pleased to note that deposits can be taken into account in calculating the hedged amount of currency for maturity time periods based on each bank's historical experience. However, according to BC17 core deposits cannot be designated as hedged item, when amount of currency for specific maturity period includes net liabilities, which are only core deposits. We find this problematic, from the point of view of sound risk management practices.

In Finnish banks, loans are mainly floating-rate assets, whereas a very high proportion of liabilities are fixed-rate core deposits. The level of deposits is stable and their amount is not price (risk) sensitive in the short run. Banks use core deposits in their hedge decisions based on assumptions about the duration of core deposits derived from historical experience.

We agree that, in general, deposits cannot be measured at fair value without unusual and peculiar impacts on earnings.

However, in hedge accounting we are of the opinion that core deposits could be valued at fair value. The main question is how the fair value of deposits can be measured so that the result is sufficiently reliable. EFRAG's draft letter proposes that the change in the fair value of deposits in a hedging relationship correspond to the change in the fair value of hedging instrument(s). This is a very practical and simple solution to avoid a situation whereby the fair value changes of hedging instruments alone are recognised in profit and loss. As a result, the hedging derivative instruments would not increase unnecessary volatility in earnings. We support this approach, but are of the opinion that the proposal requires further examination, including the carrying out of representative field tests.

FINANCIAL SUPERVISION AUTHORITY

Kaarlo Jännäri
Director General