BRITISH BANKERS' ASSOCIATION

Pinners Hall
105-108 Old Broad Street
London EC2N 1EX

Tel: +44 (0) 20 7216 8800
Fax: +44 (0) 20 7216 8811

Paul Chisnall
Executive Director

Direct Line: 020 7216 8865
Direct Fax: 020 7216 4365
E-mail: paul.chisnall@bba.org.uk

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6HX

CommentLetters@iasb.org.uk

14 November 2003

CL 50

Dear Sir David

Fair value hedge accounting for a portfolio hedge of interest rate risk

Please find enclosed a memorandum setting out the BBA's comments on the exposure draft 'Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk' and other aspects of IAS 32 and IAS 39 on financial instruments.

As you know, the banking industry has been in discussion with Board and staff members since the roundtable meetings in March and our shared view is that the dialogue has been constructive. The exposure draft on fair value hedge accounting results in part from this engagement. In addition, the IASB has considered changes on many other significant aspects of IAS 32 and IAS 39 and we understand that you intend shortly to place final text on these aspects on the IASB's website.

IAS 32 and IAS 39 are deeply complex standards and there are elements that remain ill-adapted to business process and may give rise to unwelcome economic consequences. In particular, the false volatility in equity generated by the asymmetrical accounting required by cash flow hedging would distort the financial statements, provide an inappropriate base for management decisions and user analysis, require adjustment for regulatory capital and taxation, and may increase the cost of capital. This would be in direct contradiction to the objectives of international accounting standards and the European Union's Financial Services Action Plan.

For these reasons, we believe that there is merit in a further concerted effort to resolve issues that remain outstanding. These relate specifically to hedge effectiveness and the need to find an acceptable basis for accommodating the interest rate risk arising from core deposits within fair value hedging. In addition, we believe that it would be beneficial for the IASB to make a public undertaking to make good any possible unforeseen consequences of the text on other issues that will be published without, as we understand, further consultation.

Once we have held further discussions on the macrohedging issues we will also need to consider how best any resulting approaches can be field tested in advance of IAS 39 being finalised.

IAS 32 and IAS 39 are pivotal standards for the banking industry and their endorsement into European law would constitute a landmark in the recognition of international accounting standards. We remain willing to work with the IASB with the aim of bringing about this substantial achievement.

Yours sincerely

Paul Chisnall

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London EC2N 1EX

Tel: +44 (0) 20 7216 8800
Fax: +44 (0) 20 7216 8811

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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

Opening statement

In submitting this memorandum on the Exposure Draft of Proposed Amendments to IAS 39 'Financial Instruments: Recognition and Measurement' on 'Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk', the British Bankers Association[1] would like to underline its support of the objective of the development of international accounting standards:

- A common accounting base across the European Union would constitute a landmark in the development of the financial infrastructure underpinning European financial markets.

- The full adoption of international financial standards by the European Union by 2005 would constitute a major step towards achieving global accounting standards.

- International accounting standards have the potential of substantially reducing the cost of capital, if combined with progress on corporate governance and in the use improved communication with shareholders, potential investors and intermediate providers of financial information.

Since the roundtable meetings in March, IASB Board and staff members have worked towards dealing with many of the problems generated by IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement'. A constructive dialogue has been opened up with the banking industry – the BBA has been part of a delegation of the European Banking Federation that has met with the IASB on several occasions – and the exposure draft on fair value hedge accounting is a consequence of that dialogue.

During this time, many other amendments to IAS 32 and IAS 39 have been agreed by the IASB, on issues as diverse as the basis for calculating interest rates, loan impairment and fair value measurement itself. The outcome has been a significant improvement in the two standards with the prospect that both should be more coherent and, as a result, considerably more straightforward to implement than otherwise would have been the case.

[1] The British Bankers' Association is the principal representative organisation of the banking industry in the UK. Its membership comprises the many banking and financial services institutions that operate in the UK markets. It is also an active participant in the European Banking Federation.

IAS 32 and IAS 39, however, remain deeply complex standards and the Board's constituents are not yet in a position to validate the operability of the proposed changes. Moreover, aspects of the standards remain that are ill-adapted to business process and may give rise to unwelcome economic consequences. In particular, the false volatility in equity generated by the asymmetrical accounting required by cash flow hedging would distort the financial statements, provide an inappropriate base for management decisions and user analysis, require adjustment for regulatory capital and taxation, and as a result may increase the cost of capital. This would be in direct contradiction to the objectives of international accounting standards and the European Union's Financial Services Action Plan.

Furthermore, interest rates have been relatively stable in the US since the introduction of SFAS 133 'Accounting for Derivative Instruments and Hedging Activities'. Given that the market expectation in many countries is for rises in interest rates over the medium term it can be expected that the consequence of cash flow hedging, whether under SFAS 133 or IAS 39, will be of greater significance in the future than in the past.

We are therefore of the view that a final concerted effort is needed to render IAS 32 and IAS 39 acceptable.

The remainder of this submission comprises:

- Comments on the issues raised by the exposure draft on fair value hedge accounting, including hedge ineffectiveness, core deposits and internal transactions.
- Comments on other issues discussed by the Board during the course of the year.
- Concluding remarks.

Issues raised by the ED on fair value hedge accounting

Working within the rule that all derivatives must be measured at fair value

The European banking industry has made a major concession towards convergence with the United States by undertaking to work within the rule that all derivatives must be measured at fair value. This needs to be appreciated as it is this premise that lies at the heart of the difficulty in finding an appropriate basis for reflecting sound risk management process within IAS 32 and IAS 39. At present within the European banking industry, all derivatives held for trading are measured at fair value, but derivatives mitigating interest rate risk arising from the banking book are measured at accrued cost, ensuring that the counterbalancing interest on the hedge is accrued on the same basis as the underlying position.

The instruments involved are not particularly complex, more often or not being plain vanilla swaps, in which one party transacts with another to swap interest flows from a fixed index for interest flows from a variable index. Terms are standard and transparent and the economic effect is that institutions forego profit in order to avoid loss as a result of unforeseen changes in interest rates. This enables banks to manage their risk exposures in an efficient way and is compatible with the longstanding objective of retail banking which is to earn a stable margin between lending and funding – whether in terms of the core deposit base or funds raised on the wholesale money markets or by other means.

This accounting is particularly relevant in a European context as securitisation is much less developed than in the US and it is much more common for loans, particularly mortgage loans, to be retained by the originating institution until expiry. It results in the hedge obtaining the same treatment as the hedged item, thereby ensuring that gains or losses on the hedge are reflected in the income statement in accordance with their economic purpose.

One course open to the IASB would have been to base IAS 32 and IAS 39 on this approach. This, however, was rejected by the IASC, which instead determined that international accounting standards should follow US SFAS 133 'Accounting for Derivative Instruments and Hedging Activities' in applying the rule that all derivatives should be measured at fair value.

In order to attempt to find a solution on macrohedging in time for the adoption of IAS by all listed companies in Europe by 2005, the banking industry undertook to work within the confines of this rule. While this remains an approach that we are willing to pursue, it needs to be understood that as a consequence a rules-based solution may be needed to overcome its shortcomings.

Fair value hedge accounting

The exposure draft aims to make fair value hedge accounting more accessible and reflects many of the suggestions made by banks and others in discussions held following the roundtable meetings. In particular, it aims to make macro fair value hedge accounting feasible by:

- » Allowing hedge accounting to focus on interest rate risk.
- » Permitting hedge effectiveness to be based on expected, rather than contractual, repricing dates.
- » Envisaging fair value changes to be shown as a single line entry in the balance sheet.
- » Permitting fair value changes to be estimated using statistical and other techniques.
- » Allowing derivatives to be combined for hedging purposes, including where risk offsets.

But the exposure draft also reflects the fact that it was not possible to reach agreement in two areas: hedge ineffectiveness and demand deposits.

Hedge ineffectiveness

At issue is whether hedges become ineffective as a result of lower than expected prepayment on loans and mortgages. The IASB considers that the resulting open position would constitute ineffectiveness. Risk managers, on the other hand, would consider the hedge to remain effective providing it counterbalanced equal and opposite risk and would deal with the open position as part of the next periodic review of the bank's hedging needs. This is more in keeping with the overall aim of risk management, which is not to eliminate risk but to bring the exposure within tolerable parameters.

The IASB's preferred approach has the benefit of reducing the amount of ineffectiveness as the hedged amount is based on a proportion of the assets and not a layer. Defining ineffectiveness as the Board proposes, however, results in fair value being extended since ineffectiveness will be generated from the asset and not the hedge.

The in principle reason why the banking industry favours Approach B/C is that underhedging should not result in hedge ineffectiveness. If, however, the IASB can build this into Approach D, then it may be possible for agreement to be reached on the basis of the IASB's preferred option.

Core deposits

The second area of disagreement is demand deposits, such as current accounts and savings accounts, with the IASB arguing that the maturity of these must be based on their contractual on-call maturity rather than the basis on which banks hedge the exposure to interest rate risk. As a result, banks will not be able to use fair value hedge accounting. Banks with large demand deposit bases will therefore be obliged to adopt cash flow hedging and will have to endure the false volatility in equity that this entails. Unless addressed, this will substantially impair comparability between institutions.

Lending is the prime function of banking. Within the lending process, banks draw upon monies deposited. The maturity transformation that this involves requires banks to take a view about the expected maturity of both lending and the deposit base – an exercise that clearly needs to be conducted on a portfolio level.

The IASB has concluded in its deliberations that core deposits cannot qualify for fair value hedge accounting. This is because of concern that permitting maturity based on a time period beyond the shortest period in which the counterparty can demand payment would result in a fair value gain on initial recognition as a result of the liability being less than the amount repayable on demand. The IASB also took the view that specific deposits are unlikely to be outstanding for an extended period, but are instead withdrawn and replaced with new funds, and observed that it can see parallels between the core deposit base and a portfolio of trade payables.

We would like to make it absolutely clear that the banking industry is neither arguing in favour of core deposits be measured at fair value nor proposing that a gain be recognised on the origination of a core deposit. What we are arguing for, however, is the ability to include within fair value hedge accounting the exposure to interest rate risk arising from the core deposit base. This is the only rational basis on which to reflect within financial statements the interest rate risk management undertaken. We believe that this can be achieved through specific provisions within IAS 39 and consider arguments about the fair value of the core deposit base to be an irrelevance.

Turning to the second of the IASB's stated concerns, we take the view that the details of individual transactions are lost at a portfolio level and that the distinction between 'old' and 'new' money has no real bearing. The key point is that experience consistently shows that the core deposit base is stable and can be expected to grow over time in line with GDP.

Given that the focus of what we are seeking is the ability to reflect expected maturity for interest rate risk management purposes and not to generate changes in fair value, we do not consider the comparison drawn with trade payables to be valid.

We are therefore of the view that the IASB should allow the fair value effect of changes in interest rates on exposures relating to core deposits to be included within fair value hedge accounting. This is consistent with the underlying economics and risk management processes involved and without this little will have been achieved on macrohedging.

The consequence of not accommodating core deposits within portfolio fair value hedging would be:

- A loss of comparability between institutions as equivalent positions differing only in terms of the significance of the core deposit base will be afforded different accounting treatments disproportionate to any economic difference in the source of funds.

- A loss of comparability year-on-year for specific institutions given that changes in the makeup of the banking book may result in institutions being obliged to switch between fair value and cash flow hedging.

- The false volatility in equity generated by the asymmetrical accounting required for cash flow hedging would distort the financial statements, provide an inappropriate base for management decisions and user analysis, require adjustment for regulatory capital and taxation, and may as a result increase the cost of capital.

Once we have held further discussions on these issues we may wish to consider how best any resulting approaches can be field tested in advance of the publication of the final standard.

Internal transactions

There is a further aspect of macrohedging that requires additional thought: the use of internal transactions as part of the process of managing interest rate risk.

For the avoidance of doubt, we would emphasise that the banking industry is not asking the IASB to tolerate gains or losses on consolidation being generated as a result of internal transactions. We are concerned, however, that aspects of IAS 39 are capable of being interpreted as attaching special conditions to internal transactions when it comes to financial instruments.

That internal transactions should not generate gains and losses on consolidation is a fundamental principle of accounting and should continue to be so. We can see benefit for reaffirming this principle in IAS 39, but would advocate the removal of all commentary beyond this that is capable of being interpreted as imposing additional, specific rules.

Other significant issues

Issues on which there is a clear indication of planned change

As the IASB's monthly newsletter 'Insight' shows, during the course of the year the Board has also discussed issues as significant for the banking industry as loan impairment, the calculation of interest rates and the basis of fair value measurement itself – a full list of issues on which the IASB is intending to revise the text of IAS 32 and IAS 39 is attached. Despite the fundamental nature of these changes, and their potential impact, the Board is not proposing to publish the text for final review. While we appreciate the efforts made to improve these aspects of IAS 32 and IAS 39, not publishing the changes in exposure draft form constitutes a missed opportunity.

Concerns about IAS 32

IAS 32 gives rise to two significant concerns:

- The disclosure regime that it would impose in the event of an inability to apply revised IAS 30 'Disclosures of Risk arising from and other disclosures relating to financial instruments' by 2005.

- The lack of recognition of Master Netting Agreements.

We believe that a solution to the first of these concerns remains on track, in that early adoption of revised IAS 30 would permit a risk-based approach to disclosure and in the process rationalise substantially the information required.

We remain puzzled, however, by the IASB's reluctance to recognise Master Netting Agreements and believe that the outcome will be an over-inflation of bank balance sheets, particularly in comparison to the US counterparts given that such agreements are recognised under US GAAP.

Concluding remarks

Progress has been made since the public roundtable meetings, and all concerned consider that the discussion that has taken place this year provides the beginnings of a dialogue that can only serve the common objective of developing a high quality, coherent set of accounting standards that one day may provide the basis of a global approach.

Further progress, however, must be made if we are to achieve standards on financial instruments that reflect economic circumstance and accordingly merit endorsement into European law within the 2005 timescale set under the European Union's Financial Services Action Plan. In particular:

- The IASB needs to ensure the adoption of an approach to macrohedging that is compatible with the sound principles and economic objectives of risk management.

- A means of accommodating within fair value hedging the exposure to interest rate risk generated by a bank's core deposit base must be found.

- IAS 39 should restrict itself to an in principle statement about internal transactions not generating gains or losses and not include any further comment that may be interpreted as imposing additional, specific rules.

- The IASB should make a public undertaking to make good any unforeseen consequences of other changes that it is planning to make to IAS 32 and IAS 39 within the timeframe for the completion of the standard – ie by March 2004.

British Bankers' Association
November 2003

Appendix: areas of IAS 32 and IAS 39 in which significant change is envisaged

As can be seen from the published record of Board meetings, during the course of this year the IASB has discussed amendments to aspects of IAS 39 other than macrohedging. Significant change is envisaged in several areas:

- **Disclosure requirements**
- **Scope**
- **Financial guarantees**
- **Loan commitments**
- **Effective interest rates**
- **Transactions costs**
- **Purchased loans**
- **Initial measurement**
- **Fair value hierarchy**
- **Fair value option**
- **Impairment**
- **Derecognition**
- **Repurchase or induced early conversion of convertible debt**
- **Puttable instruments**
- **First-time adoption**