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14 November 2003

Dear Sandra

IASB's Exposure Draft of proposed amendments to IAS39 Financial Instruments: Recognition and Measurement – 'Fair Value Hedge Accounting For a Portfolio Hedge of Interest Rate Risk'

I am writing to set out the UK Accounting Standards Board's (ASB) comments on the above exposure draft. Those comments are summarized below, and the Board's reasoning set out more fully in the attached paper.

Hedge designation and the resulting effect on measuring ineffectiveness

In general the ASB welcomes the exposure draft and supports the proposal to allow designation of portions of portfolios of assets or liabilities in each time period, rather than requiring designation of individual assets or liabilities. However, we do not agree with the IASB's conclusions on ineffectiveness for the following reasons:

1. In our view, in situations such as those described in the exposure draft, entities are often hedging only the interest rate risk and are not hedging prepayment risk. For example, where an entity holds prepayable fixed rate loans that are expected to be repaid in, say, five years' time, it will usually hedge the interest rate risk for just those five years, with a five-year interest rate swap. This swap provides no hedging protection against changes in the expected prepayment profile, and the prepayment risk itself is not being hedged.

2. It is our understanding that, under IAS 39, an entity with a single prepayable fixed rate loan is permitted to designate, as the hedged item, the

portion of the risk that is equivalent to the interest rate risk of a non-prepayable loan of maturity equal to the *expected* maturity of the loan. The only requirement is that this interest rate risk is capable of separate measurement – which we believe it generally is. Extending this to portfolios, it should be permissible to regard the hedged risk as the interest rate risk and not the prepayment risk.

3. Where the hedged item is designated in this way, if prepayments arise earlier than originally expected ('over-hedging'), the entity will find itself holding a derivative that was hedging something that no longer exists. In this case unmatched gains and losses on the hedging derivative will be recognised, in line with the exposure draft proposals. However, if prepayments arise later than expected ('under-hedging'), there will be a portion of the interest rate risk relating to the loan that is not hedged. Gains or losses arising from this unhedged exposure should be recognised as they accrue, in the same way as other unhedged exposures on loans held at amortised cost, and not as hedge ineffectiveness.

4. Having established that principle, we consider that the choice of method for allocating changes in expectations of prepayment is of secondary importance. Method C is our preferred solution, although there are also valid arguments for method D, provided it is modified to exclude ineffectiveness on under-hedging.

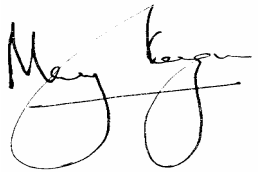
The exclusion of core deposits from the hedged portion of liabilities

We understand that there will be implications for banks if they are not permitted to include core deposits as part of the hedged item for a fair value portfolio hedge. Nevertheless, as explained in the attached paper, we remain to be convinced that fair value hedge accounting is appropriate for such items.

In our view, if hedge accounting is to continue to be permitted in the longer term, the IASB should carry out research with a view to developing approaches that better reflect the economic value of core deposits. However, this is not something that can be achieved in the short time-scale necessary for the completion of the amendments to IAS 39, so we support the IASB's proposed treatment of core deposits.

If you have any questions concerning this letter, or would like further information on any of the comments made, please do not hesitate to contact either Simon Peerless (020 7611 9721) or myself (020 7611 9702).

Yours sincerely



Mary Keegan
Chairman

Attachment to letter to IASB dated 14th November 2003

The UK ASB's comments on ED Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

1.1 The ASB fully supports the IASB's decision to amend IAS 39 to make it easier for fair value hedge accounting to be used for a portfolio hedge of interest rate risk. We consider this to be a practical response to the difficulties encountered by banks and others. The ASB does, however, have concerns over some aspects of the detailed proposals.

1.2 This paper sets out the ASB's conclusions on

- ineffectiveness resulting from changes in expected prepayments (section 2)
- the exclusion of core deposits from the hedged portion of liabilities (section 3)
- additional comments on other aspects of the exposure draft (section 4).

2. Ineffectiveness resulting from changes in expected prepayments of fixed rate loans

2.1 The ASB addressed this issue by considering:

- Should ineffectiveness arise where the expectation of prepayment changes to a later date, or only where it changes to an earlier date?
    - Is prepayment risk in fact being hedged?
    - Does the hedging framework in IAS 39 permit the designation of interest rate risk separately from the prepayment risk?
- What method should be used to allocate changes in the gross assets to the designated portion that is the hedged item?
    - 'Layer' versus 'proportionate' allocation methods.

Is prepayment risk in fact being hedged?

2.2 The IASB's position seems to be based on its conclusion that the prepayment risk of a portfolio of prepayable instruments is an integral part of the interest rate risk on that portfolio, that the two risks are not separated for risk management purposes, and that the two risks cannot be separated for the purposes of hedge accounting. In a portfolio hedge the bank has based its hedge on certain assumptions of expected prepayments and if these expectations change (and as a result the hedging derivatives no longer accurately match the interest rate exposure) then unmatched changes in fair value will arise. Those changes in fair value comprise two parts: the effect of interest rate changes on the originally expected cash flows, and the effect of changes in prepayment expectations. Since the value of the expected cash flows and the prepayment expectations are both dependent on changes in interest rates, the changes in fair value of the hedged item should reflect both effects of interest rate changes on the portfolio.

2.3 The ASB does not agree. We understand that, where normal interest rate swaps are used for hedging interest rate risk of the portfolio, banks do not consider that the prepayment risk is hedged, but is managed separately from the hedged risk. The hedging derivatives are not expected to provide any gain or loss to offset movements in fair value resulting from changes in prepayment assumptions, since the swaps merely match the interest rate risk of a loan with maturity equal to the expected maturity of the hedged position. Thus the risks arising from changes in prepayment expectations are mitigated not by entering into derivatives to provide offsetting gains and losses, but by frequent reassessment of the expected cash flows and adjustment of the hedging derivatives to match the new expectations. This frequent rebalancing of the hedging ensures that the exposures arising from changes in prepayments, and the consequent losses arising from these exposures remaining unhedged, are minimised. This risk management is carried out through a single maturity analysis process; but each time the hedge is adjusted, it only reflects exposure in the portfolio as though the prepayable items were of fixed maturity equal to their expected repayment dates.

2.4 In other words, only the interest rate risk is being hedged, as though the exposure related to non-prepayable loans of the same maturity as the *expected* maturity of the *actual* loans in the portfolio. The prepayment risk is not hedged in the meaning of IAS 39, but is being managed by frequent reassessment of the expected prepayment dates and adjustment of the hedging instruments to match the changed assessment of prepayment dates.

Does the hedging framework in IAS 39 permit the designation of interest rate risk separately from the prepayment risk?

2.5 Paragraph 128 of IAS 39 states that a financial asset or financial liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value; it places no restrictions on what qualifies as a 'portion' other than that effectiveness needs to be able to be measured. This is supported by IGC 128-2, which deals specifically with the hedge of the first five years of an asset with maturity of ten years. If a single prepayable loan were to be hedged, it would therefore be permissible to designate as the hedged item the portion of the loan represented by Libor, up to the assumed repayment date.

2.6 So we believe that, in theory, IAS 39 permits hedge accounting to be applied to hedges of the interest rate risk up to the assumed repayment date. But in practice, would the effectiveness of such a hedge be measurable reliably? We think so, because we can see no particular difficulty in determining the change in the value of the hedged item that is designated in this way, since the hedged item is then equivalent to a non-prepayable fixed rate loan of the same maturity; hence no difficulty arises in determining effectiveness. Indeed, it may be more difficult to value a hedged item that includes the prepayment risk, since this is an optional instrument – it is the prepayment element that is the portion on which measurability issues arise.

2.7 The IASB argues – and we agree – that portfolio hedging should, where possible, follow the principles of hedging of individual items; since we think it is permissible to hedge a portion of an individual loan in this way, it should be equally permissible to designate the portion of the portfolio represented by non-prepayable loans of maturity equal to the expected repayment date of the actual loans in the portfolio.

When does ineffectiveness arise?

2.8 Hedge ineffectiveness should only arise where a hedging instrument is expected to give rise to gains or losses to offset the changes in the designated hedged exposure, and this offset turns out not to be exact. Ineffectiveness should not arise where the hedging instrument was not intended or designated to offset a particular risk.

2.9 Where the expected prepayment is earlier than originally forecast, a portion of the hedging instrument no longer qualifies for hedge accounting (since part of the hedged position is no longer there), and ineffectiveness arises. However, where the expected prepayment is later than originally forecast (say after six years rather than five), there is an unhedged portion of the portfolio; no ineffectiveness arises, because the derivative was not intended to hedge the sixth year. The effects of the interest rate risk being unhedged would affect net interest in that sixth year as interest on the loan and its funding was accrued; that effect is not ineffectiveness, but the normal accounting for an interest rate exposure that is unhedged.

2.10 Accordingly, we do not agree with the IASB's conclusions that ineffectiveness arises on both over- and under-hedging; we believe it arises on over-hedging alone.

Arguments considered by IASB

2.11 The IASB also considered the following arguments on ineffectiveness:

- In paragraph BC21(c) of the exposure draft, the IASB state that 'for a fair value hedge, IAS 39 requires that ineffectiveness is recognised both in the case where the entity is overhedged (i.e. the derivative exceeds the hedged item) and in the case where it is underhedged (i.e. the derivative is smaller than the hedged item)'. We agree. However, the key issue is what is the hedged item and we do not agree with the IASB's view that prepayment risk is part of that item.

- In paragraph BC21(d), a prepayable fixed rate loan is described as capable of being viewed as a non-prepayable loan together with a prepayment option. The paragraph goes on to state that 'applying fair value hedging would require that the change in the fair value of both components, to the extent they are attributable to the hedged risk (i.e. the change in interest rates), is recognised in the balance sheet and in profit or loss'. Again, this is only the case if it is concluded that the prepayment risk is hedged; if it is not, the hedged item may be the same for each

portfolio, and thus the recognised change in fair value under hedge accounting will also be the same.

- In BC21(e) the IASB state that it is extremely difficult to measure the two components – interest rate risk and prepayment risk – separately. However, as noted above, we believe that in general it is possible to measure the change in value in response to changes in interest rates of the portion of the loan represented by a non-prepayable fixed rate loan of maturity equal to the expected prepayment date of the actual loan. There is no requirement in IAS 39 to be able to measure the portion that is not hedged.

- In BC21(f) the IASB state that 'the objective of applying fair value hedging to a hedged item designated in terms of an amount (rather than as individual assets or liabilities) is to obtain the same results as if individual assets or liabilities had been designated as the hedged item'. We agree with this statement, but think that as it is possible to designate a portion of an individual loan that excludes the prepayment risk, the same should be true for portfolios.

- Paragraph BC21(g) makes the point that a portfolio of prepayable loans may be less sensitive to interest rate risk than an equivalent portfolio of non-prepayable loans and therefore where these are hedged, the change in balance sheet carrying amount should be different for two otherwise identical portfolios. However, if the risk that is hedged does not include the prepayment risk, there is no reason for the change in carrying amount to be different – the change in fair value of each portfolio reflects the same risk.

2.12 On the basis of the above analysis, the ASB has concluded that:

- Banks typically manage the risk of a prepayable loan by hedging the portion of interest rate risk that is attributable to a non-prepayable loan of maturity equal to the expected maturity of an actual prepayable loan in the portfolio; the interest rate risk for the period beyond the expected maturity date, and the prepayment risk, are not hedged.

- Designation of the interest rate risk for the period to the expected maturity date, and excluding the prepayment risk, as the hedged risk is consistent with the 'portions' provisions in IAS 39.128 and IGC 128-2.

- Ineffectiveness arises when prepayments are expected earlier than originally forecast, but does not arise if they are expected later than originally forecast.

What method should be used to allocate changes in the gross assets to the designated portion that is the hedged item – 'layer' versus 'proportionate' allocation methods

2.13 As set out in the exposure draft, the 'layer' approaches (A, B and C) do not recognise ineffectiveness on underhedging (ie where the expected prepayments change to being later than originally forecast); whereas the 'proportionate' method (method D) does, and this distinction forms part of the basis for the IASB's preference for method D. However, this does not appear to be a necessary distinction; the top layer approach (method B) could be amended so that the hedged item was increased by the amount of any increase in the gross portfolio. On the other hand, in line with our conclusion above that ineffectiveness should not arise on underhedging, the proportionate method (method D) could be modified by 'capping' to take into account reductions in the assets but not increases.

2.14 Accordingly, the ASB does not see the choice between the approaches as really being a question of whether ineffectiveness is two-way or one-way. In its view, the issue is more about needing to take into account the extent to which the allocation to the hedged portion of changes in the gross portfolio results in meaningful ineffectiveness recognition.

2.15 Our analysis is best illustrated by an example. Assume a fixed-rate portfolio (in a particular maturity bucket) of assets of 100 and liabilities 80, and that the 20 surplus of assets is hedged with a pay-fixed/receive-variable swap. During the period, suppose interest rates fall, and as a result the fair values of the assets and liabilities increase by 10%; and the swap also shows a loss of 10% of its notional principal. Assuming IAS 39's other hedging requirements are met, the entity will recognise a loss of 2 on the swap, and an offsetting gain of 2 on the hedged item (20% of the loans). In addition, there will be an unrecognised increase in fair value on the liabilities of 8, offset by an unrecognised increase in fair value on the portion of the assets other than the hedged item of 8. Suppose also that prepayment expectations have changed so that, at the end of the period, the assets allocated to this maturity bucket have been reduced to 90.

<u>'Bottom layer' approach (method A)</u>

2.16 Under the 'bottom layer' approach (method A), the assets no longer in the bucket are treated as being part of the assets that are not hedged by the swap. So the gains and losses on the hedged item are unchanged, with a gain of 2 and offsetting loss of 2 recognised. However, the unrecognised change in value of the liabilities, of 8, is no longer fully offset by the unrecognised change in value of the assets outside the hedged portion, since these are now reduced to 70 and the change in value 7. Accordingly, the ineffectiveness of the hedging strategy has led to a loss of 1, but this has not been recognised as hedge ineffectiveness. Rather, it arises in the unrecognised changes in value of assets and liabilities held at amortised cost, and will emerge over the remaining life of these items as a difference between interest paid and received.

2.17 The 'bottom layer' approach is based on the premise that the swap is effective provided there is a sufficient 'pool' of assets to cover the swap. This appears to be allowed under the cash flow hedging method for portfolio hedges set out in IGC 121-2. In paragraph BC21(a) the IASB states that IGC121-2 should not be seen as a parallel, as

different considerations apply; the fair value hedge is relating to assets (or liabilities) that are already recognised on the balance sheet, whereas the cash flow hedge is related to probable future cash flows. However, the IASB does not explain why this distinction should lead to a different conclusion as to the appropriate treatment for portfolio hedges.

2.18 In paragraph BC21(b) the IASB argue against the bottom layer approach on the basis that it would be rare for any ineffectiveness to be recognised. This in itself does not appear to be a valid argument; ineffectiveness should be recognised only where it actually arises, and should not be 'created'. However, the ASB shares the concern that the 'bottom layer' approach recognises ineffectiveness only where the reduction in assets exceeds the amount offset by liabilities – so that although the entity has taken out swaps that have not had the effect of offsetting fair value movements in the portfolio hedged, they are not identified as ineffective. Instead, the assets no longer in the hedged item are assumed to have been covered by the natural hedge provided by the liabilities. As a result, there will be unrecognised changes in the fair value of these (now unmatched) liabilities that are no longer offset by changes in fair value of assets. The ASB's view is that this represents the overall hedging strategy as effective when it is not. For that reason we do not favour method A.

'Top layer' approach (methods B and C)

2.19 Under the 'top layer' approach (method B), the assets no longer in the bucket are treated as being part of the hedged item. As a result, all the ineffectiveness of 1 (in the example above) is recognised immediately; the unrecognised changes in liabilities and the assets other than the hedged portion offset each other. The 'top layer with cushion' approach (method C) is simply an extension of the top layer approach where the entity leaves part of the net exposure unhedged, and this unhedged layer is the first to absorb reductions in the assets in the portfolio.

2.20 In the ASB's view, the 'top layer' approaches can be seen as flowing logically from the risk management strategy – the bottom layer is the 'naturally hedged' layer offset by liabilities, the next layer is the layer that management have deliberately hedged by swaps, and the top 'cushion' is the amount, if any, they have deliberately left unhedged, perhaps precisely because it is uncertain that these amounts will actually be there. Although it is not clear that this is necessarily the only acceptable way of looking at the hedging strategy, it seems that ineffectiveness determined under this approach most closely represents the outcome of the hedge from management's perspective: no ineffectiveness arises if the reduction is within the 'cushion' layer that management has determined is *not* hedged, but below this unhedged cushion, any further reduction in assets leaves an equal amount of the swap unmatched and thus ineffective. The ASB therefore considers that the top-layer method is acceptable.

2.21 One of the IASB's concerns about method C is the size of the 'cushion', and whether an arbitrary limit needs to be imposed to prevent abuse. We do not consider that such a limit is required. The 'cushion' represents the portion of the net exposure that the bank has left unhedged; banks will have an incentive to keep this unhedged layer to an

acceptably low amount consistent with their risk management policy. On the other hand, it is also inappropriate for a standard to introduce a threshold that would have the effect of requiring entities to hedge a higher proportion of the risk than they would otherwise choose to do. An entity that wishes to leave an exposure unhedged should not be precluded from doing so; and the accounting treatment of an unhedged exposure relating to assets and liabilities held at amortised costs should be reflected in the same way, as interest is accrued in net income, irrespective of whether the exposure is the unhedged portion within a designated portfolio hedge, or is unrelated to a portfolio hedge.

'Proportionate' approach (method D)

2.22 In line with our earlier conclusion that ineffectiveness should not arise with underhedging, we consider that method D should be modified to take into account only reductions and not increases in the gross assets.

2.23 Under such a 'proportionate' method, a proportion of the overall ineffectiveness of 1 (in the example) will be recognised immediately; the remainder of the overall ineffectiveness of 1 will represent the amount by which the unrecognised change in value of the liabilities will exceed the unrecognised change on the assets other than the hedged portion. It will not therefore be recognised. This incomplete recognition of ineffectiveness may be criticised in the same way as the bottom layer approach. However, it can be argued that this approach is consistent with the portfolio hedge being viewed as a gross portfolio of assets that is hedged by both liabilities and swaps, with the swap hedging a portion of the gross assets. Therefore each asset is partly hedged by the swap and partly offset by liabilities. This is in contrast to the view that the hedging swap is a hedge of a net exposure in the existing assets and liabilities and is more consistent with the model of portfolio hedging proposed in the exposure draft. Accordingly the ASB would accept this modified method D, although we consider on balance that method C is preferable.

Conclusion

2.24 The ASB does not consider method A to be acceptable. Our preference is for method C (and method B is a special case of this where no unhedged cushion is left) which we consider results in the most meaningful measure of ineffectiveness. Valid arguments for the proportionate approach (method D) can be made, although in the light of our earlier conclusion that ineffectiveness should not arise on underhedging, method D should be modified to take into account only reductions and not increases in the gross assets.

2.25 Since there is no clear conclusion on the most appropriate method, weight should also be given to the practical considerations of each method; if one method gave rise to significantly less complicated systems requirements or lower implementation costs, we would see this as a deciding factor in its favour.

3. Exclusion of core deposits from the hedged portion of liabilities

3.1 In the ASB's view, as explained below, a hedge of the fair value interest rate risk inherent in core deposits does not fall within the boundaries of the hedge accounting model that is defined in IAS 39, but rather is more in the nature of a hedge of an unrecognised intangible asset. However, because there are clear economic reasons for banks to hedge their core deposits and the economic results of this hedging appear not to be accounted for under IAS 39 in a way that reflects the risk management process of a banking entity, we think the IASB should carry out further research with a view to developing approaches that better reflect the economic value of core deposits. We recognise that this research will however take some time, and would support the position taken by the IASB in its exposure draft in the meantime.

Nature of the item that is being hedged

3.2 The accounts making up the core deposit portfolio include 'revolving' accounts where funds are continually withdrawn and replaced; and the level of core deposits that is hedged represents the 'low water mark' below which the total deposits are not expected to fall. Accordingly, in the ASB's view, the value attributable to the core deposits portfolio comprises (at least) the following components:

	(A) Nominal amount of deposits
less	(B) Discounting adjustment to reflect deferred withdrawal of existing deposits
less	(C) Value[1] of future deposits from the same depositors
less	(D) Value[1] of future deposits from new depositors
add	(E) Costs of maintaining branch network, marketing etc., and costs of services provided free to customers

3.3 Components B, C and D are sensitive to interest rates. There is evidence from market transactions (in the US, where portions of banking businesses comprising essentially a deposit portfolio are bought and sold by banks, and intangible assets, core deposit intangibles, are recognised in the fair values on acquisition) that these components of value exist and are capable of valuation.

3.4 However, in order to qualify as a hedged item in a fair value portfolio hedge, these components must be part of the recognised financial liability. Of the above components, only A and B could properly be considered as part of the fair value of the financial instruments that are held at a particular time. The other elements relate to future expected transactions and, in our view, are better characterised as an (unrecognised) intangible asset. Under IAS 39, fair value hedge accounting can be applied only to recognised assets; furthermore, an item that is not a financial instrument cannot be

[1] i.e. the difference between the amount of the expected deposit and the discounted value of the subsequent repayment of the same amount, taking into account the period for which the deposit is expected to be held.

designated as a hedged item in relation to interest rate risk alone, but must be designated either for foreign exchange risk alone, or in its entirety for all risks.

3.5 Accordingly, in the ASB's view core deposits cannot be treated as part of the hedged item within the fair value hedging framework of IAS 39. In theory the standard should not – but currently does – prevent the interest rate in component B being hedged. In practice, the expected repayment period of the existing deposits will usually be so short that the change in the fair value of component B as interest rates change will be very small, so generally there would be little purpose in hedging solely this risk.

Economic rationale

3.6 From a business perspective, banks consider that components B, C and D all give rise to a genuine exposure to changes in interest rates. Banks have a substantial deposit base that provides very stable interest-free (or low interest) funding that, with a high degree of certainty, will remain for a period of several years (based on previous history and statistical analysis of customer behaviour). As part of the bank's treasury management, these funds may be invested in short-term investments such as treasury bills; accordingly, as interest rates change, the income from the investment of the core deposits varies, and hence the benefit to net interest margin of the interest-free deposits varies, giving fluctuations in net interest margin. The banks wish to limit these fluctuations to maintain a consistent margin, so they enter into interest rate swaps that offset the variability in the interest. The management of this core deposit hedging is carried out as part of the maturity scheduling used to determine the hedging for other fixed rate exposures such as fixed rate loans and term deposits; core deposits are treated for this exposure scheduling as fixed rate exposures of a maturity equal to the period for which the deposits are expected to remain.

3.7 For some banks, their portfolio hedging net position will sometimes be a net asset, sometimes a net liability covered by liabilities other than core deposits, and sometimes a net liability including core deposits, where their hedging will be restricted. This will vary from period to period, and from maturity band to maturity band at any one time. The inability to treat the perceived interest rate risk on core deposits in the same way as the bank's other interest rate risks means that, although economically the risks may be appropriately covered, the hedge accounting results will be inconsistent, with some gains and losses on hedging instruments offset by recognised changes in the value of the hedged item, and other similar gains and losses recognised in profit and loss without offset. This leads to inconsistent results of hedging strategies, and also requires additional systems to deal with these differences.

3.8 We believe that, as these hedges may be viewed as hedges of future margin and relate to expected future deposits, they are more naturally classified as cash flow hedges than fair value hedges. We understand, though, the complexity of splitting the core deposits hedging from other portfolio hedging of interest rate risk. Additionally, the application of the IAS 39 model of cash flow hedging to core deposits could give rise to very large fluctuations in equity as a result of changes in interest rates. Some

commentators argue that there is little or no economic meaning to these fluctuations, which are likely to be misinterpreted by users of accounts. The consequences of this are of considerable significance to banks because, to avoid equity being affected in this way, they may change their hedging and risk management strategies and their lending policies, so as to reduce the potential impact. This will obviously have wider implications for the economy and capital markets.

Conclusions

3.9 The ASB agrees that core deposits have an economic value that is not currently reflected in the financial statements. We also agree that accounting policies that do not capture the effect of hedges of that economic value are deficient. However, we do not believe that this is an issue that can be satisfactorily resolved quickly. Furthermore, we consider it essential that the revised version of IAS 39, incorporating the portfolio hedging amendment, is issued before the end of March 2004, and adopted by the EU as soon as possible thereafter. Failure to achieve this would remove a cornerstone of the standards and result in fundamental damage to the body of IFRS as adopted by the EU; without IAS 39, EU listed companies and others adopting IFRS under the Regulation would be operating without authoritative guidance or established practice in a critical area of financial reporting. We therefore support the position the IASB has taken in its exposure draft, although we also think it essential (assuming hedge accounting continues to be permitted) that, in the longer term, the IASB continues to explore ways of extending the hedging model with a view to developing approaches that better reflect the economic value of core deposits.

Other argument considered by the IASB

3.10 Paragraph BC14(c) sets out a further argument used by the IASB in support of their conclusion that we disagree with, although it does not alter our own conclusions. The IASB states that it would be inconsistent to reflect changes in the fair value of core deposits in a fair value hedge, yet measure deposits on initial recognition at nominal amount rather than the lower fair value. We do not consider it necessary for core deposits to be recognised initially at a value different from their face value; merely that, as interest rates change, an adjustment is made (included in the new separate asset or liability introduced for portfolio hedging under the exposure draft) representing the change in the fair value of the core deposits resulting from changes in interest rates in the period in which the core deposits form part of the hedged item. We do not regard this as an inconsistency; other hedged items in a fair value hedge, such as loans held at amortised cost, are measured initially on one basis and their carrying value adjusted subsequently only for changes in the fair value of the hedged portion that occur during the period in which they are hedged.[2]

4. Additional points

[2] In some scenarios the adjustment to carrying value can actually move the carrying value away from, rather than towards, the fair value.

4.1 The ASB has the following comments on other aspects of the proposals in the exposure draft.

Detailed mechanics of the method of determining ineffectiveness

4.2 We believe that there are a number of difficulties that arise from the detailed description of the mechanics of the method for calculating ineffectiveness in the exposure draft which can, in our view, give rise to incorrectly determined ineffectiveness. For example:

(a) In practice a maturity analysis may be drawn up with principal repayments in each maturity band, or alternatively showing the principal outstanding in each band. Under the first method, a loan will appear once only, in the maturity band in which it is expected to be repaid; under the second method, the same loan would appear in each maturity band up to and including the period in which it is expected to be repaid. Under the first method, a normal interest rate swap is shown solely in the period in which the end of its term falls; under the second method, it appears in each maturity band up to that point. The application of the methodology set out in the exposure draft can give rise to differing calculations of ineffectiveness for identical hedging transactions depending on which structure of the maturity analysis is adopted. It appears to us that the 'principal outstanding' method results in ineffectiveness that is consistent with the way this is described in our analysis in section 2 of this paper; to get the same results with the 'principal repayments' method modifications must be made to the basic calculation described in the exposure draft.

(b) Where the net position in a maturity bucket is a net liability, the hedged item will be a portion of the gross liabilities. Where there are changes in expected prepayments of the assets, these will not alter the liabilities and therefore it could be argued that no change in the hedged item would arise – and therefore no ineffectiveness would be recognised. The description of the method should therefore explain how to determine any changes in the hedged item in these circumstances.

(c) A more complicated situation arises where the hedged item is a portion of the assets, but the reduction in assets resulting from changes in prepayment expectations exceeds the amount of the hedged portion; or where the hedged item is a liability, and changes in prepayment expectations increase the gross assets by an amount greater than the hedged portion.

4.3 We believe it would avoid difficulties arising from these and similar situations if the standard set out the objective of calculating ineffectiveness (including specifying whether this was to be identified using a proportionate or top layer approach, and whether it arose on both under and over hedging) but that the detailed method of calculating should be set out only in illustrative examples.

Subsequent accounting for the 'separate item'

4.4 We consider that the standard needs to deal more comprehensively with the accounting in subsequent periods for the separate item recognised in assets or liabilities under paragraph 154; this paragraph states that this item shall be removed from the balance sheet when the assets or liabilities to which it relates are derecognised, but does not deal with its remeasurement in earlier periods. In some cases it appears necessary to amortise this separate item over the remaining period to maturity (or repricing) of the loans, similarly to the requirement in paragraph 157 for amortisation of the fair value adjustment to the carrying amount of a loan. For example, suppose a separate item arises in period 1 in relation to a hedge of assets, and this is matched by the fair value of the hedging swap. If no further interest rate changes occur before the maturity of the loans and the swap, the fair value of the swap will decline to zero over this period; the fair value of the loans will also converge to their principal amount over this period. However, as no changes in interest rate have occurred, the separate item would not appear to be remeasured under the exposure draft proposals.

Methods for determining the change in fair value of the hedged item

4.5 Paragraph A33 states that the standard does not specify the methods used to determine the change in fair value of the hedged item and that, 'if statistical or other estimation techniques are used for such measurement, 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'. We suggest that it would be better for the drafting to include a phrase such as 'closely approximate to ' or 'good estimate of' the measurement of the individual assets. Statistical or other estimation techniques cannot be expected to produce exactly the same answer as individual measurement.

Prospective and retrospective ineffectiveness tests

4.6 Although we had assumed that an entity adopting the portfolio hedging paragraphs of IAS 39 would be required to meet the prospective and retrospective effectiveness tests (i.e. the 'highly effective' and 80%-125% requirements) of the IAS, the detailed method set out in the draft application guidance makes no reference at all to such tests. We note that if the hedged risk is taken to include the prepayment risk, there will be cases where the effectiveness test will not be met, as the hedging instrument would provide no offsetting gain or loss corresponding to changes in fair value resulting purely from changes in prepayment expectations.

Transitional provisions

4.7 Some entities that are currently adopting cash flow hedge accounting for portfolios will want to redesignate these hedges as fair value hedges under the revised IAS 39. It would be helpful if special transitional provisions on this issue could be included in the standard to avoid inconsistent and misleading accounting.