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

United Kingdom

November 6th, 2003

**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**

Dear Sir David,

the German Board of ACI Deutschland e.V. is pleased to comment on the IASB's exposure draft. ACI - The Financial Markets Association has the largest membership of any of the international associations in the wholesale financial markets in the world and Germany is currently the largest national association by membership within the global context.

The comments have been prepared by our Asset- and Liability Management Working Group, which represents the Asset- and Liability managers of Germany's leading banks. The contact person of this group is Mr. Rolf Reichardt (rolf.reichardt@helaba.de, phone +49 69 9132 3142).

We welcome the IASB's aim to bridge the gap between current hedge accounting and best practice risk management in banks. We do also fully subscribe to the three principles for a portfolio hedge of interest rate risk as outlined in the ED Background 3 (i) – (iii), p.5.

It is our understanding that the ED is the result of an ongoing discussion with accountants from the banking industry. However, current hedge accounting rules and the ED have large impacts on subsequent risk management behaviour and data storage. We have therefore outlined best practice risk management in Appendix I and we discuss the implementation issues of the ED in Appendix II. Our comments on IASB's questions are submitted in Appendix III.



Briefly stated our main conclusions with respect to the proposed framework of the ED are:

- We prefer approach C as outlined in BC19 of the ED for a hedge designation of pre-payable items (see comments in Appendix III).
- We submit that the economic maturities of core deposits should also be accepted for hedge accounting purposes as they are in line with best practice risk management. Here, approach A would be most appropriate (see comments in Appendix III).
- Strictly interpreted the ED does not offer improvements to current hedge accounting with respect to system requirements and risk management practice (see comments in Appendix II). Rules for hedge ineffectiveness are risk management artefacts.

In order to overcome the problems discussed in Appendix II we propose a change of the ED, which we believe is in line with its three principles referred to above. We submit three options for your consideration in order of preference with a trade off between risk management practices and accounting requirements from IAS 39.

1. Designate a portfolio of assets and liabilities as well as hedge instruments. Calculate present values based on risk reporting methods of individual banks at the beginning and at the end of each reporting period. The present value differences of the entire portfolio, which may also display hedge ineffectiveness, can be reported as profit or loss. An acceptable method for present value measurement may be to use benchmark interest rates such as Euribor and interest rate swaps.
2. Designate hedged items and hedge instruments based on nominal amounts or cash flows assigned to maturity time periods. The structure of the maturity time periods is set up in line with bank risk management policies. Hedge effectiveness may be demonstrated by pooling several maturity time periods with measurement methods as outlined in the Exposure Draft.
3. As 2. but without pooling of maturity time periods for hedge effectiveness.

In view of the importance of hedge accounting for risk management policies we would highly appreciate the opportunity to discuss our proposals as well as our strong concerns about the ED with members of the IASB.

Sincerely yours,

Jörg Isselmann
President
ACI Germany e.V.

Appendix I: Risk Management in Universal Banks

This section describes best risk management practice in banks, which may differ to some extent between banks. Methodologies for assessing interest rate risk differ as well as the organisational structure. In some banks the asset liability management (ALM) is part of the group centre function, in other banks the ALM is part of the trading division.

The ALM manages the liquidity, interest rate and currency risk of retail and wholesale banking activities (banking book). Trading positions are managed separately.

The risk analysis is based on (contractual and expected) cash flow projections of financial instruments. Most financial instruments define cash flows for a series of future dates. Cash flows may be deterministic or subject to certain events, i.e. interest rate options. Option contracts require additional simulation analyses.

The ALM is concerned about the bank's risk in terms of a global portfolio rather than following a transaction by transaction approach. A basic concept of portfolio management is to aggregate the cash flows of all financial instruments according to defined time buckets. Only aggregate cash flows are subject to risk analysis. These cash flows may capture assets and liabilities, off and on-balance sheet instruments, deterministic as well as option contracts, annuities and interest payments and often model assumptions about structure and probability of designated cash flows. The cash flows assigned to time buckets may be positive or negative and differ in amount, so that some cash flows may (partially) offset cash flows from other time buckets. Similarly, hedge instruments may hedge the cash flows of several time buckets simultaneously. Individual time bucket hedges based on monthly or quarterly buckets are rather an exception to the general risk management approach.

The portfolio risk may be analysed by calculating present values of the aggregate cash flows for different interest rate scenarios or sensitivity analyses (e.g. parallel shift, steepening, flattening and twist scenarios). To achieve or optimise the target risk profile the same procedure will be applied including selected hedging instruments.

As market conditions, business volumes, risk policies etc. may vary over time, the risk management can never be static but is usually set up as a dynamic process. In order to shape the risk position in the currently desired structure, formerly installed hedges may appear to be inappropriate today and will be unwound to form a new position.

There are four crucial points where the present IAS39 regulations may cause frictions with the ALM:

1. The interest rate risk management is generally focussed on effects irrespective of the underlying financial instruments and its different accounting rules.
2. The ALM manages joint asset and liability portfolios and not single product risk.
3. Risk management is dynamic in structure in contrast to the idea of permanent and static micro or macro hedge relationships as prevailing in the IAS39 regulations.
4. Different kinds of non-maturing products (e.g. core deposits) as well as callable loans are modelled to capture the economic interest rate risk profile.

Appendix II: Comments on Implementing the ED

In the current discussions and interpretations of the ED, two potential interpretations of the new approach exist:

- Re-designation of the hedge net position(s) on a quarterly basis.
- Designation for the lifetime of the derivatives involved.

A: Frequent Re-designation

Based on the steps described in A26 (page 11 of the ED) we believe that the following five issues are crucial for an implementation:

(1) Parameters:

It is our understanding that using notional amounts ("Notional") as the basis for assessing the net position is just an example. Instead of the Notional either cash-flow profiles or risk parameters (duration or sensitivities) are used in state-of-the-art risk management techniques. Therefore, we understand that incorporating those numbers (e.g. cash flows) in the calculation of the net position is in compliance with the ED. We believe that all bank specific procedures for assessing the net position should be acceptable as long as the overall aim of the ED has been met.

(2) Length of time buckets:

The length of the maturity time bands must be determined by each bank individually to account for different risk management policies in the industry. As a matter of course the chosen time bands have to be as narrow as necessary to ensure an effective hedge relationship.

(3) Measurement of portfolio changes:

Under A35 the IASB describes potential reasons for ineffectiveness. Given the structure of the suggested portfolio approach, major reasons for ineffectiveness are changes in the identified portfolio since the date of documentation. In this context the number of contracts (loans, term deposits etc.) underlying the identified net position in each maturity time period can lead to extensive calculations. Therefore the ability to track each individual asset or liability is an issue. Given that the majority of German loans cannot be prepaid by the customer without paying the appropriate close out, ineffectiveness arising from changes in prepayment assumptions is not relevant for German banks. We will describe two possibilities to determine the changes. Given that only a minority of German banks will be capable of implementing 3a, the acceptance of both possibilities is crucial and strongly supported by ACI Deutschland e.V.

(3a) Calculation breakdown to each underlying balance sheet item:

Under this approach the bank is tracking each individual asset or liability (to 100% or only pro-rata), which belongs to the identified portfolio since the date of documentation. The changes in Notional or cash flows are summed up for each reporting period.

(3b) The accounting or treasury system delivers aggregated Notional or cash flow profiles for each maturity time band. Based on a constant sample of balance sheet items (which are identical with the net position documented by the bank) the Notional or cash flows are calculated twice. At the beginning of the reporting period (t_0) the position is calculated using

the current loan and deposit data. In t_1 (end of reporting period) the position is assessed again using the then valid data. The difference of both sums is a reflection of the ineffectiveness.

(4) Measurement of Fair Value changes:

Again the quantity of balance sheet items is the major issue with respect to the necessary calculation of fair value changes. We understand that some banks have the ability to calculate present values for each balance sheet item. Other banks cannot do so without investing heavily in data systems. Therefore we appreciate the position of the IASB that the fair value change of a portfolio can be sufficiently calculated without tracking the present value of each individual item involved. It is our understanding that next to calculating the present value of individual assets or liabilities, the fair value assessment can be done based on aggregated cash flows. It has to be ensured that for such a calculation all relevant features of the individual contracts are used. The techniques used should comply with market standards.

(5) Calculating the ineffective portion booked in P&L:

We suggest (as one possibility) the following procedure:

(5a) Assessing the net position and hedged portion as described in A26

(5b) At the end of each relevant reporting period the changes in the hedged portfolio have to be identified.

(5c) Based upon the hedge portfolio's status at the end of the reporting period (excluding the balance sheet items like prepaid loans in the reporting period) the present value of the hedge portfolio at t_0 and t_1 is calculated.

(5d) The fair value change of the hedging derivatives as well as the fair value change of the hedge portfolio (or of the hedged portion) are booked as P&L and therefore, the ineffectiveness will appear automatically in the P&L.

(5e) Close-outs received or paid for adjustments in the hedging instrument as well as the hedged item(s) could be incorporated in the effectiveness testing procedures.

B: Lifetime Designation

From our point of view a "lifetime designation" under the proposed framework is not possible because the data requirements involved cannot be managed. As an example, after 10 years an entity has to distribute its assets and liabilities over 40 maturity time bands (quarterly time bands assumed) and at the same time it has to identify the date of inception of those contracts for the last 40 reporting periods, which implies that up to 820 different portfolios have to be served! Also distributing the cash flows (or Notional) of one individual contract (e.g. an amortizing loan) over several different maturity time bands and tracking such a distribution over the lifetime of a specific hedging relationship is extremely difficult. Such an interpretation of the proposed ED would lead to a consumption of resources exceeding several times the resources needed for the implementation of a hedging approach under the old IAS 39 regime. This would contradict the IASB's aim as described in the ED (background, 3(b), page 4).

C: Final remarks

All banks may have different risk management policies. However, all banks have to comply with standards set out by their regulatory bodies (e.g. BaFin), thereby ensuring quality in risk management. It is our understanding that procedures and risk management techniques

accepted by the regulators should also be in compliance with the IASB framework (interest rate risk profile calculations, maturity assumptions of callable loans etc.).

Appendix III: Comments on IASB's questions

The aim of ACI Deutschland e.V. is to bring state-of-the-art risk management techniques in accordance with the IASB rules. We do not believe that this target has been achieved by the current proposal. Approaches A to D as outlined in BC 19 of the ED cannot perfectly mirror real hedging strategies of the ALM. As a consequence there may be "hedge ineffectiveness". We prefer an approach closer to the economic performance of the ALM as outlined in option 1 of our cover letter.

The following comments are made within the proposed framework of the ED.

Question 1:

We refer to the respective (draft) comments of EFRAG¹ regarding question 1. We prefer, as EFRAG, approach C as outlined in BC19. Approach D would lead to ineffectiveness booked through P&L, which is not in line with the economic performance achieved in the respective treasury portfolio.

Question 2:

Core deposits are not accepted in the ED as a hedged item in fair value hedging. The IASB has given the following reasons for its decision:

- (a) Recognition of core deposits with a value smaller than the face value would directly lead to profit recognition.
- (b) The only "observable" prices for sight and savings deposits are the prices used between client and bank at the beginning and termination of such an account and these are equal to the face value.
- (c) A valuation technique based on expected maturities should also incorporate administrative costs.
- (d) The market value of core deposits is independent of future movements in interest rates since they are viewed as overnight (O/N) positions. Therefore a hedge relationship between an interest rate swap and core deposits would be 100% ineffective.

Ad (a): Many banks use models for describing the behaviour of their core deposits. Some models divide the overall volume into the bottom slice, which is assumed to be stable over a medium to long-term horizon, and the remainder, which serves as a volume buffer.

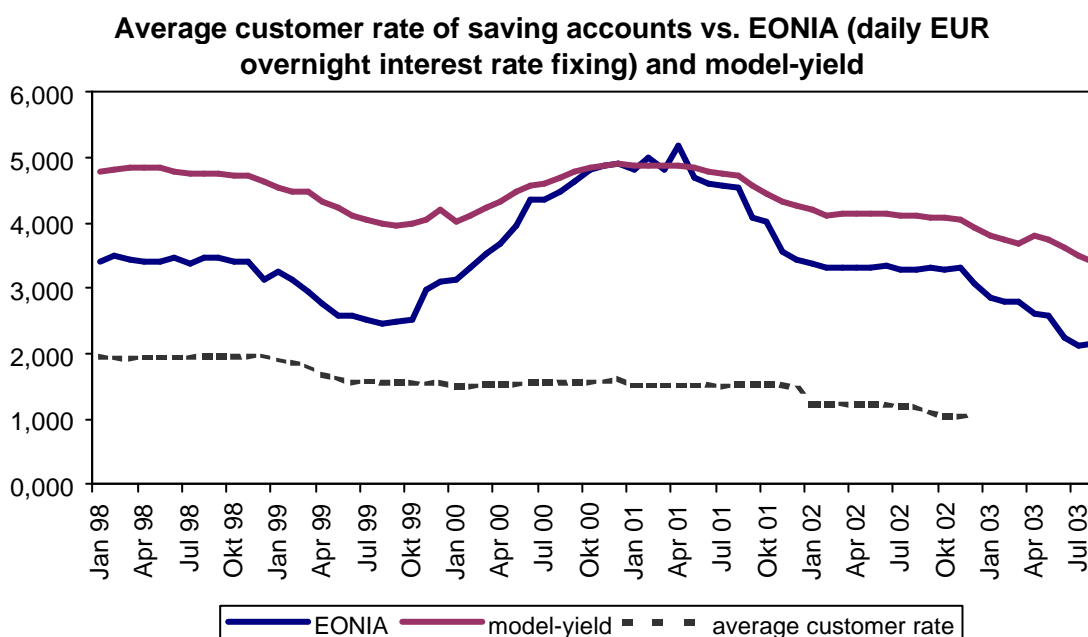
The bottom layer is invested over the medium and long term (therefore, being exposed to changes in fair value) whereas the volume buffer is treated as an overnight position. To give an example: The bottom layer is invested on a 5 year rolling basis (meaning each month 1/60 of the bottom layer is invested for 5 years at the current market rate). The transfer price for the bottom layer is then calculated as the average of the rates pertaining to these contracts. Additionally generated volume will be treated as an O/N position - based on the a.m. model - and will be recognized in the balance sheet with an amount equal to the face value so that no income effects ensue.

¹ http://www.efrag.org/doc/1218_160903EFRAGpreliminaryviewsportfoliohedginginterestrisk.doc

Ad (b): Given state-of-the-art risk management techniques used by many banks, the face value of an individual core deposit cannot be considered as an observable market price. From the bank's point of view, the overall core deposits represent a medium to long-term position. Only from the individual customer's point of view the book value is the appropriate price for a sight or savings deposit. The development of a single deposit cannot be forecasted by the bank. Banks can predict within reasonable margins the future volume of all their core deposits and related interest payments, based on historical data and interest rate scenarios. Using the observable correlation between the interest rate on core deposits and a specified portfolio of hedge instruments, banks may hedge the interest rate mismatches between O/N rates and the actual rate for core deposits. The IASB's arguments in the ED do not reflect current risk management practice in banks.

Ad (c): Future administrative costs are not exposed to changes in interest rates and therefore are not covered by hedging strategies. These costs have to be served out of future interest margins. Therefore, we do not agree that these costs should be incorporated in the fair value calculation.

Ad (d): Changes in medium and long-term interest rates have a strong impact on the economic value of core deposits. The interest margin of core deposits is affected by changes in interest rates as shown in the attached chart.



The present value of future interest margins therefore fluctuates with changes in interest rates and for this reason the overall economic value of core deposits also fluctuates. Banks have to make assumptions concerning the maturity profile of core deposits in order to calculate the interest margins' present value. These assumptions can be reviewed retrospectively ("back testing"). Hedging strategies that succeed in stabilizing the present value of future interest margins should be deemed effective (applying the effectiveness band of 80% to 125%). The effectiveness test may be documented as follows:

Face Value: € 100m

Average customer rate: 0.85% p.a. (E30/360)

Current O/N rate: 2.14% p.a. (E30/360)

Modelled maturity profile: 5 year (monthly) rolling basis

Hedging: Portfolio of equally weighted 1, 2, 3, 4 and 5 year interest rate swaps

→ Margin: 1.29% p.a.

→ The present value of future interest margins: € 3.1m

Assumed interest shock: 50 basis points

→ New margin: 0.79% p.a.

→ New present value of future interest margins: € 1.9m

Present value change of interest margins: € 1.2m

→ Fair value change of the swap portfolio: € 1.1m

⇒ Hedge effectiveness: 92%

Alternatively, one could regard the fluctuations in the model yield as the risk that is being hedged (and documented). This would also resemble more closely current practice.

A problem lies in the rule that has to be applied when documenting a hedge only for a portion of the portfolio (cf. BC 18 ff of the latest Exposure Draft). The models for sight and savings deposits widely used in the banking industry assume stable bottom layers (as mentioned previously) that can be invested over the medium to long-term. These models conform to Option A of the Exposure Draft. The IASB favours exclusively Option D, which in our opinion is not compatible with best practice.