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Sir David Tweedie
Chairman IASB
30 Cannon Street
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October 31, 2003

Re : Organismo Italiano di Contabilità (OIC): 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”.

Dear David ,

I am pleased to inform you that the Executive Committee of the OIC (“Comitato Esecutivo”) has issued its comments on the “ED Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk” enclosed herewith.

Please find herewith attached EFRAG’s draft reply to the IASB document together with the comments of the OIC.

Yours sincerely,

Prof. Angelo Provasoli
(OIC – Chairman)

cc: Kevin Stevenson

Attachments

PREFACE

We recognise the progress made by the Board in the treatment of macrohedges and in particular in the possibility of hedging a representative “value” of a net of assets and liabilities as an item without having to identify the single components that form the imbalance. This option does not lessen the impact on organisational processes and information systems but it does resolve the application problems that a strict tracing back to individual operations would have entailed. However, such a tracing back would still be needed if some of the assets forming the imbalance were to be disposed of.

In the same way, we welcome the possibility of including a number of derivatives contracts intended to hedge risk profiles that have changed over time.

While remaining firmly convinced that the correct accounting treatment for hedging operations should be to align the criterion of valuing derivatives with that of the items hedged and not vice versa, we submit below some considerations relating to the two main issues raised in the new partial draft of IAS 39.

Q1. Hedge designation and the resulting effect on measuring ineffectiveness

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 (the repricing date is the date on which the item will be repaid or repriced to market rates). 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?

Draft Response

Whilst we agree with the Board's proposal to designate the hedged item in terms of an amount of assets or liabilities in a maturity time period, rather than as individual assets or liabilities, we do not agree with the Board's proposed approach to the designation of the hedged item and the measurement of ineffectiveness. As explained in more detail below, we consider Approach C to be the appropriate way of designating the hedged item. We further believe that – in the case of a partial hedge – prepayment does not lead to ineffectiveness as long as the amount prepaid does not exceed the amount that was initially unhedged. In the case of less than expected prepayments, we believe that a revision of repricing dates does not lead to ineffectiveness if it is a revision to a date that is later than previously expected.

Our position appears to be in line with the alternative view of the five dissenting Board members set out in AV2, which is that the approach to evaluate effectiveness should lead to the recognition of ineffectiveness only when the net position in the portfolio has become over-hedged. Set out below are the principal arguments that support EFRAG's view:

How should the hedged item be designated?

In our view, the four alternative forms of designation described in BC19 represent only two basic approaches:

1. designation of a layer of assets (or liabilities), and
2. designation of a percentage of assets (or liabilities).

The process of portfolio hedging requires certain steps to be followed, as described in A26. The example in A30 uses a portfolio of fixed rate assets of CU100 and fixed rate liabilities of CU80 within one particular maturity time period (steps A26(a) and (b)). The analysis (step A26(c)) leads to a net risk position of CU20, taking into account the "natural offset" of risk from CU80 fixed rate liabilities.

The next part of step A26(c) is the decision whether to hedge fully the risk of CU20 or whether to hedge partially the risk (i.e. an amount of less than CU20).

Within the layer approaches A – C, the question arises as to how to determine the impact on ineffectiveness of earlier than expected prepayment of some assets.

In example A30, the decision is to hedge fully the net risk position. Consequently, the entity designates assets of an amount of CU20. It appears to be a logical answer that, in case of a full hedge of the net risk position, any amount of earlier prepayment leads to ineffectiveness to the extent of the prepaid amount.

Approach A refers to the designation of CU20 as a 'bottom' layer of assets. It then assumes that any prepayment would be related first to the "unhedged portion of CU80". We do not agree with this approach because, in our view, there is no unhedged portion. The assets of CU80 are (naturally) hedged by the CU80 of fixed rate assets, as described in the example.

In our opinion, the layer (designated amount) of assets has to be related to the net risk position that has determined the amount to be hedged by derivatives, instead of to the total amount of assets. Only such an approach would be consistent with the hedging process required by the risk management strategy, and as described in A27(a) – (c). Therefore, if the net risk position is fully hedged; i.e. the whole of the excess of assets has been hedged, any prepayment earlier than expected will lead to ineffectiveness of the hedge.

In effect, this is the result of Approach B which – without mentioning the term – correctly relates the hedged amount to the initial risk position to be hedged.

Approach D leads to different amounts of ineffectiveness through the use of the percentage calculation and is therefore considered inappropriate. For instance, in the case of a fully hedged net risk position (as described above) prepayment that occurs earlier than anticipated, for instance for an amount of CU10, would result under approach D in ineffectiveness only concerning an amount of CU2 due to the hedge ratio of 20%. We believe that in this example, ineffectiveness should be recognised on the full prepaid amount of CU10.

Does ineffectiveness occur in the case of a partial hedge?

As described above, step A26(c) requires an entity to make a decision about the amount that it wishes to hedge. If the hedged amount is less than the amount of the net risk position (for example, CU16 instead of CU20, as illustrated by the Board under approach C), the hedge is referred to as a partial hedge. In the Board's example of Approach C, there is an unhedged layer of CU4. We would call the CU16 the "derivative hedged layer".

As explained by the Board in BC19, Approach C is based on the same layer approach as Approach B, with the difference of being a partial hedge instead of a full hedge. In fact, Approach C encompasses Approach B. Under a "derivative-hedged layer" approach – following the risk management strategy as described by the given example – prepayments would be assumed to reduce first the unhedged layer of assets, that is, those assets that are neither hedged by derivatives nor by liabilities. As soon as prepayments exceed the unhedged amount of CU4, they would reduce the "derivative-hedged layer of assets" of CU16, and thereby cause ineffectiveness.

We support fully the arguments set out in BC20 and BC26, on the grounds that they are consistent with the described risk management strategy.

We do not believe that there is a need for an "arbitrary rule" to prevent a "cushion" becoming too large. Instead, we believe that, in view of the requirement of consistency with the documented risk management strategy to qualify for hedge accounting, draft IAS 39.142 (a) & (b) does not permit interpretations such as those used in BC23 – sentence 4. Referring to the example in BC23, we believe that it would not be compliant with the amended standard to hedge an amount larger than the net risk position. The maximum of an unhedged amount could be CU20, which would mean that no derivative is being used.

In our view, it is compatible with the current philosophy of IAS 39 that unhedged amounts should not to be related to derivatives that are designated to hedged amounts. Therefore, only prepayments beyond unhedged amounts can lead to ineffectiveness.

It is our understanding that approach D does not recognise the possibility of partial hedging as described above because it relates the hedged amount to the total amount of assets (or liabilities) at the inception of the hedge, without consideration of the “natural hedge” of CU80. Consequently, we do not support approach D.

Does revision of repricing to dates later than previously expected impact effectiveness?

We believe that the problem of later than expected prepayments is not a question of 'layers' and their designation, but of additional amounts of assets to be hedged in future periods that have not been considered for hedging so far. When entities use expected repricing dates, we believe that they hedge only the fair value of the assets that relate to the interest rate risk up to the chosen date (partial term fair value hedge). Within the periods up to that date, prepayment is highly unlikely and does not need to be considered.

We believe that the Board's conclusion that “many entities do not consider these two effects separately” (BC8/21(e)) may not be the right interpretation. Instead, we believe that the described risk management strategy actually does exactly that: it separates the interest rate risk from the prepayment risk by applying a partial-term hedge strategy during the time when no prepayment is expected. The possibility that the asset may remain longer on the books than the designated period is disregarded and not hedged. In so doing, the entity effectively carves out the prepayment risk for the time periods after the expected date. This method designates only the portion of fair value that relates to the interest rate risk for the time up to the expected repricing date, which is permitted under IAS 39 (see paragraph 128).

Revisions of repricing dates to a date later than initially expected extends the time periods for which hedging may be required in future periods because they were not covered by the initial hedge. Such revision would create new assets in future periods to be analysed within the then increased risk position. However, they do not change retroactively the initially hedged position but should be considered as new assets as described in A37, sentence 1. It is important to note that new assets do not only arrive from origination, but also from including more assets than previously estimated for their remaining period until expected repricing date.

It is our understanding that approach D would result in calculating ineffectiveness even when no derivative has been used for a hedge. We believe that in the case of revision of repricing to dates later than previously expected, no ineffectiveness should be recognised because (i) the hedge is (by default) not covering any periods beyond its maturity and (ii) the possibility that items may remain longer on the books was not considered for a hedge when it was entered into. Consequently, we believe that approach D is inappropriate and should not be retained as a possible solution.

OIC comments

In defining the method for determining the “accounting” effectiveness of a macrohedge, it is necessary to start from the premise that it is a case of adopting a convention and not a “rule” that perfectly mirrors operational reality. Viewed in this light, it is perhaps more important to apply the accounting convention coherently over time rather than strive for the most correct “absolute” rule.

The proposals envisaged by the Board for determining the effectiveness of hedging operations in terms of amount all have their pros and cons (as is also clear from the document’s “Basis for conclusions”). Hence, it is difficult to determine an absolute preference for one solution over another.

That said, among the various proposals put forward, the solution favoured by the Board (Approach D) seems to offer the most linear application. As it is a case of operations of aggregates that are in part “naturally” hedged, and therefore not valued at fair value, and in part hedged through derivatives, and therefore valued at fair value, it is difficult and perhaps arbitrary to attribute a variation in the situation as expected at the inception of the hedge to the naturally hedged component or to that hedged through derivatives.

Indeed, the solutions based on identifying layers of hedged assets or liabilities yield different results in terms of hedge ineffectiveness depending on whether the entity is in a situation where the “natural hedge” component is small (e.g. 10 out of 100) or large (e.g. 90 out of 100). In such widely differing situations, entities with exactly the same error in their estimated prepayments (e.g. 20%) would have different situations of ineffectiveness under Approaches A and B because of the different amount of derivative-hedged assets or liabilities.

Furthermore, Approaches A, B and C, which recognise ineffectiveness only in the event of an increase in prepayments compared with expectations, can have an impact on **asset and liability** management. This is because, in order to avoid the risk of highlighting situations of ineffectiveness, entities could be induced to overestimate prepayments in order to highlight a smaller share of derivative-hedged assets or liabilities and so a lower risk of ineffectiveness.

Last, recognition of ineffectiveness only in the event of an increase in prepayments leads to accounting that is not coherent where the over-hedge in one time period translates into an under-hedge in another hedged time period.

However, there are also grounds for supporting EFRAG’s view that a situation of under-hedge should not lead to ineffectiveness as the portion of assets or liabilities representative of the original imbalance and hedged is still present in the portfolio, while the portion added represents a new value that could be the subject of a new hedge on a par with the new assets and liabilities arising in the period.

Another limitation of Approach D concerns the fact that a partial hedge of the imbalance (a frequent occurrence in banking practices) leads to the recognition of situations of ineffectiveness also where prepayments are higher than

expected but within the limits of the unhedged imbalance. This appears to be inconsistent.

Moreover, Approach D leads to the recognition of ineffectiveness when, with overall derivative-hedged values being equal, there are shifts in expected flows between time periods with different derivative-hedged percentages.

Bearing these considerations in mind, Approach C could also be acceptable provided that, as IASB rightly comments, it not be applied in an arbitrary fashion. Therefore, our view is that this approach should be used only in the case of a single macrohedge portfolio that comprises all the “originated” assets and non-trading liabilities (excluding the specifically hedged items) subdivided by time period and for each of which the imbalance (which represents the “hedged value”) and the relative hedged portion are identified. Alternatively, where there is a differentiation of macrohedged portfolios, this differentiation must be based on criteria that have been defined and approved *ex ante* by the competent house organs and officially documented as required under IAS 39 for the recognition of hedging operations.

This approach has the advantage of being more in line with banking practices.

In the light of these considerations and in view of the difficulty of determining the ranking between Approach C and Approach D, one could consider the hypothesis of not obliging entities to use only one of the two methods but rather to specify their method of determining effectiveness according to Approach C or Approach D and to require that this choice be disclosed in the accounts and that it not be modified over time.

Concerning accounting for amounts included under asset or liability items that correspond to the accumulated amounts of the variations in the fair value of the hedged elements, the **derecognition** of these amounts should occur “naturally” over time: on the one hand, the current value of the asset or liability will approach the contract value at expiration, while on the other, the amount entered under such items will tend towards zero.

Q2. The treatment of core deposits

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?

Draft Response

While we recognise the progress made in the Board's proposals addressing existing concerns about portfolio hedging, we question whether the proposals in the draft's paragraph A30(b) go far enough in acknowledging the (essential) difference between a portfolio approach versus an individual item approach. This becomes particularly important in those cases where entities have a net risk position of core deposits, as further explained in detail below.

The benefit of a portfolio approach is that individual movements are not necessarily as important as under an item-by-item approach, because hedging risk can be successful as long as there are sufficient amounts to cover the impact of the hedge. In particular, it is not necessary to forecast the specific development of an individual item as long as there are sufficient amounts available within the portfolio. In fact, this is the precise logic that the Board applied in developing its basis for the portfolio approach to cash flow hedges. Therefore, we are concerned that the Board's arguments presented in support of the proposal set out in this draft run counter to the reason and justification for the adoption of any form of portfolio approach.

Certain financial institutions (such as savings banks in Europe) have a financing structure of stable, long-term low cost funds. Economic reality is that a layer of such liabilities is at the disposal of the entity, and the market value of that layer changes according to the movements in interest rates. Indeed, when interest rates go up, the value of a low carrying interest rate account will increase for the financial institution. This value component is economically linked with the core deposits and underlies the commercial substance of the bank's business. We, therefore, can see good reason to recognise the economic value on the hedged position within a portfolio hedge of interest rate risk.

On the issue of the fair value of core deposits, we understand some of the reasoning behind the Board's view that the carrying amount of a core deposit redeemable on demand cannot be less than the amount payable on demand. However, we do not find all of the arguments convincing.

We do not believe that the amount agreed between the customer and the deposit taker is a market price. We consider it to be the nominal amount

of a financial contract at its origination and settlement rather than the selling price of an existing financial instrument. Selling would require a third party to be involved being different from the two parties to the initial contract.

We agree that a market price for a portfolio of demand deposits can only arise between two licensed deposit takers. However, it is undisputed that such sales occur at prices different to the nominal amounts of the obligations transferred. The fact that such prices may include other elements – as mentioned under BC14 (c) (iii) – does not exclude the possibility (some believe the reality) that this also includes payment for the consideration of expected demand dates.

However, this does not mean that EFRAG is suggesting that core deposits should be accounted for at fair value. Instead, we recognise that hedging the risk involved with core deposits is possible under the provisions of the draft in the form of cash flow hedge accounting. Part of the progress made in the discussions so far is that core deposits can be part of the portfolio that determines the amount to be hedged as part of the “natural offset”.

However, the issue of fair valuing core deposits arises because the Board is attempting to fit the described hedging activity within the current cash flow/fair value hedging classifications of the standard to accommodate the rule of measuring all derivatives at fair value. There are legitimate arguments to support the view that there is sufficient change in the economic value of the deposits that is related to the value change in the hedging derivatives that ought to be recognised.

Under our alternative proposal, there should not be an immediate gain or loss on initial recognition when core deposits are included in fair value hedges because the changes in fair value to be recognised should be limited to the corresponding changes in fair value of the hedging instrument. The inclusion of core deposits in the hedge portfolio with their expected repricing dates should not affect the recognised amount (at their nominal value) in the balance sheet. Instead, we propose that, as an exception, a “valuation adjustment” on core deposits would be recognised. It should be noted that the subsequent changes in value due to changes of the respective yield curve do not correspond with the difference in value between a short term demand deposit of for instance one week and a five year deposit, which could be a substantial amount. They represent only the changes in value between the current and previous measurement date (e.g. one month ago) of for instance a five year deposit. Therefore, the fair value of the hedged core deposits should be determined at inception of the hedge as a memorandum item only. Any subsequent value change recognised should correspond with the change in fair value of the hedging instrument for that time period. As a result, both would be balanced off against each other in the income statement.

In conclusion, therefore, EFRAG believes that the outcome of the draft’s proposal on one consistent single hedging activity – as it stands – remains unsatisfactory because investors will find volatility in equity for some “time periods” whilst offsetting gains and losses through profit and loss – for other “time periods”. This outcome puts entities that have access to long-term, stable low cost funding at a competitive disadvantage over institutions that are required to fund themselves – at least in part – at a more volatile, higher cost level. A pragmatic solution to this problem could be the acceptance by the

Board of a net position of core deposits for portfolio hedging by way of exception in order to meet the need for a consistent accounting solution.

Whilst EFRAG is seeking comments on all the points raised in this letter, as well as any other concerns commentators might have, we explicitly ask EFRAG commentators for their views regarding the treatment of core deposits in a portfolio hedge of interest rate risk:

- **Do you agree with the views and proposed position of the IASB as set out in the exposure draft? Or,**
- **Do you believe that a net position of core deposits should be eligible for fair value portfolio hedging, and if so, on what grounds:**
 - a) because the fair value of core deposits justifies the recognition of its change when hedged? Or,**
 - b) because the fair value of core deposits can be different to their nominal amount? Or,**
 - c) because there is sufficient economic value to balance off the fair value changes of the hedging instruments? Or,**
 - d) as a pragmatic approach by way of exception on the grounds of needing a consistent accounting solution to a consistent business activity? Or,**
 - e) on the basis of some other argument (please specify)?**

OIC comments

Core deposits constitute a stable, significant and structural component of Italian banks' onerous liabilities. They will be increasingly integrated into ALM strategies for the purposes of risk management and hedging operations.

To a large extent, the portfolio of **core** deposits is structural. In essence, if it is true that every individual deposit is without a set **and determinable** duration, it is also true that the portfolio as a whole constitutes a rather broad layer that represents a source of deposits and hence a liability that is sufficiently stable over time.

In this light, this stable component of liabilities must be treated in the same way as the other financial liabilities and assets of the banking book, both in terms of determining the assets and liabilities to be hedged through macrohedges, and for the purposes of designating a hedged liability in the case of a "liability net position".

The Board maintains that such items cannot be designated "hedged items" because valuing **core** deposits at fair value would mean entering capital gains in the accounts from the moment of the inception of the hedge, as such deposits generally carry nominal rates that are lower than market rates and because their fair value cannot be different from the nominal value.

Concerning initial recognition of capital gains, the problem resolves itself through the management of the **change** in fair value rather than in absolute terms. Only the **change** in fair value between the inception of the hedge and the subsequent measurement needs to be determined. This is in line with the principle laid down in paragraph 153 subsection (b) of IAS 39, under which differences in the fair value of hedged items must be accounted for in the profit

and loss account only to the extent to which they are attributable to the hedged risk and only from the time when the hedging operation **starts**, therefore without considering **previous changes** in fair value, which reflect an unhedged risk.

Concerning the accounting, the deposit would remain entered at the nominal value and the above **change** in fair value would be accounted for in a separate balance sheet item.

Concerning the value of a **core** deposit, if it is true that for the individual depositor this coincides with the nominal value, then in the event of a transaction with a third party, where market rates differ from those contracted, the price would certainly be different from the nominal value of the deposit.

In the same way, within the scope of valuing an entity, the valorization of a hedged portfolio of deposits is certainly different from that attributed to an identical unhedged portfolio (naturally, always in a situation where market rates differ from nominal rates).

Other Comments

Concerning the determining of hedge effectiveness, the link between the provisions in the previous draft of IAS 39 (hedge ratio 80-125%) and the proposals in the new draft is not clear. The option to determine the hedged “value” in terms of expected rather than contracted cash flows increases the likelihood (because of the prepayments variable) of a partial ineffectiveness of hedging operations. Under the new provisions envisaged by the Board, this ineffectiveness must be calculated proportionately in percentage terms.

As the new provisions are to be in addition to the existing paragraphs of ED 39, it appears that the range provision remains in force. If so, then where the percentages are outside the 80-125% range, the whole operation should be considered ineffective and hedge accounting should be suspended.

However, our view is that the logic for determining the ineffectiveness for macrohedges should not co-exist with the above-mentioned range; the range should apply only to cases of specific hedges.

Where ineffectiveness arises in terms of the above threshold values in an aggregate hedge, the dynamic management of hedges enables new hedging operations to be implemented so as to make the hedge effective again for the future. In this situation, the suspending of “hedge accounting” **is not appropriate**.