POSITION PAPER

ESBG Response to:
IASB's Exposure Draft of Proposed Amendments to IAS 39 – Exposures Qualifying for Hedge Accounting

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ESBG

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Introduction

The European Savings Banks Group (ESBG) welcomes this opportunity to comment on the International Accounting Standards Board's (IASB) exposure draft (ED) of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement. We believe in the importance of working towards the adoption of a solution to ensure that all European banks can implement the hedge accounting provisions and, for that reason, we welcome the efforts made to clarify the existing IAS 39 hedge accounting rules. At the same time, we consider of utmost importance to find a solution that takes into account the risk management practices applied by banking organisations.

Our main concern in relation to the ED is that it does not take into account the specificities of those banks that grant mainly fixed-rate loans and, at the same time, fund themselves primarily with fixed-rate commercial liabilities paying interbank rates minus a margin. These institutions face significant interest rate risk arising from mismatches between those assets and liabilities. Management of interest rate risk on a comprehensive basis is central to these banks' business models. Hence, we are of the opinion that hedge accounting principles should converge with portfolio-based risk management practices. We are concerned that this is not achieved to a sufficient extent by the ED.

Furthermore, we believe that the timing chosen by the IASB to present this ED is not the best, as discussions are still underway between the Board and the European banks to find an acceptable solution to the existing "carve-out" for IAS 39 in the European Union. Moreover, the current ED seems to be incompatible with the "carve-out", as it notably proposes to amend paragraph AG 99C, which is not adopted in the European Union. In our opinion, it would be better not to adopt the proposed ED before all hedge accounting issues raised have been properly addressed.

Answers to the questions asked in the exposure draft

Question 1 - Specifying the qualifying risks

The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y. Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why? Are there any other risks that should be included in the list and why?

We do not support the proposal to restrict the risks that qualify for designation as hedged risks. The rule-based approach developed in the ED limits arbitrarily the risks that may be hedged and provides no clear principle-based framework for determining risks eligible for hedge accounting.

This prescriptive approach is ineffective and results in a list of risks that is incomplete and that will rapidly become outdated with the evolution of markets and risk management practices. The finite list resulting from this approach already fails to capture the diversity in risk management practices existing across industries and economic environments. Equity and inflation risks are for example missing from the proposed list. Additionally, we question the rationale for defining some risks, such as interest rate and foreign currency risks while others, such as credit and prepayment risks are not defined.

We are of the opinion that detailed research should instead be undertaken to define the principles that should be used to identify risks that may be hedged. We believe that any risk, which is clearly and closely related to a hedged financial instrument, should be eligible for hedge accounting as long as it is clearly identifiable and measurable.

Question 2 - Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item

The proposed amendments specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item. Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why? Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item? If so, which situations and why?

The ESBG does not agree with the proposed amendments relating to the designation of portions of cash flows.

Hedging commercial liabilities paying LIBOR minus a margin:

We believe that throughout the ED there is confusion between risks and portions of cash flows. Reporting entities hedge risk, not portions of cash flows.

Restrictions on hedges of commercial liabilities prevent a symmetric treatment for assets and liabilities. For commercial liabilities, the ED ignores market practice where:

- transaction-specific commercial margin is excluded from the hedged risk definition;
- only generic risk (the benchmark interest risk) is transferred to the market and therefore hedged – as opposed to the margin, which is specific to a particular transaction and cannot be sold to a third party.

Example:

Consider for instance the situation of an entity facing a refinancing risk related to a ten years fixed rate loan only financed for the first five years by a fixed rate liability. Before hedging its interest rate risk, the entity is exposed to a risk of an increase in interest rates. In order to hedge its interest rate risk relating to the future resource it will be required to raise in five years, the bank enters into a forward starting swap in 5 years for 5 years paying fixed / receiving floating.

With the following assumptions:

- benchmark rate (or swap rate): flat at 3%;
- fixed rate loan, 10 years 4% loans (benchmark rate + 1%);
- fixed rate liability, 5 years 2% deposits (benchmark rate minus 1%);
- hedging instrument : forward starting swap in 5 years for 5 years paying fixed 3% / receiving floating E3M.

In five years at time 5, benchmark rate is still 3% and the bank issues a liability at 1% "benchmark rate minus 2% margin. The hedging relationship will show ineffectiveness since IAS 39 – AG 99C reinforced by 80 Z (e) and (f) applies. Ineffectiveness relates to the difference between the 1% fixed rate liability and the 3% rate on the fixed leg of the swap.

AG 99C requires ineffectiveness to be measured if the contractual rate is smaller than the benchmark rate. To argue that the liability side cannot be hedged by a cash flow hedge if the rate paid on the liability is smaller (or zero) than the benchmark rate confuses the issue of risks with a physical idea of a portion of a cash flow. This argument would prevent an entity from receiving a higher rate through a hedge only because it pays a lower or no rate on its liability.

Under the IAS 39 – AG 99C provisions, hedges are therefore only permitted if the liability rate is the same or higher than the benchmark rate. This is a counterintuitive result since the business model of retail banks relates to their ability to collect resources (issue liabilities) below benchmark rate.

Another solution would be to designate the forward starting swap as a fair value hedge of the ten years loan. This solution does however not work because of the percentage approach defined by IAS 39 - AG 126. The percentage approach:

- prevents banks from applying the “bottom layer approach” (currently adopted by banks applying the “carve out” exemptions);
- and therefore requires ineffectiveness to be recognised in P&L whenever the actual redemption profile differs from the amount initially designated as hedge item.

Hedging future transactions with options:

The guidance provided in AG 99E about hedges of one sided risks with option is unclear and does not deal with the question initially submitted to IFRIC. The example given in the ED is about a hedge of the decrease in fair value of a financial asset, whereas the initial question was about hedging future transactions with options.

We disagree with AG 99E which appears to prevent the time value element of a one-sided risk from being considered when assessing and measuring hedge effectiveness.

The hedged item being a one-sided risk it includes by definition an element of time value. There is sound theoretical basis to measure one-sided risks using a probability-weighted outcome approach. Time value is not artificial; it does exist in the hedged item.

Question 3 - Effect of the proposed amendments on existing practice

The aim of the proposed amendments is to clarify the Board’s original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in practice from arising. Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

The proposed amendments would result in significant changes to existing practices and would have far reaching consequences. As already mentioned, paragraphs 80Z (e), (f) combined with AG 99C would prevent banks from hedging their commercial liabilities. This would lead to unsustainable volatility in the P&L of banks evolving in a fixed rate environment and would deter sound risk management.

Limiting the measurement of effectiveness to the changes in the one-sided risk's intrinsic value would also create significant changes. It would create artificial volatility in the P&L and generate undue costs, efforts and operational risks for reporting entities. Even when hedging relationships are perfectly effective, entities will have to distinguish and record separately changes in time value from changes in intrinsic value.

Question 4 - Transition

The proposed changes would be required to be applied retrospectively. Is the requirement to apply the proposed changes retrospectively appropriate? If not, what do you propose and why?

Should the Board decide to proceed with the proposed ED, we are of the opinion that the impact should be dealt with on a prospective basis. A retrospective application of the proposed amendments would result in significant impact for entities that would need to reverse the hedging relationships no longer allowed under the new rules. This prospective approach would be consistent with the transition rules granted to previous changes to hedging requirements.

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG Member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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