

**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**

Comments to be received by 14 November 2003

This Exposure Draft of proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in the form of an amended International Accounting Standard. Comments on the Exposure Draft should be submitted in writing so as to be received by **14 November 2003**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org.uk** or addressed to:

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Background

1. In June 2002, the International Accounting Standards Board published an Exposure Draft of limited improvements to IAS 39 *Financial Instruments: Recognition and Measurement*. The proposals in that Exposure Draft were consistent with the Board's objective of improving IAS 39 without reconsidering the fundamental approach to the accounting for financial instruments. In particular, the Exposure Draft proposed only limited changes to the requirements for hedge accounting, either to achieve convergence with the equivalent US accounting standard or to incorporate into IAS 39 guidance that had been issued by the Implementation Guidance Committee appointed by the Board's predecessor organisation, the International Accounting Standards Committee.
2. The Board received over 170 comment letters on the Exposure Draft. In addition, in March 2003, it held a series of nine roundtable discussions, in which over a hundred organisations and individuals took part. Some of the comment letters and the participants in the roundtables raised issues concerning hedge accounting for a portfolio hedge of interest rate risk (sometimes referred to as 'macro hedging') and the treatment of demand deposits (sometimes referred to as 'core deposits') in hedge accounting. They were concerned that it is very difficult under IAS 39 to achieve fair value hedge accounting for such a hedge (see paragraph BC5 of the Basis for Conclusions).
3. In the light of those representations, the Board decided to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. The Board's aim was to develop an approach that:
 - (a) meets the principles that underlie IAS 39's requirements on derivatives and hedge accounting, and
 - (b) is workable in practice for entities that manage interest rate risk on a portfolio basis, allows data captured for risk management to be used in preparing financial statements and would not require entities to make major systems changes.

BACKGROUND

The three principles that are most relevant to fair value hedge accounting for a portfolio hedge of interest rate risk are:*

- (i) derivatives should be measured at fair value;
 - (ii) all material hedge ineffectiveness should be identified and recognised in profit or loss; and
 - (iii) only items that are assets and liabilities should be presented as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be presented in the balance sheet.
4. The Board concludes that the amendments to IAS 39 proposed in this Exposure Draft meet these objectives.

* A fuller description of all of the principles that underlie IAS 39's requirements for derivatives and hedge accounting is set out in the Appendix to this Exposure Draft.

Invitation to Comment

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

The Board is not requesting comments on matters other than those set out in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than **14 November 2003**.

Question 1

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.* However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (eg 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?

* The repricing date of an item is the date on which the item will be repaid or repriced to market rates.

INVITATION TO COMMENT

- (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?

Question 2

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 (ie 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?

Proposed Amendments to [draft] IAS 39 (Revised 200X)

In the hedging section of [draft] IAS 39, amend draft paragraph 126F and insert paragraphs 128A and 154. These proposed amendments are shown below as marked changes to the June 2002 Exposure Draft. New text is underlined. For ease of reading, draft paragraphs 128 and 153 are also included, although no further changes are proposed to them.

Hedging

Designation of Hedging Instruments

126F. Two or more derivatives, or proportions thereof, may be viewed in combination and jointly designated as the hedging instrument, including where the risk(s) arising from some derivatives offset those arising from others. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (such that a net premium is received).

Designation of Financial Items as Hedged Items

128. If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions thereof or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).

128A. In a fair value hedge of the interest rate exposure of a portfolio of financial assets and/or financial liabilities, the portion hedged may be designated in terms of an amount of currency (eg dollars, euro, pounds) rather than as individual assets (or liabilities). Although the portfolio may include, for risk-management purposes, assets and liabilities, the amount designated is an amount of assets or an amount of liabilities.

PROPOSED AMENDMENTS

Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate based on expected, rather than contractual, repricing dates. Where the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness will arise if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Fair Value Hedges

153. *If a fair value hedge meets the conditions in paragraph 142 during the financial reporting period, it shall be accounted for as follows:*

...

(b) *the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised immediately in profit or loss. This applies even if a hedged item is otherwise measured at fair value with changes in fair value recognised directly in equity under paragraph 103(b). It also applies if the hedged item is otherwise measured at cost.*

154. For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets and/or financial liabilities, the requirement in paragraph 153(b) may be met by presenting the gain or loss attributable to the hedged item either:

(a) in a separate line item within assets, if the hedged item for a particular maturity time period is an asset, or

(b) in a separate line item within liabilities, if the hedged item for a particular maturity time period is a liability.

The separate line items referred to in (a) and (b) above shall be presented next to financial assets or financial liabilities. Amounts included in these line items shall be removed from the balance sheet when the assets or liabilities to which they relate are derecognised.

Effective Date and Transitional Provisions

In the effective date and transition section of [draft] IAS 39 new paragraph 172 is added for the proposals in this Exposure Draft. These are consistent with the effective date and transitional provisions that the Board has tentatively decided should apply for those adopting IAS 39 for the first time in 2005.

172. An entity shall apply the amendments set out in [draft] paragraphs 126F, 128A, 154 and A26-A40 for annual financial statements for periods beginning on or after 1 January 2005. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact. These amendments shall be applied prospectively. Transactions entered into before the date the amendments are first applied shall not be retrospectively designated as hedges.

Add application guidance to Appendix A of the June 2002 Exposure Draft.

Appendix A

Application Guidance

This appendix is an integral part of the [draft] Standard.

...

Hedging a portfolio in a fair value hedge of interest rate risk

A26. For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities or both, an entity may comply with this [draft] Standard as set out in (a)-(h) below.

PROPOSED AMENDMENTS

- (a) The entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise both assets and liabilities.
 - (b) The entity analyses the portfolio into maturity time periods based on expected, rather than contractual, repricing dates.
 - (c) Based on this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure to be used for testing ineffectiveness.
 - (d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (eg LIBOR).
 - (e) The entity designates one or more hedging instruments for each maturity time period.
 - (f) The entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), based on the expected repricing dates determined in (b). The result is recognised as a gain or loss in the income statement and in one of two line items in the balance sheet as described in paragraph 154. The change in fair value need not be allocated to individual assets or liabilities.
 - (g) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognises it as a gain or loss in the income statement. The fair value of the hedging instrument is recognised as an asset or liability in the balance sheet.
 - (h) Any ineffectiveness will be recognised in the income statement as the difference between the change in fair value referred to in (f) and that referred to in (g).
- A27. This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with financial assets and/or financial liabilities.

- A28. The portfolio identified in paragraph A26(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.
- A29. In applying paragraph A26(b), the entity determines the expected repricing date of an item as the earlier of the date that item is expected to mature or reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout its life, based on historical experience and other available information. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates. However, the methodology for such an allocation shall be applied consistently and be in accordance with the entity's risk management procedures and objectives.
- A30. As an example of the designation set out in paragraph A26(c), if in a particular maturity time period an entity estimates it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates as the hedged item assets in the amount of CU20. The designation is expressed as an 'amount of currency' (eg dollars, euro, pounds) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—ie all of the CU100 of assets in the above example—must be:
- (a) items whose fair value changes in response to changes in the interest rate being hedged, and

PROPOSED AMENDMENTS

- (b) items that could have qualified for fair value hedge accounting if they had been hedged individually. In particular, because this [draft] Standard* specifies that the fair value of a financial liability that the holder can redeem on demand (demand deposits and some time deposits) is not less than the amount payable on demand, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated.
- A31. The hedging instrument referred to in paragraph A26(e) may be a single derivative or a portfolio of similar derivatives (eg a portfolio of interest rate swaps), including a portfolio containing offsetting risk positions. However, it may not include written options or net written options, because this [draft] Standard† does not permit such options to be designated as a hedging instrument (except for when a written option is designated as an offset to a purchased option).
- A32. In applying paragraph A26(f), a change in interest rates affects the fair value of a prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 128 of this [draft] Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 128A permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of *expected*, rather than contractual, repricing dates. Where the item hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (eg to reflect a

* This reflects the Board's decision in April 2003. An equivalent requirement is contained in IAS 32, paragraph 86, but the June 2002 Exposure Draft proposed its deletion. In the light of comments received, the Board decided in April 2003 to include this requirement in IAS 39.

† paragraphs 124 and 126F

change in expected prepayments), or actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph A36.

- A33. This [draft] Standard does not specify the techniques used to determine the amount referred to in paragraph A26(f), namely the change in the fair value of the hedged item that is attributable to the hedged risk. 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. It is not appropriate to assume that changes in the fair value of the hedging instrument equal changes in the value of the hedged item.
- A34. Paragraph 154 requires that if the hedged item for a particular maturity time period is an asset, the change in its value is presented in a separate line item within financial assets. Conversely, if the hedged item for a particular maturity time period is a liability, the change in its value is presented in a separate line item within financial liabilities. These are the separate line items referred to in paragraph A26(f). Specific allocation to individual assets (or liabilities) is not required.
- A35. Paragraph A26(h) notes that ineffectiveness will arise to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:
- (a) actual repricing dates being different from those expected, or expected repricing dates being revised;
 - (b) items in the hedged portfolio becoming impaired or being derecognised;
 - (c) the payment dates of the hedging instrument and the hedged item being different; and
 - (d) other causes (eg if some of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged).

All material ineffectiveness shall be identified and recognised in profit or loss.

PROPOSED AMENDMENTS

- A36. An entity tests for ineffectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses ineffectiveness and the next, it shall calculate the amount of ineffectiveness as follows:
- (a) it calculates the percentage of the assets (or liabilities) in each maturity time period that was hedged, based on the estimated repricing dates at the last date it tested for ineffectiveness.
 - (b) it applies this percentage to its revised estimate of the amount in that maturity time period to calculate the amount of the hedged item based on its revised estimate.
 - (c) it calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph A26(f).

Ineffectiveness is the difference between the amount determined in (c) and the change in the fair value of the hedging instrument (see paragraph A26(g)).

- A37. To measure ineffectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each maturity time period, including new assets (or liabilities) that have been originated since it last tested for ineffectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph A36 are then repeated at the next date it tests for ineffectiveness.
- A38. As each time period expires, items that were originally scheduled into it will be derecognised because of prepayment, maturity, write-offs due to impairment or sale. When this occurs, any amount included in the separate line item referred to in paragraph A26(f) that relates to that maturity time period shall be removed from the balance sheet, and included in the gain or loss that is recognised on derecognition. For example, assume an entity schedules into three maturity time periods. At the previous redesignation, the change in fair value reported in the single line item on the balance sheet was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets

attributable to period 1 have either been realised or rescheduled into other periods. CU7 is therefore derecognised from the balance sheet and recognised in profit or loss. CU8 and CU10 are now attributable to periods 1 and 2 respectively. All three periods are then adjusted, as necessary, for changes in fair value as described in paragraph A36.

- A39. In addition to expected prepayments and maturities, assets (or liabilities) contained in the hedged portfolio may be derecognised for other reasons, eg because they are repaid other than as expected, are sold, or become impaired. When derecognition occurs, any amount included in the separate line item referred to in paragraph A26(f) that relates to those items shall similarly be removed from the balance sheet and included in the gain or loss that is recognised on their derecognition. For this purpose, it is necessary to know the maturity time period(s) into which the derecognised item was scheduled, because this determines the maturity time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph A26(f). For example, when a loan is derecognised, if it can be determined in which time period it was included, it is removed from that time period; if not, it is removed from the earliest available time period.
- A40. As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the group into each maturity time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first maturity time period expires, CU100 of assets are derecognised (because of expected repayments, unexpected repayments, impairment and sales). In this case, all of the amount contained in the separate line item referred to in paragraph A26(f) that relates to the first time period is removed from the balance sheet, plus 10 per cent of the amount that relates to the second time period.

Illustrative Example

This [draft] example accompanies, but is not part of, the [draft] Standard.

Facts

- IE1. At the beginning of month 1, Company A identifies a portfolio comprising assets of CU300 million and liabilities of CU250 million whose interest rate risk it wishes to hedge. The entity views all of the items in the portfolio as fixed rate items. The liabilities include demand deposit liabilities.
- IE2. For risk management purposes, Company A analyses the principal amount of all items in the portfolio into maturity time periods based on expected repricing dates. The company uses monthly time periods and schedules items for the next five years (ie it has 60 separate monthly time periods). The portfolio includes a group of similar prepayable assets that Company A allocates into time periods based on the expected prepayment dates, by allocating a percentage of the group, rather than individual items, into each time period. The portfolio also includes a group of similar demand deposits that the entity expects to repay between one and five years and that, for risk management purposes, are scheduled into time periods on this basis.
- IE3. Based on this analysis, Company A decides what amount it wishes to hedge in each time period. This example deals only with the 12-13 month time period (a similar procedure would be applied for each of the other 59 time periods). Company A has scheduled assets of CU100 million and liabilities of CU80 million into this time period. All of the liabilities are demand deposits. Company A decides, for risk management purposes, to enter into an interest rate swap to pay a fixed rate and received LIBOR, with a notional principal amount of CU20 million and a fixed life of 12.5 months.
- IE4. Company A tests for ineffectiveness on a monthly basis. At the end of month 1, when it next tests for ineffectiveness, LIBOR has risen. Based on historical prepayment experience, Company A estimates that, as a consequence, prepayments will be slower than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) to be CU120 million.

- IE5. At the end of month 1, the fair value of the interest rate swap is CU2 million (ie the swap is an asset). Also, Company A estimates that, excluding the effect that the change in interest rates has had on expected prepayments, the fair value of the assets in this time period has fallen by CU0.10 for every CU1 in the time period (ie in this example it is assumed that no ineffectiveness arises from causes other than prepayments).

Accounting treatment

- IE6. At the beginning of month 1, Company A designates as the hedged item an amount of CU20 million of assets in the 12-13 month time period. It designates as the hedged risk the change in the value of the hedged item (ie the CU20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraph 142(a) of the Standard.
- IE7. Company A designates as the hedging instrument the interest rate swap described in paragraph IE3.
- IE8. At the end of month 1, Company A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows:
- (a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent ($CU20,000 / CU100,000 \times 100$ per cent).
 - (b) Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (CU120 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU24 million.
 - (c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU24 million) that is attributable to changes in LIBOR. This is CU2.4 million (CU24 million \times 0.10 per CU)

ILLUSTRATIVE EXAMPLE

IE9. Company A makes the following accounting entries relating to this time period:

Dr Derivative asset	CU2 million
Cr Income statement (gain)	CU2 million

To recognise the change in the fair value of the derivative.

Dr Income statement (loss)	CU2.4 million
Cr Separate line item (within financial assets)	CU2.4 million

To recognise the change in the fair value of the hedged item.

IE10. The net result is to recognise a loss of CU0.4 million. This represents ineffectiveness in the hedging relationship.

IE11. Company A then repeats the steps set out in paragraphs IE6-IE8 for month 2, based on its revised estimate of the amount of assets in the time period. For example, if at the start of month 2 it estimates that it has assets (including new assets originated in month 1) of CU130 million and liabilities of CU112 million, it could designate CU18 million as the hedged item and adjust the amount of the interest rate swaps to CU18 million (eg by taking out an offsetting swap with a notional principal amount of CU2 million).

IE12. It should be noted that at the end of month 1, Company A reported an amount of CU2.4 million relating to this time period as a contra-asset, in a line item adjustment to financial assets. This amount will be adjusted in each of the next 12 months to reflect the change in the value of the hedged item in each of those months. Whatever amount remains in the balance sheet in 12 months' time must be removed, as the time period to which it relates expires.

Basis for Conclusions

Reasons for publishing the Exposure Draft

- BC1. The Exposure Draft of proposed improvements to IAS 39 *Financial Instruments: Recognition and Measurement* published in June 2002 did not propose any substantial changes to the requirements for hedge accounting as they applied to a portfolio hedge of interest rate risk.
- BC2. However, some of the comment letters on the Exposure Draft and participants in the roundtable discussions raised the issue of hedge accounting for a portfolio hedge of interest rate risk. In particular, some were concerned that portfolio hedging strategies they regarded as effective hedges would not qualify for fair value hedge accounting under IAS 39. They would either:
- (a) not qualify for hedge accounting at all, with the result that profit or loss would be volatile, or
 - (b) qualify only for cash flow hedge accounting, with the result that equity would be volatile.
- BC3. In light of these concerns, the Board decided to explore whether and how IAS 39 could be amended to enable fair value hedge accounting to be used more readily for portfolio hedges. Its discussions have resulted in the approach proposed in this Exposure Draft.

Scope

- BC4. The Board decided to limit any amendments to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. In making this decision it noted that:
- (a) implementation guidance on IAS 39* already sets out how cash flow hedge accounting is applied to a hedge of the interest rate risk on a portfolio of items.

* IGC 121-1 and 121-2

BASIS FOR CONCLUSIONS

- (b) the issues that arise for a portfolio hedge of interest rate risk are different from those that arise for hedges of individual items and for hedges of other risks. In particular, the three issues discussed in the next paragraph do not arise in combination for such other hedging arrangements.

The issue: why fair value hedge accounting is difficult to achieve under IAS 39

BC5. The Board noted that there are three main reasons why a portfolio hedge of interest rate risk may not qualify for fair value hedge accounting under IAS 39.

- (a) Typically, many of the assets that are included in a portfolio hedge are prepayable, ie the counterparty has a right to repay the item before its contractual maturity. Such assets contain a prepayment option whose fair value changes as interest rates change. However, the derivative that is used as the hedging instrument typically is not prepayable, ie it does not contain a prepayment option. When interest rates change, the resulting change in the fair value of the hedged item (which is prepayable) differs from the change in fair value of the hedging derivative (which is not prepayable), with the result that the hedge may not meet IAS 39's effectiveness test.*
- (b) IAS 39[†] prohibits the designation of an overall net position (eg the net of fixed rate assets and fixed rate liabilities) as the hedged item. Rather, it requires that individual assets (or liabilities) or groups of assets (or liabilities) that share the risk exposure equal in amount to the net position, be designated as the hedged item. For example, if an entity has a portfolio of CU100 of assets and CU80 of liabilities, IAS 39 requires that individual assets of CU20 are designated as the hedged item. However, for risk management purposes, entities often seek to hedge the net position. This net position changes each period as items reprice or are derecognised and new items are originated. Hence, the individual items designated as the hedged item also

* IAS 39, paragraph 146

† IAS 39, paragraph 133

need to be changed each period. This requires de- and re-designation of the individual items that constitute the hedged item, which gives rise to significant systems needs.

- (c) Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effect of changes in the hedged risk.* Applied to a portfolio hedge, this could involve changing the carrying amounts of many thousands of individual items. Also, for any items subsequently de-designated from being hedged, the revised carrying amount must be amortised over the item's remaining life.† This, too, gives rise to significant systems needs.

BC6. The Board agreed to explore ways to deal with each of these issues. The Board also agreed that it would propose a change to IAS 39 only if the change was consistent with the principles that underlie IAS 39's requirements on derivatives and hedge accounting. The three principles that are most relevant to a portfolio hedge of interest rate risk are:

- (a) derivatives should be measured at fair value;
- (b) all material hedge ineffectiveness should be identified and recognised in profit or loss; and
- (c) only items that are assets and liabilities should be reported as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be presented in the balance sheet.

Prepayment risk

BC7. In considering the issue described in paragraph BC5(a), the Board noted that a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. It follows that the fair value of a fixed rate prepayable item changes for two reasons when interest rates move:

* IAS 39, paragraph 153

† IAS 39, paragraph 157

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- (a) the fair value of the contracted cash flows to the contractual maturity date changes (because the rate used to discount them changes), and
- (b) the fair value of the prepayment option changes (reflecting, among other things, that the likelihood of prepayment is affected by interest rates).

BC8. The Board also noted that, for risk management purposes, many entities do not consider these two effects separately. Instead they incorporate the effect of prepayments by grouping the hedged portfolio into maturity time periods based on *expected* repayment dates (rather than contractual repayment dates). For example, an entity with a portfolio of 25-year mortgages of CU100 may expect 5 per cent of that portfolio to repay in one year's time, in which case it schedules an amount of CU5 into a 12-month time period. The entity schedules all other items contained in its portfolio in a similar way (ie on the basis of expected repayment dates) and hedges all or part of the resulting overall net position in each maturity time period.

BC9. The Board decided to permit the scheduling that is used for risk management purposes, ie on the basis of expected repayment dates, to be used as a basis for the designation necessary for hedge accounting. As a result, an entity would not be required to compute the effect that a change in interest rates has on the fair value of the prepayment option embedded in a prepayable item. Instead, it could incorporate the effect of a change in interest rates on prepayments by grouping the hedged portfolio into time periods based on expected repayment dates. The Board noted that this approach has significant practical advantages for preparers of financial statements, because it allows them to use the data they use for risk management. The Board also noted that the approach is consistent with IAS 39 paragraph 128, which permits hedge accounting for a portion of a financial asset. However, as discussed further in paragraphs BC16-BC27, the Board also concluded that if the entity changes its estimates of the time periods in which items are expected to repay (eg in the light of recent prepayment experience), ineffectiveness will arise, regardless of whether the revision in estimates results in more or less being scheduled in a particular time period.

Designation of the hedged item and liabilities with a demand feature

BC10. The Board considered two main ways to overcome the issue noted in paragraph BC5(b) and (c). These were:

- (a) to designate the hedged item as the overall net position that results from a portfolio containing assets and liabilities. For example, if a maturity time period contains CU100 of fixed rate assets and CU90 of fixed rate liabilities, the net position of CU10 would be designated as the hedged item.
- (b) to designate as the hedged item a portion of the assets (ie assets of CU10 in the above example), but not to require individual assets to be designated.

BC11. Some favour designation of the overall net position in a portfolio that contains assets and liabilities. In their view, existing asset-liability management (ALM) systems treat the identified assets and liabilities as a natural hedge. Management's decisions about additional hedging focus on the entity's remaining net exposure. They observe that designation based on a portion of either the assets or the liabilities is not consistent with existing ALM systems and would entail additional systems costs.

BC12. In considering questions of designation, the Board was also concerned about questions of measurement. In particular, the Board observed that hedge accounting requires measurement of the change in fair value of the hedged item attributable to the risk being hedged. Designation based on the net position would require the assets and the liabilities in a portfolio each to be measured at fair value (for the risk being hedged) in order to compute the fair value of the net position. Although statistical and other techniques can be used to estimate these fair values, the Board concluded that it is not appropriate to assume that the change in fair value of the hedging instrument is equal to the change in fair value of the net position.

Liabilities with a demand feature

BC13. The Board noted that under the first approach (designating an overall net position), an issue arises if the entity has liabilities with no specified maturity that are repayable on demand or after a notice period (referred

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to below as 'core deposits'). This includes items such as demand deposits and some time deposits. The Board was informed that, when managing interest rate risk, many entities that have core deposits include them in a portfolio hedge by scheduling them to the date when they *expect* the total amount of core deposits in the portfolio to be due because of net withdrawals from the accounts in the portfolio. This expected repayment date is typically a period several years into the future (eg 3-5 years). The Board was also informed that some entities wish to apply fair value hedge accounting based on this scheduling, ie they wish to include core deposits in a fair value portfolio hedge by scheduling them on the basis of their expected repayment dates. The arguments for this view are:

- (a) it is consistent with how core deposits are scheduled for risk management purposes. Interest rate risk management involves hedging the interest rate margin resulting from assets and liabilities and not the fair value of all or part of the assets and liabilities included in the hedged portfolio. Interest rate margin of a specific period is subject to variability as soon as the amount of fixed rate assets in that period differs from the amount of fixed rate liabilities in that period.
- (b) it is consistent with the treatment of prepayable assets to include core deposits in a portfolio hedge based on expected repayment dates.
- (c) the inclusion of core deposits in a macro-hedge is similar to the inclusion of assets, ie based on expected rather than contractual maturities. Whilst the expected maturity for assets is earlier than its contractual maturity (because of expected prepayments), the expected maturity for core deposits is later than its contractual maturity. As with assets, expected maturities for liabilities (including core deposits) is based on the historical behaviour of customers.
- (d) applying the fair value hedge accounting framework to a portfolio that includes core deposits would not entail an immediate gain on origination of such deposits since all assets and/or liabilities enter the macro-hedged portfolio at their carrying amounts.

- (e) historical analysis shows that a base level of core deposits is very stable. Whilst a portion of the core deposits varies with interest rates, the remaining portion—the base level—does not. Hence entities regard this base level as a long-term fixed rate item and include it as such in the scheduling that is used for risk management purposes.

BC14. The Board considered these arguments and decided that a core deposit cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. The Board's reasons are as follows:

- (a) The deposits included in the balance sheet are unlikely to be outstanding for an extended period (eg several years). Rather, these deposits are usually expected to be withdrawn within a short time (eg a few months or less), although they may be replaced by new deposits. Thus, the liability being hedged is the forecast receipt and rollover of new deposits. Under IAS 39, a hedge of such a forecast transaction cannot qualify for fair value hedge accounting.
- (b) A portfolio of core deposits is similar to a portfolio of trade payables. Both comprise individual balances that usually are expected to be paid within a short time (eg a few months or less) and replaced by new balances. Also, for both, there is an amount—the base level—that is expected to be stable and present indefinitely. Hence, if the Board were to permit core deposits to be included in a fair value hedge on the basis of the expected repayment dates, it should similarly allow a hedge of a portfolio of trade payables to qualify for fair value hedge accounting on this basis.
- (c) To use fair value hedge accounting for core deposits based on expected repayment dates implies that the fair value of a core deposit is the present value of the amount of the deposit discounted for the period to the expected repayment date. The Board noted that it would be inconsistent to permit fair value hedge accounting based on the expected repayment dates, but to measure the fair value of the deposit on initial recognition on a different basis. Measuring the fair value of a core deposit based on the expected repricing date is inconsistent with the Board's

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decision that the fair value of a deposit liability without a specified maturity (ie a core deposit) is not less than the amount payable on demand. The reasons for this decision include:

- (i) Recognising a core deposit at less than the amount payable on demand would give rise to an immediate gain on the origination of such a deposit.
 - (ii) Often the only observed market price, which is the best evidence of fair value, for a core deposit is the price at which demand deposits are originated between the customer and the deposit-taker—ie the amount payable on demand.
 - (iii) Whilst portfolios of core deposits are occasionally sold by one deposit-taker to another, the transaction normally encompasses more than the demand deposit. In particular, the sale includes the relationship between the depositor and the deposit-taker (sometimes referred to as the ‘core deposit intangible’), and may include property, plant and equipment such as a branch network. Thus, it is not a price for only the deposit.
 - (iv) Any valuation that is based on expected withdrawals should also take into account the associated costs of servicing core deposits.
- (d) Including a core deposit in a fair value hedge implies that its fair value changes with movements in interest rates. This is inconsistent with the Board’s decision that the fair value of a core deposit is not less than the amount repayable on demand, because that amount does not change with movements in interest rates. Under the Board’s view, if a core deposit whose fair value does not change with movements in interest rates is hedged by a derivative whose fair value does change with movements in interest rates, the hedge will be 100 per cent ineffective.

BC15. However, the Board also noted that what is designated as the hedged item in a portfolio hedge affects the relevance of this issue, at least to some extent. In particular, if the hedged item is designated as a *portion of the assets* in a portfolio, this issue is irrelevant. To illustrate, assume that in a particular time period an entity has CU100 of fixed rate assets and CU80 of what it regards as fixed rate liabilities and the entity wishes

to hedge its net exposure of CU20. Also assume that all of the liabilities are demand deposits and the time period is not the earliest one in which the items are repayable on demand. If the hedged item is designated as CU20 of *assets*, then the demand deposit *liabilities* are not included in the hedged item, but rather are used only to calculate how much of the assets the entity wishes to designate as being hedged. In such a case, whether the demand deposits can be designated as a hedged item in a fair value hedge is irrelevant. However, if the overall net position were to be designated as the hedged item because the net position comprises CU100 of assets and CU80 of demand deposits, whether the demand deposits can be designated as a hedged item in a fair value hedge becomes critical.

BC16. Given the above points, the Board decided to propose that a portion of assets or liabilities (rather than an overall net position) may be designated as the hedged item, to overcome part of the core deposits issue. It also noted that this approach is consistent with IAS 39, whereas designating an overall net position is not. IAS 39* prohibits an overall net position from being designated as the hedged item, but permits a similar effect to be achieved by designating assets (or liabilities) equal to the net position.

BC17. However, the Board also recognised that its proposed method of designation would not fully resolve the core deposits issue. If, in a particular maturity time period, the entity has so many core deposits that (a) they comprise nearly all of what the entity regards as its fixed rate liabilities and (b) its fixed rate liabilities (including core deposits) exceed its fixed rate assets in a particular maturity time period, the issue is still relevant. In this case, the entity is in a net liability position. Thus, it needs to designate a portion of the *liabilities* as the hedged item. But unless it has sufficient fixed rate liabilities other than core deposits that it can designate as the hedged item, this implies designating core deposits as the hedged item. Consistently with the Board's decision discussed above, such a hedge does not qualify for fair value hedge accounting.

* IAS 39, paragraph 133

What portion of assets should be designated and the impact on ineffectiveness

- BC18. Having decided that a portion of assets (or liabilities) could be designated as the hedged item, the Board considered how to overcome the systems problems noted in paragraph BC5(b) and (c). The Board noted that these problems arise from designating individual assets (or liabilities) as the hedged item. Accordingly, the Board considered whether the hedged item could be expressed as an *amount* (of assets or liabilities) rather than as individual assets (or liabilities).
- BC19. The Board noted that designation determines how much, if any, ineffectiveness arises if actual repricing dates in a particular maturity time period vary from those estimated or if the estimated repricing dates are revised. Taking the above example of a maturity time period in which there are CU100 of fixed rate assets and the entity designates as the hedged item an amount of CU20 of assets, the Board considered the following four approaches.

Approach A

To designate the 'bottom' layer of CU20 as the hedged amount. Under this approach, if some assets prepay earlier than expected so that the entity revises downwards its estimate of the amount of assets in the maturity time period (eg from CU100 to CU90), these reductions are assumed to come first from the unhedged portion of CU80. Thus no ineffectiveness arises so long as at least CU20 of assets remain in this maturity time period. To put it another way, unexpected early prepayments of up to CU80 would not give rise to ineffectiveness. In addition, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this maturity time period (eg from CU100 to CU110), no ineffectiveness will arise, on the grounds that the hedged 'bottom' layer of CU20 is still there and that was all that was being hedged.

Approach B

To designate the 'top' layer of CU20 as the hedged amount. Under this approach, if some assets prepay earlier than expected so that the entity revises downwards its estimate of the amount of assets in this maturity time period (eg from CU100 to CU90), these reductions are assumed to come first from the hedged portion of CU20. Thus, ineffectiveness arises on the first CU20 of the decrease (in the example,

ineffectiveness arises on CU10). However, as in approach A, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this maturity time period (eg from CU100 to CU110), no ineffectiveness arises, on the grounds that the increase does not affect the hedged ‘top’ layer of CU20.

Approach C

This is a variant of approach B, whereby the entity designates the hedged amount as the ‘top’ layer of CU20 but hedges only a portion—say CU16—of the risk associated with this hedged amount. Under this approach, if some assets prepay earlier than expected so that the entity revises downwards its estimate of the amount of assets in this maturity time period (eg from CU100 to CU90), these reductions are assumed to come first from the unhedged risk associated with the hedged amount of CU20, and then from the hedged risk associated with the hedged amount of CU20. Thus ineffectiveness does not arise on the first CU4 of the decrease, but does arise on the next CU16 (in the example, ineffectiveness arises on CU6). As in approaches A and B, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this maturity time period (eg from CU100 to CU110), no ineffectiveness arises, on the grounds that the increase does not affect the hedged amount.

Approach D

To designate the amount as a percentage. Under this approach 20 per cent of the assets of CU100 in this maturity time period is designated as the hedged item. As a result, if some assets prepay earlier than expected so that the entity revises downwards its estimate of the amount of assets in this maturity time period (eg from CU100 to CU90), ineffectiveness arises on 20 per cent of the decrease (in this case ineffectiveness arises on CU2). Similarly, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this maturity time period (eg from CU100 to CU110), ineffectiveness arises on 20 per cent of the increase (in this case ineffectiveness arises on CU2).

BC20. The arguments for approach A are as follows:

- (a) It is consistent with IGC 121-1 and IGC 121-2, which allow, for a cash flow hedge, the ‘bottom’ portion of reinvestments of collections from assets to be designated as the hedged item.

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- (b) The entity is hedging interest rate risk rather than prepayment risk. Any changes to the portfolio because of changes in prepayments do not affect how effective the hedge was in mitigating interest rate risk.
- (c) The approach captures all ineffectiveness on the hedged portion. It merely allows that hedged portion to be defined in such a way that the first of any potential ineffectiveness relates to the unhedged portion.
- (d) A prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. Approach A can be viewed as hedging a part of the life of the non-prepayable item, but none of the prepayment option. For example, a 25-year prepayable mortgage can be viewed as a combination of (i) a non-prepayable, fixed-term 25-year mortgage and (ii) a written prepayment option that allows the borrower to repay the mortgage early. If the entity hedges this asset with a 5-year derivative, this is equivalent to hedging the first five years of component (i). If the position is viewed in this way, no ineffectiveness arises when interest rate changes cause the value of the prepayment option to change, because the prepayment option was not hedged.

BC21. The arguments against approach A are as follows:

- (a) The considerations that apply to a fair value hedge are different from those that apply to a cash flow hedge. In a cash flow hedge, it is the cash flows that are associated with the reinvestment of probable future collections that are hedged. In a fair value hedge it is the fair value of the assets that currently exist.
- (b) It would be rare for any ineffectiveness to be recognised under this approach, given (i) the large 'cushion' (of CU80 in the above example) by which the assets in the maturity time period can decrease with no ineffectiveness arising and (ii) the fact that no ineffectiveness is recognised if the amount in a maturity time period is re-estimated upwards. This is inconsistent with the principle underlying IAS 39 that all material ineffectiveness should be identified and recognised. Representatives of banks whom the Board consulted in developing these proposals have indicated that they do not support approach A. In their view, the

approach creates a 'cushion' against ineffectiveness (CU80 in the example above) that is inconsistent with both good risk management and the Board's objectives for hedge accounting.

- (c) The fact that no ineffectiveness is recognised if the amount in a maturity time period is re-estimated upwards (with the effect that the entity is under-hedged) is not in accordance with IAS 39. For a fair value hedge, IAS 39 requires that ineffectiveness is recognised both in the case where the entity is over-hedged (ie the derivative exceeds the hedged item) and when it is under-hedged (ie the derivative is smaller than the hedged item).
- (d) As noted in paragraph BC20(d) above, a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. When interest rates change, the fair value of each of these components changes. In the absence of the simplification for prepayment risk set out in paragraph BC9, applying fair value hedge accounting would require that the change in the fair value of *both* components, to the extent they are attributable to the hedged risk (ie the change in interest rates), is recognised in the balance sheet and in profit or loss. Because the hedging derivative typically contains no prepayment option, the change in its value will be different from that of the hedged item and ineffectiveness will be recognised for the difference. The simplified treatment of prepayment risk described in paragraph BC9, which involves scheduling items based on expected prepayment dates, should similarly give rise to ineffectiveness if prepayment expectations are not met or are revised.
- (e) Interest rate risk and prepayment risk are so closely interrelated that it is not appropriate to separate the two components referred to in paragraph BC20(d) and designate only one of them (or a part of one of them) as the hedged item. In practice, it is extremely difficult to measure the two components separately. Furthermore, entities do not separate the two components for risk management purposes. Rather they incorporate the prepayment option by scheduling amounts based on expected maturities. The Board is proposing to use this risk management practice—based on not separating—as the

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basis for designation for hedge accounting purposes. It would be inconsistent to assess ineffectiveness as if the entity had separated the two components.

- (f) The objective of applying fair value hedge accounting 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. If individual prepayable assets had been designated as the hedged item, the change in their fair value that is attributable to the hedged risk (ie the change in interest rates) would differ from the change in the fair value of the hedging derivative (unless that derivative includes an equivalent prepayment option) and ineffectiveness would be recognised for the difference. It follows that if the hedged item is designated in terms of an amount, ineffectiveness should similarly arise.
- (g) If interest rates change, the effect on the fair value of a portfolio of prepayable items will be less than the effect on the fair value of a portfolio of otherwise identical but non-prepayable items. However, under approach A this difference would not be recognised—if both portfolios were hedged to the same extent, both would be recognised in the balance sheet at the same amount.

BC22. The Board was persuaded by the arguments set out in paragraph BC21 and decided not to propose approach A.

BC23. The Board noted that the many of the arguments against approach A—in particular those set out in paragraph BC21(c)-(g)—also apply to approaches B and C. It therefore decided not to propose either of those two approaches. In addition, for approach C, the Board noted that it would need to introduce an arbitrary rule to prevent the ‘cushion’ from becoming too large. For example, if the entity were to designate the hedged item as CU100 of which it is hedging a portion of CU16 of the risk, this would result in a cushion of CU84. This large cushion could be avoided by specifying that the hedged portion (ie the CU16) must be at least x per cent of the hedged item—for example if x were set at 80 per cent then the hedged item could be no more than CU20 and the cushion no more than CU4. However, the Board did not favour introducing such an arbitrary rule, which was a further reason for its decision not to propose approach C.

BC24. The Board concluded that approach D is the most consistent with IAS 39, and decided to propose this approach. In particular, the Board concluded that the hedged item should be designated in such a way that if the entity changes its estimates of the maturity time periods in which items are expected to repay or mature (eg in the light of recent prepayment experience), ineffectiveness arises, both when estimated prepayments decrease, resulting in more in a particular maturity time period, and when they decrease, resulting in less.

BC25. The Board considered the following arguments against approach D:

- (a) The entity is hedging interest rate risk rather than prepayment risk.
- (b) So long as assets equal to the hedged portion remain, there is no ineffectiveness. For example, if in a time period an entity estimates there are fixed rate assets of CU100 and designates CU20 of assets as the hedged amount, provided that any change in estimate does not result in there being less than CU20 of assets in this maturity time period, there are still sufficient assets to be covered by the hedging derivative.

BC26. Some of the bank representatives whom Board members consulted favour a combination of approaches B and C. In their view, the two approaches differ only in the extent to which an entity's hedges assets or liabilities based on its net position. In approach B, the entity hedges an amount of assets (or liabilities) equal to the entire net position. In approach C, the entity hedges a part of the net position. They regard approach C as partial hedging, and the resulting 'cushion' as consistent with existing fair value hedge accounting under IAS 39. Those who support approaches B and C might make one or more of the following arguments. In their view approaches B and C:

- (a) are consistent with the manner in which ALM techniques are used to manage interest rate risk;
- (b) are generally consistent with cash flow hedging described in IGC 121-1 and 121-2;
- (c) are consistent with the view that the entity is hedging interest rate risk rather than prepayment risk; and
- (d) capture all ineffectiveness on the hedged portion, as defined in approaches B and C.

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- BC27. The Board disagreed with the arguments in paragraphs BC25 and BC26, for the reasons set out in paragraph BC21. In particular, the Board noted that if it were to make no simplification for prepayment risk, IAS 39 would require the entity to calculate the full effect of a change in interest rates on the fair value of the hedged item. This would include the effect of the change in interest rates on the fair value of the prepayment option that is embedded in the hedged item which, in turn, would give rise to ineffectiveness. The Board concluded that any simplified treatment of prepayment risk that schedules items on the basis of their expected maturity, should similarly reflect that a change in interest rates affects the value of the prepayment option and should capture the resulting ineffectiveness.
- BC28. The Board was informed that, to be practicable in terms of systems needs, any approach should not require tracking of the amount in a maturity time period for multiple periods. Therefore it decided to propose that ineffectiveness should be calculated by determining the change in the estimated amount in a maturity time period between one date on which effectiveness is measured and the next, as described more fully in paragraph A36. This requires the entity to track how much of the change in each maturity time period between these two dates is attributable to revisions in estimates and how much is attributable to the origination of new assets (or liabilities). However, once ineffectiveness has been measured as set out above, the entity in essence starts again, ie it establishes the new amount in each maturity time period (including new items that have been originated since it last tested ineffectiveness), designates a new hedged item, and repeats the procedures set out above at the next date it tests for ineffectiveness. Thus the tracking is limited to movements between one date when ineffectiveness is measured and the next. It is not necessary to track for multiple periods. However, the entity will need to keep records relating to each time period (a) to reconcile the amounts for each time period with the total amounts in the two separate line items in the balance sheet (see paragraph A26(f)) and (b) to ensure that amounts are removed from the balance sheet when the maturity time period to which they relate expires.
- BC29. The Board also noted that the amount of tracking required by approach D is no more than would be required by any of the other approaches. Thus, the Board concluded that none of the approaches was clearly preferable based on systems needs.

The carrying amount of the hedged item

BC30. The last issue noted in paragraph BC6 is how to present in the balance sheet the change in fair value of the hedged item. The Board noted the concern of respondents that the hedged item may contain many—even thousands—of individual assets (or liabilities) and that to change the carrying amounts of each of these individual items would be impracticable. The Board considered dealing with this concern by permitting the change in value to be presented in a single line item in the balance sheet. However, the Board noted that this could result in a reduction in the fair value of a financial asset (financial liability) being reported as a financial liability (financial asset). Furthermore, for some maturity time periods the hedged item may be an asset, whereas for others it may be a liability. The Board concluded that it would be incorrect to present together the changes in fair value for such maturity time periods, because to do so would combine changes in the fair value of assets with changes in the fair value of liabilities.

BC31. Accordingly, the Board decided to propose that two line items should be presented, as follows:

- (a) if the hedged item for a particular maturity time period is an asset, the change in its fair value is presented in a separate line item within financial assets; and
- (b) if the hedged position for a particular maturity time period is a liability, the change in its fair value is presented in a separate line item within financial liabilities.

BC32. The Board noted that these line items represent changes in the fair value of the hedged item. For this reason, the Board decided that they should be presented next to financial assets or financial liabilities.

The hedging instrument

BC33. The Board was asked by commentators to address one other issue. This is whether the hedging instrument may be a portfolio of derivatives containing offsetting risk positions. Commentators noted that IAS 39 is unclear on this point.

BC34. The issue arises because the assets and liabilities in each maturity time period change over time as prepayment expectations change, as items are derecognised and as new items are originated. Thus the net position,

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and the amount the entity wishes to designate as the hedged item, also changes over time. If the hedged item decreases, the hedging instrument needs to be reduced. However, entities do not normally reduce the hedging instrument by disposing of some of the derivatives contained in it. Instead, entities adjust the hedging instrument by entering into new derivatives with an offsetting risk profile.

BC35. The Board decided to permit the hedging instrument to be a portfolio of derivatives containing offsetting risk positions. It noted that all of the derivatives concerned are measured at fair value with changes in fair value recognised in profit or loss. It also noted that the two ways of adjusting the hedging instrument described in the previous paragraph can achieve substantially the same effect. The Board therefore proposes to clarify paragraph 126F to this effect.

**Alternative views on
Proposed Amendments to IAS 39
Financial Instruments:
Recognition and Measurement—
Fair Value Hedge Accounting for a
Portfolio Hedge of Interest Rate Risk**

AV1. Five Board members voted against the publication of the 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*. Their alternative views are set out below.

Alternative view of the five Board members

AV2. Five Board members voted against publication of this Exposure Draft because they do not agree with the approach to evaluating effectiveness that incorporates the effect of a change in interest rates on the prepayment option inherent in a portfolio of assets. In their view, measuring effectiveness in the manner described in this Exposure Draft is inconsistent with the manner in which a financial institution hedges its interest rate margin on a portfolio of fixed rate assets and liabilities. They also observe that the approach creates what they regard as an unjustified difference between the evaluation of effectiveness in cash-flow and fair-value hedge accounting. They would apply the approach described in IGC 121 to both cash flow and fair value hedge accounting for hedges of interest rate risk in a portfolio of prepayable assets. That approach would lead to recognition of ineffectiveness only when the net position in the portfolio is over-hedged.

AV3. The Board members are persuaded by the arguments outlined in paragraphs BC20 and BC26. Approach A, as described in paragraph BC19, would achieve the same measure of ineffectiveness as the approach in IGC 121, but they could also accept approach B or C.

ALTERNATIVE VIEWS

- AV4. Four of the dissenting Board members agree with the Board's conclusions about liabilities that are subject to withdrawal on demand. They would not, therefore, extend the rationale to a hedge of a portfolio of liabilities with a demand feature. Those liabilities can be hedged, but only using cash flow hedge accounting.
- AV5. The fifth Board member, although admitting to the theoretical validity of not extending the rationale to the hedge of a portfolio with a demand feature, would favour this extension for practical reasons.

Appendix

The Principles that Underlie IAS 39's Requirements for Derivatives and Hedge Accounting

This appendix sets out the principles that underlie IAS 39's requirements for derivatives and hedge accounting. It is an extract from a paper that was prepared for the roundtable discussions on IAS 39 that were held in March 2003. The full paper is available on the Board's Website at www.iasb.org.uk.

Principles underlying the ED's requirements – derivatives

1. The following principles underlie the ED's requirements for derivatives:
 - (a) Derivative contracts create rights and obligations that meet the definition of assets and liabilities and, as a result, should be recognised.
 - (b) Fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient transparency in the financial statements. The cost of most derivatives is nil or immaterial. Hence if they were to be reported at cost, they would not be included in the balance sheet at all and their success (or otherwise) in reducing risk would not be visible. In addition, the value of derivatives often changes disproportionately in response to market movements (put another way, they are highly leveraged or carry a high level of risk). Fair value is the only measurement basis that can capture this leveraged nature of derivatives—information that is essential to communicate to investors the nature of the rights and obligations inherent in derivatives.

Principles underlying the ED's requirements – hedge accounting

2. Hedge accounting allows entities to depart selectively from the normal accounting treatment that would otherwise be applied to the items included in the hedging relationship. In particular, cash flow hedge accounting provides an exception by deferring the recognition in the income statement of derivative gains and losses, whereas fair value

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hedge accounting provides an exception by accelerating the recognition of gains and losses on the hedged item. Hence hedge accounting principles are needed to provide discipline over the use of hedge accounting. Without such principles, the exceptions noted above would permit a free choice over when to recognise gains and losses. These hedge accounting principles fall into two groups:

- (a) those that underlie the ED's conditions for when a hedging relationship qualifies for hedge accounting (paragraph 3); and
 - (b) those that underlie the ED's requirements for the accounting treatment of a qualifying hedging relationship (paragraph 4).
3. A hedging relationship should qualify for hedge accounting only when the hedging relationship is:
- (a) clearly defined by designation and documentation;
 - (b) reliably measurable; and
 - (c) actually effective.
4. As regards the accounting treatment of a qualifying hedging relationship:
- (a) to the extent that a hedging relationship is not effective, the ineffectiveness is recognised immediately in the income statement.
 - (b) to the extent that a hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in the income statement at the same time.
 - (c) only items that meet the definitions of assets and liabilities are recognised as such in the balance sheet.