

POSITION PAPER



ESBG position paper on portfolio hedge accounting

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1. Introduction

The world has experienced a dramatic financial crisis and there is a clear need to address the rules on accounting for financial instruments. This necessary improvement can only be achieved if accounting appropriately reproduces the economic reality and takes into account the specificities of the business model of savings and retail banks. Indeed, banks finance two third of the European economy while capital markets finance only one third of it. In addition, the crisis has demonstrated that savings and retail banks' business model - which consists in originating loans, holding these loans on their balance sheets and funding them with stable resources such as demand deposits - proved to be extremely resilient during the crisis as opposed to the originate-and-distribute business model.

The IASB project to replace IAS 39 consists of three main phases and hedge accounting is the third phase. ESBG would like to take the opportunity to affirm its position on this topic. More precisely, as the main issue for ESBG members appears to be portfolio hedge accounting, ESBG's Position Paper will focus on the key messages and principles on which portfolio hedge accounting should be based upon.

ESBG believes in the importance of working towards the adoption of a solution to ensure that all European banks can implement the same hedge accounting provisions. At the same time, we consider it of utmost importance to find a solution that takes into account the risk management practices applied by banking organisations.

2. ESBG draft Position on portfolio hedging

ESBG strongly supports the IASB in looking for a more practical application of the International Financial Reporting Standards (IFRS) and especially concerning portfolio hedge accounting. However, ESBG has some concerns on the piecemeal approach that the IASB has decided to follow. ESBG would have preferred individual and portfolio hedging to be treated at the same time and not split into two phases. This approach could result in unintended consequences for portfolio hedging which is of the utmost importance to us.

We firmly believe that the "business model" should be the primary criteria for the classification and measurement of a financial instrument. In accordance with the IASB, we also consider that an "*entity's business model does not relate to a choice (i.e. it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way that an entity is managed, and information is provided to the management of the entity*" (IFRS 9 - BC 32). We stress that the need to introduce anti-cyclical measures to financial reporting has become, for us, self-explanatory and we consider that giving more consideration to the business model would prevent undue volatility. We also believe that financial statements can provide an adequate representation of the results and present information only through consistency between the management of a financial instrument and its classification measurement criteria.



2.1. Hedge accounting should be based on the business model and principle based

As far as hedge accounting is concerned, we would encourage the Board to define accounting principles that adequately reflect the economic and financial reality of interest rate risk management. An appropriate accounting representation of the effects of sound risk management techniques would certainly provide relevant and useful information to the readers of financial statements. It is highly important that appropriate hedge accounting rules avoid undue volatility in Profit & Loss (P&L).

Hedge accounting principles should be consistent with the principles of sound risk management, in particular the techniques used to manage interest rate risk in the Asset and Liability Management (ALM). Only by referring to risk reduction techniques used by banks, hedge accounting principles would draw the adequate line between risk reduction strategies techniques and trading activities.

Finally, we consider that hedge accounting principles should be principle based. A principle-based approach is more robust and responsive to developments in markets, products and hedging strategies.

2.2. Description of ALM activities in banks

Interest rate risk arises from mismatches between assets and liabilities kept on the balance sheet: the bank P&L does not results from the absolute levels of interest on loans and on funding, but rather from the difference between them. This difference is not always constant, as it is impacted by the various commercial rates granted on both sides and by maturity mismatches between assets and liabilities.

These interest rate risks resulting from this originate-and-hold business model are managed on a portfolio basis through ALM strategies. ALM refers to the management of risks incurred by the bank with respect to its activity as an intermediary between economic agents that have different needs and risk appetites. Therefore, ALM allows for the transformation of short term resources into long term uses. More precisely:

- The revenue of the bank comes from the collection of contractual cash flows over time from financial instruments that are held in the balance sheet (customer loans and deposits, interbank lending and various ALM financial instruments).
- The risk management consists of reducing the variability of the margin due to the mismatches by entering into hedging transactions which offset part or all of the mismatches.

As a consequence, the purpose of hedging is not to manage the fair value exposure of the asset or liability but to achieve a target interest margin.

2.3. The concept of portfolio hedging

Savings banks mainly manage their risks on a portfolio basis. In our opinion, acknowledging this when drafting hedge accounting rules is the only way forward to simplify accounting for financial instruments.



It is imperative that the concept of “portfolio hedging”, which is the cornerstone of asset and liability management strategy, be recognised by the IASB. The IASB should recognise that through risk mutualisation, the risk of the portfolio is not the same as the sum of the risks of each item of the portfolio. Indeed, portfolio hedging follows an economical and statistical treatment which is quite different from an individual hedging. This is why economic cash flows should prevail over contractual cash flows. Banks should have the possibility to sum up cash flows from a pool of transactions and hedge them on a portfolio basis.

2.4. A bottom layer approach is consistent with the business model

Risks on the banking book can be separated into two components: interest rate risk and prepayment risk. Banks do not try to hedge the entire risk attached to the assets and liabilities scheduled by time periods. They only try to hedge the interest rate risk related to the stable non-prepayable portion. The part of the net position which is not hedged is supposed to capture the prepayment option.

When assessing the more appropriate approach to measure hedge effectiveness in a portfolio hedge of interest rate risk, we believe that the IASB should favour the method reflecting as much as possible to the true hedged item targeted by the ALM. Asset and liability management is not aimed at cancelling all the interest rate risks, but is aimed at reducing it. We do not believe that over-hedging and under-hedging have the same effect in terms of ineffectiveness. When the objective is to under-hedge a risk exposure, the hedging position should be considered as effective as long as they reduce the risk exposure.

When an entity hedges a portfolio of fixed-rate loans it adopts a bottom-layer approach that should be recognised by accounting standards in order to be consistent with real asset and liability management. This would result in recognizing ineffectiveness only in case of over-hedging.

2.5. Core deposits should be eligible hedged items

The inclusion of core deposits, which form a major part of the European banks' liability-side, as eligible hedged items is crucial should hedge accounting principles be aligned with the actual management of interest rate risk. In Continental Europe all statistics show that core deposits are the more stable liabilities a bank can count on. The fundamental social value of banks is to harvest the portfolio effects that simply do not exist at transaction level, the most important of which is to transform contractually short term deposits into long term loans that are needed by the economy.

In other words, the retail activity of banks consists in matching theoretically short-term, but in substance long-term resources into medium and long-term assets. The most important difference between theoretical and effective maturity is observed on core deposits. Therefore, it is crucial that we:

- recognise that behaviourized demand deposits give rise to interest rate risk and should therefore be hedgeable items;
- include core deposits in the portfolio hedged and schedule them into time bands reflecting the expected withdrawals instead of the contractual ones.



2.6. Only risks transferable to the market are hedged

Banks only hedge risks that are transferable to financial markets: inter-bank interest rates, excluding credit spread on both assets and liabilities. We believe that the replacement of IAS 39 should authorise banks to exclude the margin of the liabilities which are hedged. Hedging interest rate risk, excluding margins on both assets and liabilities should be allowed. This is currently not the case as IAS 39 authorises banks to exclude the margins on the asset side but not on the liability side (the “LIBOR minus” issue). Partial hedging should be authorised risk-wise: hedging interest rate risk within assets/liabilities excluding the commercial margins

2.7. Effectiveness tests and risk reduction

As a banking association, we recognise that effectiveness tests are required in order to demonstrate the hedging nature of derivatives, hence deserve hedge accounting treatment. Our main point is that effectiveness tests should be aligned with risk management methods. It is important to simplify and align the accounting treatment of hedge accounting as much as possible with the way ALM is performed.

As ESBG considers that accounting rules should reflect the reality, effectiveness tests should not concern full risk reduction but should instead consist in demonstrating a sensible reduction of the risk over the portfolio. More precisely, we would propose to set up effectiveness tests that will consist of demonstrating the reduction of the sensitivity of the hedged portfolio to interest rate risks.

2.8. Hedge Accounting should not increase volatility in the Other Comprehensive Income category

Fair value hedge accounting should not increase volatility in the Other Comprehensive Income (OCI) category. Reporting OCI volatility is not appropriate in this case because both hedged items and hedged instruments are on the balance sheet and their fair value changes are offset. This could also have dramatic prudential consequences in terms of solvency ratios if such hedge reserve in OCI is not filtered. We deem it highly desirable that both accounting and prudential principles recommended by banking supervisors for ALM lead to converging treatments.



About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

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 € 5,972 billion (1 January 2008). It represents the interests 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.



ESBG - Association internationale sans but lucratif/Internationale vereniging zonder winstoogmerk/
International not-for-profit association

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