

BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL, SWITZERLAND

THE CHAIRMAN

25 August 2000

VIA FACSIMILE

Sir Bryan Carsberg
Secretary General
International Accounting Standards Committee
166 Fleet Street
London EC4A 2DY
UNITED KINGDOM

Dear Sir Bryan,

The Basel Committee of Banking Supervision welcomes the opportunity to comment on the proposed IAS 39 Implementation Guidance (Batch III). You will find in the enclosed note our comments on the draft issued for comment on July 14, 2000. The Basel Committee's Accounting Task Force, chaired by Dr. Arnold Schilder, has prepared the note.

If you have any questions regarding our comments, please feel free to contact Gerald A. Edwards, Jr. at the Board of Governors of the Federal Reserve System (202-452-2741) or Bengt A. Mettinger at the Basel Committee secretariat (41 61 280 9278).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'W.J. McDonough', written in a cursive style.

W.J. McDonough

Enclosure

Proposed IAS 39 Implementation Guidance – Draft issued for comment on 14 July 2000 (Batch III)

Background

The first paragraph states that, at the time the Board approved IAS 39, no country other than the United States had comprehensive standards on accounting for financial instruments. We believe that this may be somewhat of an overstatement. Before IAS 39, banks in a number of countries were subject to comprehensive accounting rules for financial instruments, although these differed in many cases from IAS 39's approach. In our judgement the comment should therefore be deleted or redrafted.

Question 121 – 2 – a

In discussing accounting for hedges related to interest rate risk, the suggested answer describes cash flow hedges as hedges of forecasted transactions. We believe that broadening the use of the term “forecasted transaction” to include cash flows from existing assets and liabilities is a drawback when explaining and discussing the standard. In our opinion the more narrow use of the term in IAS 39.137 is preferable

Anticipated reinvestments of cash inflows and anticipated refinancings or rollovers are used as the main examples of items that can be hedged in the suggested answer to issue 121 – 2 – a. However, from the draft answer to issue 121 – 2 – b, System considerations it is clear that what is actually meant are the prospective cash flows arising from those forecasted reinvestments and refinancing transactions. Moreover, if the hedged items were the reinvestments and refinancings themselves, it would appear that IAS 39.160 would require basis adjustment of the new asset or liability. We recommend that the suggested answer to issue 121 – 2 – a be redrafted to reflect the prospective cash flows from forecasted reinvestments and refinancing transactions rather than the items themselves.

The drafted answers in issue 121 – 2 – a, and in the following issues, frequently use the terms “reinvestment” and “refinancing.” If this is not intended to introduce any qualification, and since these terms may have different meanings internationally, we suggest that you add a comment making it clear that there is no difference in the accounting treatment of an investment and a “reinvestment” or a financing and “refinancing.”

The second paragraph of the suggested answer compares the accounting and economic aspects of fair value hedges and cash flow hedges. The main point that is made is that “under either perspective, the fair value or cash flows of the interest rate swap offsets the exposure to interest rate changes.” What we presume the draft language is attempting to express is that on an overall level, the economic effect of an interest rate swap is the same irrespective of whether it is accounted for as a fair value hedge of a fixed interest rate asset or as a cash flow hedge of a variable interest rate liability. We believe that the language of the suggested answer should be redrafted to clarify this point.

Issue 121 – 2 – b

Effects of prepayments

The discussion of prepayment risk and hedge accounting differentiates fair value hedges from cash flow hedges. While it is explicitly stated that for cash flow hedges “an enterprise may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of a portion of the gross cash flows as the hedged item,” such an approach is, however, not mentioned in the discussion of fair value hedges. In fact, the language used in the suggested answer to discuss fair value hedges seems to indicate that such approach is not permitted under IAS 39 for this type of hedge.

We believe that it would be beneficial to also permit this same approach for fair value hedges.

System considerations

This part of the suggested answer discusses the more detailed prerequisites for hedge accounting. We believe that the suggested answer is more restrictive in outlining the necessary prerequisites for hedge accounting treatment of fair value hedges than what is evident in the standard.

Regardless of possible differences in status between black letter paragraphs and gray letter paragraphs in International Accounting Standards, it is clear that the black letter paragraph IAS 39.121 explicitly makes IAS 39.122 - 164 mandatory, including paragraphs IAS 39.127 - 135 which address what qualifies as a hedged item. In particular, IAS 39.127 states that: “The hedged item can be (a) a single asset, liability, firm commitment, or forecasted transaction or (b) a group of assets, liabilities, firm commitments or forecasted transactions with similar risk characteristics.” (emphasis added)

Although the important option to designate a group of similar assets or liabilities as the hedged item is contained in paragraph IAS 39.127, it is not contemplated in the second paragraph of the suggested answer on page 9. Instead, the suggested answer asserts that changes in the fair values adjustments have to be allocated to the hedged assets and also states that it generally will be necessary to establish a system to associate the changes in the fair value with individual hedged items. In our view, the language of the suggested answer should be amended to recognize the validity of designating a group of assets or liabilities as the hedged item as contemplated in Paragraph IAS 39.127. Specifically, we recommend that the phrase “or group of hedged assets” be added after “the hedged assets” in the next to the last sentence on page 9, and that the phrase “or groups of hedged items” be added after individual hedged items” in the first sentence on page 10.

Concerning cash flow hedges, please see our comment above on forecasted transactions and reinvestments and refinancing.

Issue 121 – 2 – c

Issue 121 – 2 – c addresses the issue of documentation in cash flow hedge accounting.

The hedging relationship

The suggested answer states that the maturity schedule of cash flows used for risk management purpose would provide part of the documentation. In our judgement, a broader statement along the lines of the documentation used for risk management purposes will often be useful to draw upon when preparing documentation on the hedging relationship, provides a greater flexibility to accommodate evolving changes in risk management practices.

The hedged risk

The term “overall exposure” seems to be used to contrast “a portion” of a specified interest rate. As the term “overall” in hedge accounting discussions normally is used in a different sense, we suggest that it be deleted.

Issue 121 – 2 – g

We believe that the language used in the standard IAS 39.158 (“gain or loss on the hedging instrument”) is clearer than the one used in the suggested answer (“hedging gains and losses”). Also, since the description given in this section does not include the guidance in IAS 39.160, we recommend that the phrase “which is generally summarised” precede the words “as follows:” in the first sentence of this proposed guidance.

Issue 121 – 2 – h

This part of the question and answer address, among other issues, the accounting treatment of a cash flow hedge of forecasted transactions when those transactions are no longer expected to take place. We would like to mention that there might be some risk of manipulation of the income statement in the area of forecasted transactions. For example, if an enterprise decides to change its intent to purchase a certain type of assets (while simultaneously establishing its intent to buy other similar assets) it might be able to successfully argue that it no longer fulfils the prerequisites for cash flow hedge accounting on the original forecasted transactions, and that the related accumulated gains on the hedging instruments should be transferred from equity to the income statement. The ability to make this and similar kinds of subjective changes in assessment of forecasted transactions might create the potential for manipulation of the income statement. We suggest that the Implementation Guidance Committee consider issuing additional guidance in this regard.

Issue 121 – 2 – l

Issue 121 – 2 – l discusses certain prerequisites for cash flow hedges for groups of forecasted transactions. One reference point in the standard is paragraph IAS 39.132, which states that the change in fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

However, this prerequisite is normally not meaningful in the case of cash flow hedges, as cash flow hedges typically hedge variable rate financial assets and liabilities, for which there is no fair value risk. Therefore, we recommend that the reference to fair value changes be deleted from this first paragraph of guidance under Issue 121 – 2 – l. Also, the discussion in paragraphs two and

three of this issue, which address differences in terms (and resulting cash flow exposures) for groups of forecasted transactions that are hedged with cash flow hedges, is somewhat unclear or incomplete. The discussion seems mainly to be relevant only for groups of forecasted transactions that consists of interest rate payments for anticipated investments and financing transactions. For cash flow hedges of existing groups of floating rate assets and liabilities (which also are forecasted transactions in the language of the suggested guidance), the issue of credit risk would normally not be a concern, as long as the hedge is expected to be highly effective. Moreover, it is not clear what is meant by “portfolio” in the final paragraph. The term portfolio is normally associated with existing assets and liabilities. In this case, it would probably be more precise to discuss groups of forecasted transactions, with some additional explanation of what kind of forecasted transactions are the subject of the issue.

We recommend that the suggested answer is rewritten to make it clear that in the case of cash flow hedges of existing assets and liabilities credit risk is normally not a concern if the hedge is expected to be highly effective.

Finally, in the last paragraph of this proposed guidance, the discussion from sentence two through the next to the last sentence seems to be overly complex and to introduce concepts that are in FAS 138 but not in IAS 39. For example, the concepts of a “risk-free interest rate” or “changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio” are not found in IAS 39 and seem to introduce complexity that is not necessary to illustrate the main point which is being made in this paragraph. Therefore, we recommend that this part of the discussion be eliminated. An appropriate substitution might be something along the following lines: “For example, certain groups of financial instruments may have a LIBOR-based interest rate that reprices or resets with a common frequency (e.g., LIBOR interest rate that reprices each quarter). A cash flow hedge may be designated as a hedge of the variability in cash flows that arise from the common interest rate risk shared by a group of LIBOR-based variable rate financial instruments.” This approach avoids introducing into the implementation guidance additional complexities that are not already in IAS 39.