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Our response to FRED 51 - Draft amendments to FRS 102 *Hedge Accounting*

Introduction

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 45 UK building societies. Building societies have total assets of nearly £330 billion and, together with their subsidiaries, hold residential mortgages of over £230 billion, 18% of the total outstanding in the UK. They hold over £230 billion of retail deposits, accounting for 19% of all such deposits in the UK. Building societies account for about 28% of all cash ISA balances. They employ approximately 39,000 full and part-time staff and operate through approximately 1,600 branches.

The majority of building societies operate straightforward businesses with limited product ranges. They are also small. They operate in the UK only, many on a regional or local basis. Building societies are subject to statutory restrictions relating to transactions in securities, commodities, currencies and derivatives. The UK government has openly backed[1] the mutual sector and expressed an intention to foster diversity in financial services.

Executive summary

We agree with the overall objectives of the exposure draft, particularly the goal of aligning hedge accounting towards the more principles-based approach of IFRS 9 compared to the rules-based approach of IAS 39. The proposals laid out in the exposure draft are mostly helpful, if lacking in clarity in places. Our over-riding concern is the lack of a macro hedging provision. Reversion to IAS 39 is not appropriate for the majority of smaller building societies.

Commentary

Throughout the consultation process of this exposure draft, and on earlier consultations, we have been encouraged by the willingness to engage on the part of the FRC staff.

During our dialogues with various FRC staff, we outlined specific and urgent concerns about IFRS (and by extension FRS 102) and how they relate to financial institutions such as building societies. It is worth repeating them here. These concerns are the effective interest rate and hedge accounting. We realise both are key to IFRS in terms of income recognition and fair value calculations but an understanding by standard setters of how these affect smaller financial institutions is vital if a new accounting framework is to work sensibly.

With other simplified regimes, such as the PRA's liquidity and capital schemes, model-based approaches are avoided. We suggest the FRC follows those examples.

[1] The Coalition: our programme for government: www.cabinetoffice.gov.uk/sites/default/files/resources/coalition_programme_for_government.pdf

1. Effective interest rate

- **process of determining expected loan life**

This process will place a significant and ongoing strain a smaller society's resources. Its reliance on complex spreadsheet-based analysis brings significant operational risks. But all the evidence points to the fact that outcomes are close to the product term. It would be appropriate to recognise this and align this to the product period.

- **fee income**

The determination of net initial fee income/ cost is disproportionate to the adjustment given the amount of work involved in collating data to feed the relevant model and ongoing maintenance of the same over-recognition of initial fee income is currently constrained by the BBA SORP (already withdrawn).

With broad constraints on up front fee recognition the product rate will be close to the EIR excluding ERC income. We believe there is a case for simplification of application of EIR on mortgages using the product rate adjusted for amortised fees/costs and early repayment charge income.

2. Hedge accounting

In smaller societies, a propensity to enter into derivative transactions due to the regulatory framework and a limited ability to manage hedge accounting increases further the potential for volatility in the accounts. The impact of volatility on profit is crucial for building societies as it can destroy confidence and start a run.

We agree that derivatives should appear on the balance sheet. But FRED 51 has the potential to act as a disincentive for smaller building societies to enter into derivatives. It runs the distinct risk that they put accounting treatment over risk management.

As we argue later, the most significant barrier to FRS 102 adoption by building societies is the lack of a macro hedge. Other responses[2] to the FRED have highlighted the need to permit groups of similar transactions to be hedged together rather than singularly

Q1 *Do you support the adoption in FRS 102 of the three hedge accounting models as set out in this FRED? If not, why not?*

We support the three models set out in the exposure draft.

Q2 *Do you agree with the overarching principle of setting the requirements for hedge accounting in a way that can be straightforwardly applied by entities undertaking relatively simple economic steps to manage risk? If not, why not?*

We endorse fully the overarching principle of making the hedge accounting requirements as straightforward as possible. But these requirements may be new to some of our members, particularly the smallest building societies. To help them better understand the requirements, we propose clearer language and more detailed

[2] Examples are Grant Thornton and ICAEW responses.

guidance in places. EIR and mortgage loss provisions are examples. This will ensure the principles are understood and applied consistently across the building society sector.

What is missing from FRED 51 is provision of a macro hedge arrangement. In discussions with the Financial Reporting Council, it is clear that there will be no macro hedging available in the final version of FRS 102 as the new international hedging standard – now decoupled from IFRS 9 - is nowhere near ready. Those wishing to carry out portfolio hedging are guided to IAS 39 or IFRS 9 (standard not yet agreed so firms will still have to revert to IAS 39 on matters such as macro hedging).

We are not convinced that using a discredited and soon-to-be-discontinued standard for part of the new UK GAAP is the correct approach. Furthermore, the complexity in IAS 39 is disproportionate to the size, nature and spread of building societies' business. Building society auditors do not believe macro hedging is possible under FRED 51 even though the exposure draft makes hedge accounting easier and less costly than IAS 39 and better aligns hedge accounting with an entity's risk management strategies. We understand that the FRC will review FRS 102 once the new standard on hedging is published but that date is somewhere in the distant future.

We therefore suggest that the FRC does what it originally planned to do – take elements of the full standard and make them into a portfolio hedging provision that is suitable for smaller, less complex entities. This was to have been IFRS 9, the introduction of which has been delayed several times. This leaves only IAS 39. While this is imperfect – and inconsistent with the direction of prudential regulation in its treatment of impairment and incompatible with accurate financial reporting – it could be used as a starting point for smaller financial institutions such as building societies. Once IFRS 9 becomes available, this interim measure would be discontinued.

Changes that could be made to IAS 39 to increase its suitability as a transitional solution for smaller financial institutions therefore include:

- a move away from the incurred loss model and leave provisioning standards consistent with current UK GAAP in terms of the point of recognition but use the approach to assessing the quantum of the provision as per IAS 39 pending finalisation of an expected loss model under IFRS 9.
- removal of IAS 39's 80-125% “bright line” test with a requirement for an economic relationship between the hedged item and hedging instrument. If removal is not possible, widening of the percentages would be acceptable.

We would be pleased to review any such proposals with our members in smaller societies.

Macro hedge accounting is the methodology most frequently used by building societies that hedge the interest rate risk arising from their deposit gathering and lending activities. It is used particularly for high volume fixed rate mortgage portfolios.

When the volume of loans is relatively low, hedging and hedge accounting can be applied at the individual loan level. For higher volume portfolios, such as residential mortgages, the costs and manual effort involved with documentation, monitoring and

measuring means that it is impractical to apply hedge accounting at the individual loan level. **By deliberately omitting a macro hedging option in the new UK GAAP, the FRC has left building societies without a credible alternative. Few will use sections 11 and 12 of FRS 102.**

The UK government has made it clear it wants greater diversity in banking and more access to their own homes for its citizens. A seemingly technical oversight in accounting is making both policy objectives harder than they need to be.

Q3 *The draft amendments to FRS 102 require an economic relationship between the hedging instrument and hedged item. Do you agree with this approach to establishing whether a hedging relationship exists? If not, why not?*

We agree that this approach is an appropriate way of establishing if a hedging relationship exists.

As others have already pointed out, more information on the timing of the economic relationship would be helpful. Some of our members are unclear if the designation of a hedging relationship must be at the same time as the associated instruments are first recognised or if it can be made at a later time.

Q4 *The draft amendments have the effect of removing the requirement to make a binary assessment at the beginning of a hedging relationship that defines that hedge as effective or ineffective. The effect of this would be to allow hedge accounting to be used for the effective portion of any relationship meeting the qualifying conditions.*

Do you agree with this approach? If not, why not? If you envisage practical application difficulties, please provide an illustration of these.

We support this approach.

Q5 *The draft requirements for net investment hedges state that when a hedging relationship is discontinued, amounts deferred in equity may not be reclassified to profit or loss. This is to achieve consistency with paragraphs 9.18A and 30.13 of FRS 102. Do you agree with this proposal, or should recycling of gains or losses on hedging instruments be permitted regardless of the mismatch with the foreign currency movements?*

We support this proposal.

Q6 *The draft amendments propose an alteration to Section 11 of FRS 102 to broaden the range of instruments that may be designated at fair value through profit or loss, with the effect of allowing, in some cases, economic hedging. Do you agree with these changes? If not, why not?*

An industry discussion we took part in during late 2013 suggested that the FRC would address the complications and confusion thrown up by the definition and treatment of complex financial instruments. We look forward to hearing the progress of FRC deliberations in due course. Under FRS 102, mortgages with an interest rate cap or floor and possibly even those that move from, for example, discount to SVR after a given period will be complex financial instruments and required to be fair valued through the profit and loss account. That will add volatility and complexity that the vast majority, if not all, of smaller building societies are prepared to accept.

The only solution left to them is IAS 39, which is due to be replaced shortly. This is not a satisfactory state of affairs.

Q7 *Included as non-mandatory guidance in the draft amendments are examples of the three proposed hedge accounting models (Appendix to Section 12). In your view, are these examples helpful application guidance of the requirements of paragraphs 12.15 to 12.25? If not, please provide examples of hedges that could be more usefully included.*

The examples of the three hedging models are a helpful introduction. They are not sufficiently sophisticated, however, to cover the range of hedging arrangements that entities enter into.

Q8 *The draft amendments propose a transitional exemption which will allow certain one off remeasurements of hedging instruments and hedged items at the transition date. Do you believe that these exemptions facilitate application of hedge accounting to arrangements in place at transition? If you have reservations, please tell us why and provide details of alternative transitional arrangements.*

The effective date of transition is 1 January 2014 for a 31 December year end firm. This is when hedges come on the balance sheet at fair value. Building societies therefore have to account for hedges in existence at that date. This has left little time for them to have fair value documentation in place. We note that the FRC has signalled it will allow hedge accounting documentation to be “backdated” where FRS 102 sections 11 and 12 are applied but not where entities have chose to apply IAS 39 or IFRS 9. Given building societies have had no choice to apply IAS 39, they are unable to take advantage of this extension (IFRS 9 is not yet finalised so is not an option). In view of this, we suggest that the extension of the documentation deadline should be made available to all entities that use FRS 102.

We are most disappointed that no concession has been given on the provision of comparatives for hedging even though they were not required in 2005. Those excused comparatives in 2005 were in the main very large, well-resourced and sophisticated firms whereas those caught by the requirement in 2014 are generally speaker smaller, domestically focused and without specialist technical expertise – this has to be bought from external advisers. That is certainly the case with building societies. We question why smaller entities are burdened in this way when the 2005 “wave” was not.

Building societies are already dealing with the implementation of major CRD changes such as COREP and FINREP, the provisions of EMIR and new information reporting requirements ushered in by FATCA. Small and medium-sized societies are simply not resourced to perform any extra. And perhaps most importantly, we are yet to be persuaded there is any benefit from smaller entities producing these comparatives.

Delaying the implementation of hedging by a year is not an option as it could leave building societies open to volatility.

Andrea Jeffries
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