

BANQUE DE FRANCE

LE SOUS-GOUVERNEUR

Paris, 20th November 2003

Dear Sir David,

The Commission bancaire and the Banque de France welcome the opportunity to comment on the Exposure Draft amendments to IAS 39 *Financial Instruments: Recognition and Measurement - Fair Value Hedge Accounting for a Portfolio Hedge of Interest Risk*. In substance, even though the Board's proposal brings important progress to its current hedge accounting requirements, substantial problems remain concerning ineffectiveness measurement and the inclusion of core deposits, which form a major part of the European banks' liability-side, in the proposed accounting treatment of interest risk.

You will find detailed comments on these two subjects in the enclosed note.

In addition and although the Board has declared it is not willing to reopen debates about other issues relating to IAS 32 and IAS 39, I consider it of utmost importance that the Board take into consideration the difficulties and negative consequences linked to several provisions of this text.

As European banks are preparing themselves for the implementation of IASB standards and to the Basel II solvency reform, I deem it highly desirable that both reforms should lead to converging treatments of banking operations. It is crucial to avoid a situation where banks would be required to hold two different information systems for prudential purposes on the one hand, and for accounting purposes on the other hand, as this may lead to conflicting signals for investors as well as escalating reporting costs. This issue is particularly relevant for loan loss provisioning, in which banking supervisors have a keen interest since it constitutes an essential component of banking stability. In this respect, banking supervisors favour a forward-looking approach, notably with a view to contribute to reducing the extent of financial cycles. Therefore, I believe that the Board's initial suggestion on this aspect in its IAS 39 Exposure Draft dated June 2002 went in the right direction.

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I also have a deep concern relating to the fair value designation option proposed in the Exposure Draft on amendments to IAS 39. This option appears contrary to basic accounting and prudential rules in that it allows the use of this valuation method, unconditionally, at the discretion of the companies concerned. Aside from the major drawback of going against the comparability objective, the application of this option would result in the recognition in the profit and loss account of unrealised gains on balance sheet items that would not be sufficiently liquid or tradable to guarantee the likelihood of realisation of these gains. It would also have the innovative effect of improving the earnings of a troubled company, that would benefit from the fall in the fair value of its own debts. Therefore, in order to meet prudential objectives, this option should be severely restricted.

The Commission bancaire and the Banque de France attach the greatest importance to these issues, and you already know that the Basel Committee shares the same concerns in this regard.

Finally, I would like to draw your attention to a point which does not seem having been debated a lot so far but which is essential to many credit institutions in Europe. It concerns the shares of mutual institutions and cooperative entities, which at first glance do not meet the definition of equity instruments provided for by IAS 32 but are considered as core capital in prudential regulations, taken into account their economic characteristics. As indicated beforehand, I deem it important that accounting and prudential frameworks be consistent each one with another in this case too. These shares are issued by large players within the European banking sector, which could be destabilised by a mere formal application of the provision in question.

The Commission bancaire and the Banque de France hope that you will find their comments useful and constructive.

Yours sincerely.

Best personal regards


Hervé HANNOUN

Question 1— Hedge designation and the resulting effect on measuring ineffectiveness

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 only 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 (the repricing date of an item is the date on which the item will be repaid or reprice to market rates). However, the Board concluded that ineffectiveness would arise 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-BC26 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?

(a) If not, in your view how should the hedged item be designated and why?

We agree with the Board's proposal that in a portfolio hedge of interest rate risk, the hedged item may be designated in terms of an amount of financial instruments (assets or liabilities) in a maturity time period, rather than as individual assets or liabilities, **although we would prefer the overall net position to be designated as the hedged item.**

We strongly believe that hedge accounting rules should be consistent with the principles of sound risk management, in particular the techniques used to manage interest rate risk in the Asset and Liabilities Management (ALM). This is an important consideration from the perspective of banking supervisors, but we think that it should also appear as a desirable objective for accounting standard setters, as 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. Therefore we welcome that the Board in its Basis for Conclusions refer to risk management techniques used by banks. However, we have the impression that the Board did not draw all the conclusions from such a reference when proposing accounting provisions related to the designation of the hedged item, as it refuses the overall net position to be designated as the hedged item.

Paragraph BC 11 indicates that some Board members favour the designation of a net position. While we agree with these dissenting views, we take note that the Board considers such a designation as inconsistent with §133 of IAS 39. But, **when assessing the more appropriate approach to measure ineffectiveness in a portfolio hedge of interest rate risk, we believe that the Board should favour the method reflecting as near as possible the true hedged item targeted by the ALM.**

In such a perspective, approach A appears to be the less consistent with the ALM's targeted hedged item, because it designates the completely opposite part of the eligible financial instruments (in the example, the part of the assets, called the "bottom" layer, which would be the last one to be considered as the net risk position if actual amounts represent expected ones) as the hedged item. We also agree with arguments against approach A developed in § BC21 (b) considering that such an approach provides such a huge "cushion" that in practice

ineffectiveness will never be captured, and we consider that the designation of the “bottom” layer as the hedged item is inconsistent with the natural hedge observed in terms of risk analysis between the portion of assets matched with corresponding liabilities. **For such reasons, we definitively not support approach A.**

Approach D is also not consistent with the ALM's targeted hedged item, although this inconsistency is less important than the one observed with approach A. This approach assumes that a percentage of the whole amount of assets (in the example) is the hedged item. As in approach A, this ignores the natural hedge observed in terms of risk analysis between the portion of assets matched with corresponding liabilities. So these assets should not be considered as a part of the hedged item resulting from the voluntary hedge operation initiated by the entity.

Moreover, approach D could lessen the relevance of the test of ineffectiveness, as only a part of the difference between the expected hedged risk position and the actual one is captured. For example, if the actual amount of assets designated as partially hedged is 90 instead of expected 100, the net risk position will be reduced to 10 instead of 20. The ineffectiveness due to over-hedging would be 10% in approach D (2 over 20), instead of 50% in approach B (10 over 20) and 37,5% in approach C (6 over 16). **So we consider that approach D is not the appropriate way to designate the hedged item.**

Approaches B and C are much more consistent with the ALM's targeted hedged item, as they both designate the “top” layer as the hedged item, which in fact corresponds to the targeted hedged item.

But they are not completely consistent with the ALM approach, as they do not take into account the potential difference between the actual and expected amount of liabilities not designated as the hedged item (in the example) when assessing the effectiveness of the hedge. This drawback, shared by the four proposed approaches, could result in not capturing all ineffectiveness in terms of actual risk exposure, or in the contrary, measure ineffectiveness that does not exist in reality. For example, if the actual amount of liabilities is 90 instead of expected 80, the actual net risk position is 10 instead of expected 20 and risk management analysis would conclude to an over-hedging. But none of the four proposed approaches would be able to capture it if the actual amount of asset is 100, that is equal to the expected one. On the contrary, if the actual amount of asset is 90 and the actual amount of liabilities is 70, all approaches would conclude to an ineffectiveness whereas in terms of risk exposure the actual net risk position is 20, that is equal to the expected one.

Such a drawback could be removed if the hedged item were designated as an amount of assets (or liabilities) within the amount of assets (or liabilities) exceeding the amount of corresponding liabilities (or assets) in a time band. Then ineffectiveness would be measured by comparing the actual exceeding amount of assets (or liabilities) to the expected one.

- (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 and loss?*

We agree with the principle that all material ineffectiveness should be identified and recognised in the income statement. **However, we do not agree with the Board who concludes in paragraph BC 21 (e) that interest rate risk and prepayment risk are so**

closely interrelated that it is not appropriate to separate the two components and designate only one of them as the hedged item.

In practice, ALM Departments do not try to hedge changes in the fair value of the prepayment option attached to the assets and liabilities scheduled by time periods, no matter if portion of these changes are due to interest rate risk. They only try to hedge the interest rate risk related to the non-prepayable component of the assets or liabilities concerned. More sophisticated ALM practices may be observed, where prepayment risk could be hedged. But, in that case, each component is hedged using different elements: interest rate risk is hedged by interest rate swaps, and prepayment risk by other derivatives, as options.

It is also observed that changes in prepayments are not so closely related to changes in interest rates, as many other factors may influence the behaviour of counterparties, especially in the retail banking activities.

Assuming that prepayment risk and interest rate risk can be considered separately, IAS 39 allows to hedge only one risk component: so it is possible to hedge interest rate risk without hedging prepayment risk. If the ALM Department clearly notifies at the inception of the hedging operation that prepayment risk is not included in the hedge, only the interest rate risk component must be taken into consideration to assess subsequent ineffectiveness.

Moreover, we do not believe that over-hedging and under-hedging have the same effect in term of ineffectiveness.

In a fair value hedge, ineffectiveness arises if changes in the fair value of the hedged item and in the hedging item do not perfectly match. In the case of an over-hedging situation, the actual exceeding notional amount that can be designated as the hedged item is lower than the notional amount of the hedging instrument. As a result, there is no change in the fair value of a hedged item that can match the change in the fair value of the portion of the hedging instrument that correspond to the over-hedging. The ineffectiveness correspond in this case to the whole change in the fair value of the exceeding portion of the hedging instrument.

In the case of an under-hedging situation, the total actual exceeding notional amount that can be designated as the hedged item is higher than the expected one. But, it should not result in considering that the actual designated hedged item is higher than the expected one, since the higher exceeding notional amount derives from some financial instrument expected to be repaid in previous time bands and thus were not expected to be hedged subsequently. In such case, ineffectiveness arises only when assessing the effectiveness of the hedge related to the previous time band, as changes in the fair value of hedging instruments and hedge items which have different effective maturity dates are not perfectly correlated.

In the perspective of the conclusions reached above, we consider that approach C is the most consistent approach to measure the ineffectiveness as it recognises the possibility to hedge interest rate risk without hedging prepayment risk. The part of the net risk position which is not hedged is supposed to capture the prepayment option. Approach C it consistent with current ALM practices in terms of managing interest risk, assuming that all ineffectiveness as apprehended above are captured.

Approach B is only a specific case of approach C where the ALM Department decides to hedge the entire net risk position. In this case, the ALM department is supposed to hedge also the prepayment risk. But, it does not correspond to general practices.

We don't agree with the Board comment in § BC 23 that it would need to introduce an arbitrary rule to prevent the <<cushion >> that it presumes to exist in approach C from becoming too large. ALM Department have no interest in using large "cushion" as it would result in a weaker economic efficiency of the ALM management. And IAS 39 does not require it.

On the contrary, we consider that approach D is not appropriate in the perspective described above, as it does not recognise the possibility to hedge interest rate risk and prepayment risk independently and the fact that over-hedging and under-hedging don't have the same economical consequences and should not be recognised in the income statement in the same way.

(c) Under your approach, how and when would amounts that are presented in the balance sheet line items referred in paragraph 154 be removed from the balance sheet.

We consider that the fair value adjustments would be removed from the balance sheet when the amount designated as the hedged item is (presumed to be) repaid. Normally, this amount will be removed to a large extent through the revaluation process made at each closing date, as the nearer the maturity date is, the less the difference between fair value and repayment price is. If the hedge become ineffective, or if the actual amount designated as the hedged item is repaid later than expected, the amounts presented in the balance sheet should be amortised on the remaining life of the amount designated as the former hedged item, using an method consistent with the valuation method applying to the amount designated as the former hedged item.

Question 2— The treatment of core deposits

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 BC11-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 ?

No. 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 of resources is observed on demand deposits. So it is crucial that the Asset and Liability Management monitors interest rate risk by including demand deposits in the portfolio hedge and scheduling them into time bands reflecting the expected withdrawals instead of the contractual ones.

Thus, we welcome that the Board refer in its Basis for Conclusions to risk management techniques used by banks. Part of the progress made in the discussions with the Board so far is that

demand deposits can be part of the portfolio that determines the amount to be hedged as part of the “natural offset”. This means that, as far as demand deposits can be matched with assets, the Board agrees to consider demand deposits as instruments that can be naturally hedged against interest rate risk in different time bands within the portfolio fair value hedge approach. However, the Board has a different approach in the cases where entities’ net risk position consists in demand deposits, as it does not allow demand deposits to qualify for fair value hedge accounting. We think these different approaches are not consistent with one another. As a matter of fact, IAS refuses to acknowledge in the accounting treatment what it accepts as a management technique.

So, we do not believe that the Board has met the objective to define accounting rules that totally reflects the economic and financial reality of interest rate risk management, even if significant progress were realised.

As mentioned in paragraph BC 17, the Board recognised that the proposed method of designation in this Exposure-Draft would not fully resolve the core deposits issue. We deeply regret that the Board does not attempt to solve this problem appropriately and stress it to achieve the important effort already made by setting provisions in line with the objective by the Exposure-Draft on the specific issue of demand deposits.

In fact, we consider that two options are included in contracts related to client deposits accounts: the first one allows the client to withdraw cash at any time and the second one allows the client to increase the deposit amount. On day one, it is statistically proved that the option to increase deposit is quite systematically used whereas the withdrawal option is not automatically used at the shortest period available, as the hypothesis made by the Board stands. **In Continental Europe, all statistics show that core deposits are the more stable liabilities a bank can count on.** As these options are embedded in the initial and sole contract creating the deposit account, they must be taken into account when assessing the true nature of core deposits, following the same logic as the one admitting prepayment options where the related expected cash flows are included in the fair value macro hedged items.

Therefore and based on clients behaviour, core deposits have a far much longer than one day maturity. So we do not agree with the fact that they can not qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterpart can legally demand payment as this accounting treatment is not consistent with the behavioural options. As these deposits have some duration and a low or non-existent but fixed rate, their fair value changes if interest rates changes and so they can be designated as hedged items.

Another argument could be drawn up, as the probability to use the option to increase the deposit amount is almost 100%, it can be considered that the bank has a firm commitment related to this option. The Board itself proposed that firm commitments could be eligible to fair value hedge instead of cash flow hedge. So this could apply to demand deposits.

(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?

No. Although we believe that the initial fair value of demand deposits is their nominal value, we think that the fair value of these demand deposits, included in a portfolio of demand deposits, may change in subsequent periods in connection with changes in interest rates. As explained above, we believe that, in substance, the real maturity of a portfolio of demand deposits is beyond the shorter period in which depositors may demand

payment. As demand deposits bear most of the time fixed interests (or no interest, which is economically a 0% fixed interest), their fair value is sensitive to changes in interest rates. Therefore, they are eligible as an hedged item in a fair value hedge.

(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?

No. We have noted that this question remains one of the most challenging issues related to core deposits. We are strongly opposed to the initial recognition of a gain on core deposits as they enter the macro hedged portfolios at their nominal amount, which is the cash provided by the depositor. Furthermore, under the fair value hedge accounting framework, any change in the fair value of core deposits that is attributable to the hedged risk and in the fair value of the hedging instrument would be recognised, with the result that from period to period (in each time band), the changes should be lower than the arithmetical difference between the fair value of the deposits at inception and their contractual amount.

Therefore we consider that this approach does not prevent from including core deposits in a fair value portfolio hedge and applying the same treatment as the one reserved for assets.

If you do not agree that is the result, how would you characterise the change in value of the hedged item?

Based on clients behaviour, core deposits have a far much longer than one day maturity. As the deposits have some duration and a low or non-existent but fixed rate then fair value changes if interest rates change.

Additional comment: perspective of using cash flow hedging to demand deposits

As explained above, we strongly believe that fair value hedge is the appropriate way to represent the portfolio hedge of interest rate risk when the amount designated as the hedged item is demand deposit.

The Board envisages the cash flow hedge approach to be used when the amount designated as the hedged item is demand deposit. We think that such a proposal raises the following issues:

- Banks or other financial institutions may often be both asset sensitive or liability sensitive at the same time, depending on their exposure within the different time bands. So, the same kind of hedging operations would be simultaneously be recognised as fair value hedge or cash flow hedge, depending of the respective amounts that can be designated as the hedged item. In another case, some hedging operations could be recognised as a fair value hedge at one closing date and as a cash flow hedge at another one. This would be very burdensome as changes in fair value would be first recognised in the income statement and later in equity. Such different representations of the same kind of operations would bring confusion and undermine the understanding of the financial statements by readers.
- Cash flow hedges that in substance hedge recognised fixed rate items generate a volatility in equity that does not correspond to a volatility in a risk management's perspective. Therefore, if

cash flow hedge accounting is applied to core deposits, readers will not have a relevant information on the real risk exposure of the entity.

As a conclusion, it would be highly preferable in our point of view to apply the same accounting treatment to operations that are of the same nature and pursue the same goals. This would facilitate the understanding of the financial statements by readers. So fair value hedge should be allowed for hedging demand deposits in a portfolio hedge of interest rate risk as a practical expedient, even if the Board believe that it is not sustained by conceptual reasons.