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BELGIAN BANKERS' ASSOCIATION
Member of the Belgian Finance Federation

Studies, Statistics and
Banking Supervision
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Sandra Thompson
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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Brussels, November 13, 2003

Dear Mrs Thompson,

Exposure Draft of Proposed Amendments to IAS 39.
Position of the Belgian banks.

In August of this year, the IAS Board held a consultation concerning IAS 39.

The document concerned is "*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*".

We would like to thank you for giving us the opportunity to express our opinion with respect to these proposals. Please find enclosed our point of view.

Yours sincerely,

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Head of the Departement Studies, Statistics and
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PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS 'RECOGNITION AND MEASUREMENT - FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF INTEREST RATE RISK': POSITION OF THE BELGIAN BANKS

1. General position

The Belgian banks have carefully examined the proposed amendments to the IAS-39 standard. Our main conclusion is that these proposals do not fully reflect the way asset liability management works within banks and consequently, they must be considered to be impracticable.

We are mainly concerned about the proposals dealing with demand deposits. Although we agree with the general proposal to exclude fair value as for demand deposits, we are of the opinion that demand deposits should qualify as hedged items (at fair value). As for the recognition of ineffectiveness, the solutions proposed skip the fact that the bank's intention is to hedge a margin and not a portion of assets or liabilities. For these reasons, we cannot accept the amendments which have been proposed, as a sufficient basis for implementing fair value hedge accounting in a banking environment.

2. Demand deposits

Although we agree on the principle that demand deposits should not be recognised at fair value it should be clear that for hedging purposes it is necessary to measure the fair value of the demand deposits in order to minimize volatility.
We also agree that derivatives are recognised as assets or liabilities. The only way to do so, is by making sure they are entered at fair value in the balance sheet.

Nevertheless, we cannot agree with the amendments as proposed by the IAS Board because of the two following issues:
- the solution proposed by the Board is inconsistent, because it allows to take demand deposits in account for calculating a net position however without accepting all of the consequences,
- the solution does not reflect the way in which banks manage interest rate exposure. The misunderstanding leads to recognition of ineffectiveness in the P&L, which is not relevant for banking business.

The solution is inconsistent: the Board agrees with the use of models by banks for time-spreading the amount of demand deposits; it accepts to take them into account when calculating the net position for hedging purposes, but it does not accept all of the consequences. The Board does not accept that demand deposits are marked as hedged items, when the net position in liabilities mainly consists of demand deposits. The rationale behind this ban is that demand deposits cannot be recognised at fair value. As already said before, we agree with this and we do not want demand deposits to be recognised at fair value. However, we think this argument will not prevent banks from hedging a net position chiefly made up of demand deposits. The ban is based on a misunderstanding about how banks try to manage interest rate exposure.

3. Ineffectiveness of the hedging of a net position: inconsistent with ALM in banks

The recognition of ineffectiveness as described in the Exposure Draft does not reflect banking business. In order to assess effectiveness of macro-hedging relationships, the Board asks banks to apply re-estimated parameters to the portion of assets or liabilities. In doing so, the Board presumes that the hedge position is fully stable and consequently, it considers the net position to be equivalent to a portfolio of assets or liabilities. When using macro-hedging relationships, banks aim at hedging a margin instead of a portion of assets or liabilities.

We can take as an example a net position of CU (currency unit) 20 coming from a portfolio of assets amounting to CU 100 and a portfolio of liabilities amounting to CU 80. The management decides to hedge only CU 15. The portfolio of assets is not stable: let us suppose that new loans are granted to clients for an amount of CU 25. The mismatch created by new loans is entirely compensated for by an increase in liabilities, since the bank's intention is to hedge a margin. The management decides to keep the split between the hedged and non-hedged net position (i.e. CU 15 is hedged and CU 5 is kept open). The portfolio of assets has been modified from CU 100 to CU 125, so the Board asks the bank to calculate ineffectiveness and to recognise it in the P&L. In terms of mismatch managing and margin hedging, there has been no change as for the economic value nor for the management's intention (the management having decided to keep the net open position unchanged).

Consequently, the recognition of ineffectiveness stemming from the hedge relationships does not reflect the management's intention. When applying the proposed amendments to IAS 39, banks may include volatility into their financial reports. This kind of volatility will arise from the two issues described above. First, if a bank hedges a net liability exposure consisting of demand deposits for the bigger part, it will recognize hedging items at fair value with adjustments accounted for in P&L without offsetting those effects by effects coming from the hedged items, as the amendments do not allow a hedge relationship of this kind. So, a perfect economic hedge relationship does not qualify for hedge accounting and will bring volatility into financial reports! Secondly, ineffectiveness will also cause volatility even if the management's intention is to achieve a perfect hedging of a margin as described in the example above.

4. Conclusions

Although we agree on the principle that demand deposits should not be recognised at fair value it should be clear that for hedging purposes it is necessary to measure the fair value of the demand deposits in order to minimize volatility. We also agree that derivatives are recognised as assets or liabilities.

By combining these two premises with the macro-hedging of interest rate exposure (the margin hedging) we would like to propose a solution based on hedging a net position, which is a fixed amount of CU. As long as the bank will keep that net position, there will be no ineffectiveness arising from the hedge relationships.
If there are changes in the assets or liabilities portfolio, the net position will be modified. In that case, if the bank does not modify its hedge relationship, the hedging items will not match the net position as they used to. Hence, ineffectiveness will arise and should be recognised in P&L.