BANKING ADVISORY COMMITTEE

CHAIR

CL 18

Brussels, 12.11.2003
MARKT

Sir David Tweedie
Chairman,
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David,

Exposure Draft ***Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk***

I am writing to you as regards your recent Exposure Draft on hedge accounting. The Banking Advisory Committee (BAC) established by the EU Codified Banking Directive 2000/12/EC will assist the European Commission in the development of banking legislation, including accounting rules applicable to credit institutions. In 2001, the BAC set up a Subcommittee on Accounting and Auditing (the Subcommittee) to provide a banking perspective on the development of accounting and auditing standards particularly relevant to banks. The Sub-committee is composed of specialists from the Member State authorities in charge of the regulation and supervision of banks.
The Subcommittee has reviewed the Exposure Draft on hedge accounting. It has focused on the issues arising in relation to hedge designation, to the resulting effect on the measurement of ineffectiveness, and on the treatment of deposits.

You will find the Sub-committee's comments in annex to this letter. They also provide some general comments for your consideration before the standards for hedge accounting are finalised.

Yours sincerely,

José-Maria ROLDAN ALEGRE
Chairman

Comments on the IASB's Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*

General Comments

The issue dealt with in the Exposure Draft has been identified as being of major importance to the banking sector.

We commend the Board's efforts to involve various interested parties in exploring the issues and potential solutions.

We understand the objective of changes being proposed as to make it easier for hedge accounting to be applied to macro hedges of interest rate risk without departing from the principles on which IAS 39's hedge accounting requirements are based. The three principles that are most relevant to a portfolio hedge of interest rate risk are reminded in paragraph BC6 of the ED. The Members' comments have been drawn up taking note of the fact that the hedging of net interest rate positions should meet these principles.

At the same time Members widely recognise that the 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. This is an important consideration from the perspective of banking supervisors. Therefore we welcome that the Board in its Basis for Conclusions refer to risk management techniques used by banks.

As a general comment, Members feel that the Board should have made clearer how this ED fits in the ED IAS 39 revised, in particular the relationship between the ED and the paragraphs about fair value hedges in the ED IAS 39 revised (e.g. paragraphs 146, 150 and 157). It is also unclear how this ED relates to the IGC questions and answers about using cash flow hedges to manage interest rate risk, especially to the complex Question 121-2. Members would prefer a global approach to macro hedging in IAS 39 to the actual dispersed approach.

Our other comments concentrate on the major issues raised in the ED.

Hedge designation and the resulting effect on measuring ineffectiveness

The ED 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. Members agree on this proposal.

The ED also proposes that the entity may hedge a portion of the interest rate risk associated with the 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). Members also agree on this proposal.

The Board concluded that ineffectiveness arises if these expected repricing dates are revised, or actual repricing dates differ from those expected. The Basis for Conclusions sets out alternative methods of designation and their effect on measuring ineffectiveness. The Members examined these alternatives in the light of the following principles:

- all material ineffectiveness in hedging interest rate risk should be identified and recognised in profit or loss (this principle is also relevant to the Board as mentioned in paragraph BC6.b). Members stress the importance of materiality in the ineffectiveness test and would appreciate the Board to be more specific on this issue;
- the hedge accounting rules should be consistent with the principles of sound risk management (see General Comment above).

Members realise that the issue whether or not prepayments affect how effective the hedge was in mitigating interest rate risk is of particular importance when considering the Approaches A to D.

Many supervisors favour Approach B and its variant C, as these approaches are seen as the most consistent with both the existing fair value hedge accounting under IAS 39 and the principles of sound risk management.

However, other Members believe that there are advantages and disadvantages associated with each of the four options. They point out that the proposals will create a number of challenges for preparers and their auditors, such as the estimation of the value of each maturity time band. A number of these Members see particular merits in Approach D, e.g. its ability to capture ineffectiveness arising on both under-hedging and over-hedging.

The diverging views within the supervisory community and within the Board (five Board Members expressed an alternative view) led Members to believe that the issue merited further research/discussion. They would therefore urge the Board to continue to work closely with interested parties, including the banking industry, to reaching a broad consensus on a model that leads to the most meaningful financial information. Timing being crucial, such discussions should take place urgently to ensure that they do not prolong finalisation of the standard unnecessarily.

The treatment of deposits

The ED proposes that all of the assets and 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. The Board decided that core deposits cannot qualify for fair value hedge accounting for any time beyond the shortest period in which the counterparty can demand payment. The Members examined the Board's reasons as stated in paragraph BC14.
The Board is of the opinion that deposits included in the balance sheet are unlikely to be outstanding for an extended period (eg several years). The Board believe that these deposits are withdrawn within a short time although they may be replaced by new deposits. Therefore, the liability hedged is seen by the Board as the forecast receipt and rollover of new deposits. A forecast transaction cannot qualify for fair value hedge accounting under IAS 39.

Members agree that, while the Board's reasoning may be valid for real demand deposits used by individuals and companies to manage their day-to-day income and expenses, banks receive important amounts of core demand deposits that are equivalent to long term savings. They note that in reality these amounts remain with the banks for longer periods, even when they are legally available to the depositors on demand or on very short notice. Such core demand deposits are a fundamental characteristic of the European banking industry. Members also underline that the amounts of core demand deposits are very important, particularly for Continental European banks.

The Board observe that core deposits are similar to a portfolio of trade payables and that both comprise individual balances that usually are expected to be paid within a short time and replaced by new balances.

As explained above, Members do not share this observation of the Board for core demand deposits.

To recognise the particularities of the large majority of European banks, many Members believe that the Board should develop a practical accounting standard that allows a net position of core demand deposits to qualify for fair value hedging. The standard should include a workable definition of core demand deposits. They believe that this approach is also consistent with sound interest rate risk management techniques as explained in the consultative document of the Basel Committee: '*Principles for the Management and Supervision of Interest Rate Risk*', September 2003.

However, other Members believe that the issue of hedging core demand deposits can be solved by using cash flow hedges as explained in the IAS 39 Implementation Guidance. They believe that this approach is in conformity with all accounting principles and they observe that also the American FASB rules allow only cash flow hedge accounting for core deposits.