

14 November 2003 (trzO3-873)

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

Dear Sir,

Reference: **Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments**

The Netherlands Bankers' Association studied the "Exposure Draft of Proposed Amendments to IAS 39" of the International Accounting Standards Board (IASB) and gratefully responds to your invitation to comment.

We welcome and appreciate the effort made by the IASB in developing in cooperation with European banks an Exposure Draft to improve the implementation of IAS 39. Hedge accounting, in particular macro hedge accounting has been the subject of many debates in Europe and also in the Netherlands. Although we have comments of a technical nature, we generally agree with the attempt to create a possibility for applying a fair value hedge accounting model to what banks refer to as macro hedging.

Answers to questions raised in the Exposure Draft

Question 1: Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness?

We agree with the proposed designation of an amount of hedged items rather than individual assets and liabilities.

Given our preference for a principles based, rather than rules based approach, for the standard, we prefer that the approach to measuring ineffectiveness is in the standard not prescribed in detail, so that entities have the possibility to align the measurement of ineffectiveness to their ALM practice.

We do not agree with the proposed percentage approach to measuring ineffectiveness. We prefer a layer approach. The reasons are as follows:

- We are of the view that prepayment risk and interest rate risk can be distinguished and are in fact distinguished by many banks in their ALM.

- The approach to ineffectiveness differs from the approach taken in the cash flow hedge accounting model included in Q&A's 121-1 and 2.
- The way the Exposure Draft proposes to measure ineffectiveness, by using percentages hedged and adjusted percentages hedged based on changes in expectations, is rather artificial. Also the removal of fair value changes ultimately when the related assets or liabilities are de-recognised may lead to more volatility than in the one-to-one fair value hedge model.

We prefer approach B, and consider C as second best, when IASB still wants to prescribe a solution. For approach B/C we would then strongly advise to sharpen this approach to a net of asset and liabilities approach, which is more in the way current ALM is considering the hedging activities. This means that ineffectiveness results when the net amount of assets and liabilities is lower than the notional amounts of the derivatives designated as a hedge (a net "over-hedged" situation).

We agree that only an over-hedged and not an under-hedged situation should lead to ineffectiveness being recorded

Question 1. a: Does ineffectiveness occur in case of partial hedging?

In case prepayment risk is not part of a hedged position, ineffectiveness should only be recorded after the un-hedged position is fully absorbed

Question 1. b: Does revision of repricing to dates later than previously expected impact ineffectiveness?

No, as under IAS 39 it is possible to hedge a part of a repricing term, assuming the term hedged has been appropriately designated. This is consistent with ALM practice.

Question 1.c: How and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet?

Their removal is linked to the duration of assets and liabilities involved.

Question 2: 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?

EFRAG states that certain financial institutions (such as savings banks in Europe) have a financing structure of stable, long-term low cost funds. Economic reality is that a layer of such liabilities is at the disposal of the entity, and the market value of those layer changes according to the movements in interest rates. Indeed, when interest rates go up, the value of a low carrying interest rate account will increase for the financial institution. This value component is economically linked with the core deposits and underlies the commercial substance of the bank's business. We, therefore both, can see good reason to recognise the economic value on the hedged position within a portfolio hedge of interest rate risk.

On the issue of the fair value of core deposits, we agree with EFRAG and understand some of the reasoning behind the Board's view that the carrying amount of a core deposit redeemable on demand cannot be less than the amount payable on demand. However, we do not find all of the arguments convincing.

We agree that a market price for a portfolio of demand deposits can only arise between two licensed deposit takers. However, it is undisputed that such sales occur at prices different to the nominal amounts of the obligations transferred. The fact that such prices may include other elements - as mentioned under BC14 (c) (iii) - does not exclude the possibility (some believe the reality) that this also includes payment for the consideration of expected demand dates.

Conclusion

The Netherlands Bankers' Association believes that the outcome of the draft's proposal on one consistent single hedging activity— as it stands - remains unsatisfactory because investors will find volatility in equity for some "time periods" whilst offsetting gains and losses through profit and loss - for other "time periods". This outcome puts entities that have access to long-term, stable low cost funding at a competitive disadvantage over institutions that are required to fund themselves - at least in part - at a more volatile, higher cost level. So we support a pragmatic solution as suggested by EFRAG meaning the acceptance by the Board of a net position of core deposits for portfolio hedging by way of exception in order to meet the need for a consistent accounting solution.

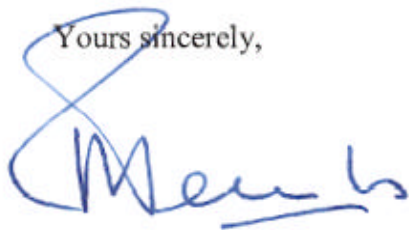
The real point is that neither cash flow nor fair value hedging really applies to banks. Both methods assume that assets or liabilities are being hedged whereas banks are hedging their interest risks and interest margins. Because it is the net margin that is the real item being hedged, banks have a fairly arbitrary choice of using cash flow hedge accounting or fair value hedge accounting. This creates the false volatility in cash flow hedge accounting. We therefore believe that some form of compromise is needed. We believe that macro fair value hedging with core deposits included provided the best way forward at this time and minimises the overall risks to the financial sector at this time of enormous change.

For many banks the use of cash flow hedging to hedge interest rate risk may result in transfers in or out of reserves which are substantial. A typical European bank which has a third of its funding from core deposits faced with a 3% rise in interest rates could find that, by using cash flow hedging rather than fair value hedging, it

would report that it had no equity at all .whereas risk management would show, using the approved internal risk models which are the basis of Basel II the bank to be perfectly hedged, with no loss of equity.

We would welcome further discussion on this paper.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'M. Feenstra', with a large, stylized initial 'P' or 'F' at the beginning.

Mr Paul M. Feenstra
Head of Banking Supervision Department