

14 October 2002 (trz02.739)

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 32 and IAS 39**

Introduction

The Netherlands Bankers' Association studied the "Exposure Draft of Proposed Amendments to IAS 32 and IAS 39" of the International Accounting Standards Board (IASB) and gratefully responds to your invitation to comment.

We welcome IASB's steps to increase transparency and comparability of enterprises and financial institutions. On several occasions we have indicated that nevertheless IAS 32 and 39 would mean substantial unwanted changes in reporting and in the management of banking business. In this letter we have formulated proposals with regard to the main issues for our industry, which we believe would lead to improvements to reporting by the banking industry without harming the fundamental issues of transparency and comparability.

We provide our comments on a principles based approach, in order to address what we consider to be the critical issues for banks arising from these exposure drafts. These principles regard the typical bank balance sheet, the use of macro hedges and the role of central risk management.

1. A typical bank balance sheet

In Annex 1 you will find a table that summarises existing accounting principles for a bank's portfolio and the accounting principles in the IAS 39 exposure draft.

The rules mentioned do or do not align with internal control principles, depending on the purpose of a portfolio.

A bank's investment portfolio can serve a number of purposes:

- an investment portfolio can be held to manage the long-term interest rate risk of a bank, or
- the investment portfolio can be a true held-to-maturity (HtM) portfolio.

When an investment portfolio is used to manage the interest rate risk of the bank, it may be necessary to sell and replace investment securities periodically in order to manage its risk profile, e.g. to shorten or lengthen duration. However, the long-term nature of the

investment portfolio is not compromised by these replacement activities. As a consequence of the strict IAS criteria for HtM these investment portfolios used for hedging balance sheet risk, can only be classified as available-for-sale.

We propose:

- that either the strict rules for HtM should be stretched, or
- a further category of financial assets should be created.

This in such a way that the long-term nature of investment portfolios used for interest rate risk management is recognised and thus investment portfolios subject to replacement can be accounted at amortised cost.

2. Micro hedges vs. Macro hedges

An other major anomaly in the accounting principles for IAS 39 is that all derivatives must be mark-to-market (MtM), including derivatives that are hedging portfolios accounted for on an amortised cost or accrual basis. Hence, in IAS 39, the IASB has overturned the principle that the accounting rules for the hedging instrument should follow the accounting for the hedged item. The Risk Management Departments of banks currently hedge overall positions on the basis of generated cash flows, rather than on individual balance sheet items.

The micro hedge approach in IAS 39 does not concur with such a macro hedge approach that all banks apply. The only mechanism by which a bank is able to manage the potential volatility in its profit and loss from fair valuing the hedging derivatives is by adopting either:

- fair value hedge accounting which allows the hedged item to also be fair valued in the profit and loss for the hedged risk, or
- by adopting cash flow hedge accounting which allows the hedging derivatives to be fair valued through equity.

The workaround given in Q&A 121 does - to a certain extent- enable the hedge of portfolios. However, doing so, the accounting does not necessarily reflect any more the result of the risk management activities of the bank. In making this choice between cash flow or fair value hedge accounting, we have serious concerns that hedges can be designated against hedged items in a way that separates the economic purpose of a hedge from its designation as a cash flow or fair value hedge.

We also have concerns if and to which extent the general public understands that the same financial hedge instrument can be accounted for as fair value hedge or cash flow hedge.

Comparability

If the objective of the IASB is to achieve comparability and transparency in the financial statements of companies by introducing IAS 39, there is clearly some doubt as to whether this will be achieved due to the points noted above. Some banks may also just choose to MtM their hedges and not adopt hedge accounting at all. Furthermore a fair value option has now been introduced into the exposure draft, allowing any financial asset or liability to be held for trading even if this was not the economic intention. Whilst this option was introduced to ease the problems with adopting hedge accounting, banks will make use of such an option on a discretionary basis, resulting in even less comparability.

Again, we propose:

- stretching the criteria for HtM, or
- creating a new category of financial asset which allows for replacement of investment portfolios accounted for at amortised cost, and
- a return to the key accounting principle that hedging instruments are accounted for in the same way as the portfolios they are hedging. The remaining (not allocated derivatives) should be valued MtM.

This will much better reflect the performance of a risk management function within a banking organisation and will maintain comparability between banks' results.

3. Internal derivatives - The role of central risk management

IAS 39 requires that only derivatives:

- that are settled against a party external to the entity can be designated as hedging instruments, and
- that internal transactions between group entities as well as gains and losses on those transactions need to be eliminated.

Q&A 134-1 (a and b) explain that only if internal transactions are offset by derivatives with external parties, hedge accounting can be applied to those external derivatives.

In practice

For foreign currency hedges it is possible to hedge the net exposure of a bank since foreign currency hedges are re-valued under IAS 21 to the closing rate. However, for interest rate positions a similar approach cannot be applied as interest rate positions are considered to generally be measured at amortised cost. Banks require for risk management and internal control purposes that there is one central in-house bank department that manages and monitors all internal inter-group hedge transactions. This in-house bank department enters into an internal hedge transaction with the tradingdesk. The only one entity/department entering into transactions with an external party is the trading desk. That acts as the 'window' to the market for the whole bank. That department is furthermore the only department authorised to take trading risk positions, an activity that is generally performed by banks.

In our view a similar approach to interest rate hedges could be applied, if it can be proven that for the portfolio of internal hedges with the risk management units the trading desk has fully laid off the risk in terms of currency, duration and interest rate risk.

We propose:

To consider whether the evidence provided for tested the offsetting of the internal transactions for banks in interest rate risk hedging could be based on the following:

- Internal transactions are settled on exactly the same terms and applying the same (test and reviewed) pricing models as applied for external transactions and are all measured on a fair value basis.
- The trading department is separately managed and operates under strict limits.
- The trading department is active on the external financial markets and it is authorised to deal on it.
- Internal controls ensure compliance with limits set.
- When the limits are reached, the department always enters into transactions with external parties.
- The trading department operates in the 'fair value' environment of the entity, functionally segregated from the 'banking/cost' environment and is separately managed and controlled.

4. Loan provisioning

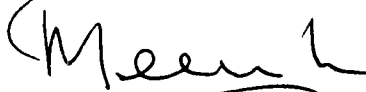
We would like to make one additional comment on details. In the exposure draft it is proposed that impairment on loans should be calculated using the effective interest rate method. The use of effective interest rates on an asset by asset basis over the life of the financial instrument would involve going beyond the existing data sources even for banks planning to follow the advanced IRB method under Basel 2. This is a radical shift in the basis upon which loan provisions are made. Basing provisions on the net recoverable amount would be more compatible with the measurement of loans at amortised cost.

We propose:

That IAS 39 also offers alternatives for the provisioning on loans, as is currently the case under US GAAP.

We would welcome further discussion on this paper.

Yours sincerely,



Mr Paul M. Feenstra
Head of Banking Supervision Department

Annex:

1. Table of the existing accounting principles for a bank's portfolios and the accounting principles in the IAS 39 exposure draft.

Annex 1

Table (summarises) of the existing accounting principles for a bank's portfolios and the accounting principles in the IAS 39 exposure draft

Portfolio	Existing Accounting Principle	IAS 39 Accounting Principle
Investment Portfolio	<i>Amortised Cost</i>	<i>Held to Maturity – Amortised Cost Available for Sale – Fair Value in Equity</i>
Loans and Advances	<i>Amortised Cost</i>	<i>Held to Maturity – Amortised Cost Own Originated – Amortised Cost Available for Sale – Fair Value in Equity</i>
Trading Portfolio	<i>Fair Value on Balance and P & L</i>	<i>Fair Value on Balance and P & L</i>
Derivatives	<i>Hedging – Accrual Trading – Fair Value in P & L</i>	<i>Fair Value in P & L</i>
Savings Accounts	<i>Accrual</i>	<i>Accrual</i>
Other Financial Liabilities	<i>Amortised Cost</i>	<i>Amortised Cost</i>