



LE PRESIDENT

14 October 2002

Re: Exposure Draft of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement.

Sir.

We are pleased to provide our comments on the above exposure draft.

As financial institutions are subject to the recently approved European regulation that will impose IAS on all listed companies by 2005, implementation of IAS 32 and IAS 39 represents a major challenge for us. First, major investments will be required to change our information systems in order to prepare the information requested. Secondly, some of the requirements will be intrusive to the way we conduct our business and will have a significant impact on our financial statements. Finally, we will need to prepare ourselves to explain to the users of our financial statements how to read and understand the new financial information published, which will be dramatically different compared to the information currently presented.

To prepare for the change and meet the 2005 deadline, each of our entities/subsidiaries started an IAS conversion process more than a year ago. Therefore, our comments on the proposed revised IAS 32 and IAS 39 are the results of a thorough study of both the current requirements of IAS 32 and IAS 39 and their proposed amendments. Our current IAS conversion exercise has allowed us to test the implementation aspects of the proposed requirements. We want to share with you our findings concerning those areas where we find that implementation of IAS 32 and IAS 39 is particularly complex or gives results whose relevance may be called into question for financial institutions.

Sir David Tweedie
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Among other comments, we have strong reservations about the following principles.

We believe that:

the principle that all derivative instruments should always be measured at fair value regardless of how they are used is inconsistent with the principles for the measurement of other financial instruments, for which intent is considered (e.g., there is different treatment depending on whether there is intent to hold an instrument for trading or to maturity!). All financial instruments should follow the same principles. We cannot see any reason why derivative instruments and cash financial instruments should be treated differently. This conceptual error leads to two other major flaws:

- fair value hedge accounting under IAS 39 requires that the hedged instrument follows the same treatment as the hedging instrument. This is inconsistent with the main reason why the transaction was entered into. We believe that the hedging instrument should follow the treatment of the hedged instrument and not vice-versa;
- cash flow hedge accounting under IAS 39 requires value changes of the hedging instrument to be recognised in equity whereas the value changes of the hedged instrument are not reflected in the financial statements. We believe that this treatment does not give a timely true and fair view of the transactions that have been entered into and that it gives a misleading representation of the financial position of the company.

If the IASB continues to require that all derivative instruments that are used in a hedging relationship are measured at fair value, which we do not believe is supported conceptually, the Framework should be modified so that the accounting entries to give hedge accounting treatment (if the criteria are met) are recognised not as a change in equity but elsewhere in the balance sheet;

- the option to designate at inception any financial instrument as a held-for-trading financial instrument is proposed solely to mitigate the fatal flaws in IAS 39. We urge the IASB to revise the Standard so that its application gives a relevant presentation of the transactions and activities without the need for this option. In addition, we are concerned that this option may be used by unscrupulous members of management to conceal the real financial position;
- it is inappropriate to use the last available published price quotations to recognise unrealised gains and losses on strategic equity investments and equity investments in venture capital in the balance sheet (they will be classified as available-for-sale financial assets and measured at fair value). We are highly concerned by this lack of prudence in measuring long term financial instruments in such a way, which is likely to have a negative effect on the stability of financial markets.

Furthermore, we regret the IGC has disregarded our proposals for an appropriate solution to accounting for hedging net positions and the consideration of internal contracts, which are crucial in the transformation process and hedging of the positions of financial institutions and their segmental reporting.

Financial institutions will be key users of the Standards on financial instruments. For a Standard to be relevant to their activities, it is necessary to acknowledge their practices of hedging net positions or transforming them.

We urge the IASB to take action on our comments before finalisation of the revised Standards.

If you have any queries regarding our comments, please do not hesitate to contact Véronique de La Bachelerie at 33 (1)42.14.49.86.

Yours faithfully.



Daniel BOUTON
Chairman and Chief Executive Officer

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1. Due process

In the Introduction to the Proposed Amendments to IAS 32 and IAS 39, it is indicated that the IASB did not intend to change the basic principles in those Standards. The purpose of the amendments is *“to reduce some of the complexity by clarifying and adding guidance, eliminating inconsistencies, and incorporating into the Standards key elements of existing SIC Interpretations and IAS 39 Implementation Guidance”*.

We believe that some of the proposed amendments introduce significant changes to the current Standards and may represent something close to a change to the basic principles. Among other proposed changes, we have noted the introduction of an impairment test on sound portfolios to cover credit risk (which is of major importance to financial institutions) and an option allowing measurement of any individual financial instrument at fair value.

We are very surprised that such major innovations should be introduced without any prior consultation or discussions before the publication of an Exposure Draft with financial institutions representatives (for example accounting representatives at the International Banking Association Accounts Committee), accounting standard setters who are Liaison Members of the Board (such as the Conseil National de la Comptabilité in France – CNC), or the technical bodies in charge of providing an opinion on the proposed IASB rules to the European Commission (such as the European Financial Reporting Advisory Group).

The IASC Foundation Constitution indicates in paragraph 32(b) that the IASB shall *“publish an Exposure Draft on all projects and normally publish a DSOP or other discussion document for public comment on major projects”*. We believe that some of the proposed changes to IAS 32 and IAS 39 (refer to above) would have warranted the publication of a discussion document before reaching the stage of an Exposure Draft.

2. Hedge accounting and internal contracts

We believe that the requirements for hedge accounting are fundamentally flawed.

Much of the complexity of IAS 39 stems from the principle that all derivatives should be recognised and re-measured at fair value, whether or not entered into as part of a hedging relationship. This principle is inconsistent with the principles for the measurement of other financial instruments, for which intent is considered (e.g., there is different treatment depending on whether there is intent to hold an instrument for trading or to maturity). All financial instruments should follow the same principles. We see no reason why derivative instruments and cash financial instruments should be treated differently.

As a result, we believe that fair value hedge accounting under IAS 39, which requires that the hedged instrument follows the same treatment as the hedging instrument, is inappropriate. This treatment is inconsistent with the main reason why the transaction was entered into. We believe that a more adequate model would be for the hedging

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instrument to follow the accounting treatment of the hedged item, to ensure that the gains and losses on the hedging instrument unfold at the same time as the equal and opposite gains and losses on the hedged item. We would support disclosure of the market value of liquid instruments.

Furthermore, we also believe that the treatment of cash flow hedges under IAS 39 is inappropriate. We understand that the recognition in equity of gains and losses on derivatives entered into as a cash flow hedge is intended to avoid unjustified volatility in the income statement. We want to highlight that using equity in this way may have very significant consequences for a bank's capital base. We also would like to know more about the IASB's 'Reporting Financial Performance' project before concluding on the treatment of cash flow hedges. We consider that cash flow hedge accounting results in a loss of symmetry on the balance sheet of an entity that is confusing for the users of the financial statements. It does not give a timely, true and fair view of the transactions that have been entered into and it gives a misleading representation of the financial position of an entity. Cash flow hedge accounting under IAS 39 requires value changes of the hedging instrument to be recognised in equity whereas the value changes of the hedged instrument are not reflected in the financial statements.

We also consider that there are other major flaws in the hedge accounting rules set out in IAS 39 and the IGC literature including:

- the fact that non-derivative financial instruments are not considered as hedging instruments for the purpose of hedging interest rate risk;
- the prohibition of internal transactions as far as hedging risks other than currency risk are concerned;
- the fact that held to maturity investments cannot be hedged for the interest rate risk; and
- detailed restrictions on enterprise-wide interest rate risk management.

IAS 39 specifically ignores portfolio risk management and is unsuited to the circumstances of financial institutions engaging in risk offsetting external/internal transactions. A strict application of the Standard would result in hedging rules which unduly hinder the risk management process. It will lead banks to transact with external third parties to hedge interest rate exposures on a gross basis (rather than on a net basis) and, as a consequence, it will expose them to increased credit and operational risk and additional undue costs.

We do not understand the principle behind or basis for these restrictions and we believe that the hedging principles should be organised around straightforward requirements for designation, documentation and effectiveness.

We set out in Appendix 1 our comments and proposals for hedge accounting.

3. Measurement of available-for-sale financial assets at fair value

We do not support the principle that requires the systematic use of the last available published price quotations for the valuation of strategic equity investments and equity investments in venture capital (which normally would be classified as available-for-sale financial assets). While such an application of the fair value measurement principle to trading activities (for which there is an intention of selling the instruments in the short-term) is appropriate to reflect the performance of an enterprise and its management, we believe that the application of this principle to strategic equity investments and equity investments in venture capital that are held for a longer period of time is inappropriate.

Since the changes in the fair value of all equity securities that are not held for trading - irrespective of the intent and the holding period - are recognised in equity, we believe that instability or high volatility of stock markets would create volatility in an entity's equity, which would vary according to the performance of completely extraneous factors.

The users of financial statements should be provided with relevant and reliable information. Shareholder's equity represents an essential component of this information. We do not believe that the current requirements of IAS 39 for the measurement of strategic equity investments and equity investments in venture capital will meet the objectives of relevance and reliability.

4. Collective impairment

The proposed method for collective impairment requires the recognition of impairment losses on individual loans specifically identified as impaired (IAS 39.111) as well as a collective assessment for impairment of groups of individually non-impaired loans with similar credit risk characteristics (IAS 39.112). We understand that the removal from the portfolio of an individually impaired asset does not automatically lead to a reduction in the impairment calculated on a portfolio basis, which is not consistent with risk management practice.

We would prefer a general approach for determining impairment losses on loan portfolios for the credit risk associated to these portfolios, with first the determination of a global impairment loss calculated on the total loan portfolios (including individually impaired and non-impaired loans). Secondly, impairment losses on individually impaired loans should be calculated. Finally, impairment losses on the non-impaired loans should be calculated by difference between the global impairment loss and impairment losses on individually impaired loans. This approach is consistent with the steps in the Standard to recognise impairment.

We also believe that the assessment of risk premiums as well as estimated cumulative cash flow loss rates per year, being influenced by the short term perception that both the market and those responsible for the internal rating systems hold at a particular period during the economic cycle, would introduce an exaggerated volatility in profit or loss generated by financial institutions, being contrary to the stability needed for the international banking system. Therefore, we recommend that the methodology to

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assess risk premiums and estimated cumulative cash flow loss rates per year uses an objective internal methodology, which is not influenced by the assessment of risk by the market at any particular point of time, but is based on an observation of an entity's historical average losses experience by group of assets showing similar credit risk characteristics over a long period of time (i.e. for the period to year-end).

Finally, when considering the implementation of the proposed approach, we have identified several technical and operational flaws. Under the proposed approach as set out in the examples provided, the computation of impairment would include the margin on the loans as well as already collected fees.

5. Presentation of the financial statements of financial institutions

We understand that the IASB has two projects under way that may affect significantly the presentation of the financial statements of financial institutions:

- the project on Deposit-Taking, Lending and Securities Activities
- the project on Reporting Performance.

Implementation of each of these projects may require complex and major changes to our information systems. We wish to express our concern about the timetable for those projects, should they result in final Standards that would become effective in 2005.

In addition, we have considered the preliminary tentative conclusions of the IASB on those projects that are available on the IASB's website. With respect to the project on Reporting Performance, we are unclear how some of these preliminary conclusions would apply to financial institutions, particularly for the distinctions between operating and financing items. We would recommend that the IASB ensure that financial institutions specialists are involved in the project and that the issues specific to performance reporting by financial institutions are dealt with.

6. Option to classify any financial instrument in the held-for-trading category

We have concerns with IAS 39's proposal to allow any financial instrument to be classified in the held-for-trading category and measured at fair value with changes in fair value recognised in profit or loss. As explained in our detailed comments below, we believe that this option is too wide. It will dramatically damage the comparability of the financial statements of an entity through time and between entities.

In addition, we are concerned that this option may be used by unscrupulous management to conceal the real financial position of an entity.

We understand that the purpose of the option was to mitigate some of the deficiencies of the mixed-attribute model in IAS 39 and to ease its application. We urge the IASB to revise the Standard so that its application gives a relevant presentation of the transactions and activities without the need for this option. We propose hereafter an alternative proposal that we consider more suitable for financial institutions, inasmuch

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as it would allow the marking-to-market of liabilities used to fund trading activities and the measurement of any hybrid instrument at fair value.

7. Derecognition

Whilst we support some of the principles in the proposed revised IAS 39 in order to assess a failed sale, we have difficulty understanding the relevance, and the consistency with the framework, of the accounting entries that result in a partial derecognition of financial assets.

8. Insurance

Definition of insurance contracts

We concur with the comments of both EFRAG and the Conseil National de la Comptabilité on this subject, except concerning the fourth proposal of EFRAG dealing with a “shadow accounting”.

First, we believe that credit insurance as practised by European insurance companies should be clearly excluded from the scope of IAS 32 and IAS 39 as we believe that credit insurance meets the definition of an insurance contract (see further comments below).

Secondly, we believe that the definition of ‘*insurance contracts that principally involve the transfer of financial risk*’ does not give sufficient guidance in order to determine which insurance contracts should be excluded from the scope of IAS 32 and IAS 39.

Insurance activities

As part of our activities, our financial institutions also control some insurance groups. As a result, we are also preoccupied by the accounting for insurance activities. On 18 September 2002, the European Insurance Group wrote to you to propose an approach for an interim solution for insurance companies. We want to express our support for the proposals and arguments expressed in the letter. In particular, we agree with the proposed headline disclosures relating to insurance business

- we agree with disclosure of the value of the long-term insurance business as supplementary information to the primary statements
- we support the proposal that no specific insurance contracts classification should be required at present, and that insurance contracts should be excluded from the scope of IAS 32, IAS 37, IAS 38 and IAS 39
- we support an exemption from the application of IAS 39’s requirements to embedded derivatives in insurance contracts, until an IFRS for insurance contracts is published
- a solution needs to be found for those financial assets that would normally be classified in the available-for-sale category. Indeed, application of IAS 39 would

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create a mismatch in the financial statements of insurance groups since it would require measurement of those financial assets at fair value while the contract liabilities would be on a different basis

- we have similar concerns about the project on Reporting Performance (refer to our General Comments).

9. Convergence

We are supportive of convergence actions with US GAAP and the IASB's actions to encourage the FASB to modify their standards around IAS solutions, when superior.

We have noted differences between IAS and US GAAP that put IAS entities at a competitive disadvantage compared to US entities. In particular, we would welcome action by the IASB to recommend to the FASB changes in its requirements in the following areas: classification of issued financial instruments between equity and financial liabilities (including split accounting), offsetting and master-netting agreements, recognition/reversal of impairment losses for held-to-maturity securities, use of the short-cut method for hedge accounting, etc.

10. Transition to the proposed revised IAS 32 and IAS 39

We have concerns about the magnitude of the proposed changes compared to our current practice. Although we do not expect to convert to IAS before 2005, we have concerns about the shortness of the time period to implement the changes, particularly when we note that the requirements are not yet finalised.

One of the areas that we will have most difficulty with relates to the implementation of the new derecognition requirements. For this reason, should these requirements be maintained, we support some grandfathering of the treatment of transactions that occurred prior to the date the revised IAS 39 becomes effective.

11. Need for a substantial revision of the Standards

While we are supportive of the overall objective of international harmonisation of accounting standards, we do not believe that this objective should prevail over a goal of issuing a Standard that can actually be implemented and result in high quality financial reporting. In the present case, we believe that IAS 32 and IAS 39 would need substantial revisions to achieve those two objectives.

As we explain in our letter, we believe that solutions can be found, discussed and exposed for comments before the critical deadline of 2005 for European companies. Although this process would not allow sufficient time to prepare for restatement of comparative information, we consider that they could be implemented on a prospective basis starting from the financial year beginning on or after 1 January 2005.

IMPROVEMENTS TO IAS 32

Question 1. Probabilities of different manners of settlement (paragraphs 19, 22, and 22A).

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

We agree with the principle that financial instruments should be classified in accordance with the substance of the contractual arrangements on initial recognition and that the classification continues at each subsequent reporting date until the financial instrument is derecognised. However, we believe that the proposed amendments do not result in clear guidance and will create confusion.

1. Classification of an issued instrument: assessment of the substance of the contractual arrangement

We understand that when an issued instrument provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the right to the holder to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, the instrument meets the definition of a liability.

For an instrument that does not establish such a contractual obligation explicitly, we believe that there should be an assessment, when the instrument is issued, whether the issuer will be compelled to redeem or settle the instrument in cash or with another financial instrument in the future, in order to classify the instrument as a liability or as equity. This assessment will necessarily require consideration of explicit or implicit obligations to redeem or settle the instrument in cash or with another financial instrument. In making that judgement, and because instruments issued can have complex features, there will need to be some assessment of the probabilities of whether the instrument will be redeemed or settled in cash or with another financial instrument.

For example, at the date when an instrument is issued, the economic characteristics of the instrument (e.g. a contractually step-up accelerating dividend) may be such that the issuer will have no other realistic alternative but to redeem the instrument in cash in the future. In this case, we believe that the instrument should be classified as a

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financial liability when the instrument is issued, even if the terms of the instrument do not establish explicitly this obligation. Of course, judgement will need to be exercised to assess whether the step-up in the contractually accelerating dividend is of such significance that it will create an economic compulsion for the issuer to redeem the instrument in cash.

Finally, we agree that issued instruments that do not give rise to an obligation, either explicit or implicit, on the part of the issuer to deliver cash or another financial asset meet the definition of equity instruments.

2. Economic compulsion

As explained above, in assessing the substance of an instrument where settlement is at the issuer's choice, we believe that, among other factors, there should be an assessment of the economic compulsion for the issuer to redeem or settle the issued instrument in cash or another financial instrument (i.e. the issuer will be without any other realistic possibility but to redeem or settle in cash or another financial instrument the issued instrument).

As a result, we disagree with the proposed deletions of the references to economic compulsion in IAS 32.22. The deletions create confusion. Our interpretation of the last sentence of IAS 32.22 ("*A preferred share that does not establish such a contractual obligation explicitly may establish it indirectly through its terms and conditions*") is that it implicitly indicates that economic compulsion is a factor to consider. Is our interpretation correct? If so, the text should be clarified and the example in IAS 32.22 should not be deleted.

3. SIC 5

We agree that IAS 32 should incorporate the conclusion of SIC 5 that a financial instrument for which the manner of settlement depends on the occurrence or non-occurrence of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument should be classified as a financial liability.

We also agree with the proposed amendment that eliminates the possibility of classifying an instrument as an equity instrument if the possibility of the issuer being required to settle in cash is remote at the time the financial instrument is issued (IAS 32.22A).

Question 2. Separation of liability and equity elements (paragraphs 28 and 29).

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

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First, as a general principle, we want to reaffirm our support for IAS 32's approach where a compound instrument is split into its equity and financial liability elements. We acknowledge that it is a convention and that it may raise implementation questions but we agree with it.

Secondly, because it complies with the IASB's policy of reducing options and it is pragmatic, we support the approach in the Exposure Draft that the equity element of a compound instrument should be determined as the residual amount of the instrument issued after measurement of the liability element.

Question 3. Classification of derivatives that relate to an entity's own shares (paragraphs 29C – 29G).

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

1. Preliminary comments: transactions in an entity's own equity instruments

We believe that IAS 32's principles for the recognition of transactions in an entity's own equity instruments would not permit appropriate reflection of the economics of certain types of transactions and would generate mismatches in terms of profit or loss recognition.

IAS 32.29A requires that *“if an entity reacquires its own equity instruments, those instruments shall be deducted from equity and no gain or loss is recognised in the income statement on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid or received is recognised directly in equity”*.

Financial institutions are involved in specific arbitrage activities (usually called “basket trading”) aiming at taking opportunity of temporary de-correlation between a specific index (e.g. CAC 40 in France) and the basket of equity securities that replicates the index. Major French banks' equity instruments form part of the CAC 40 index. For these banks, entering into those arbitrage transactions and replicating the index imply that, since they are part of the basket, they reacquire some of their treasury shares – but only for a limited period of time – and concurrently enter into a derivative contract based on the index, through a CAC 40 future for example.

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For these banks, the consequences of applying IAS 32.29A would be as follows:

- the reacquired treasury shares would be deducted from equity and no gain or loss would be recognised in profit or loss on subsequent disposal of the treasury shares;
- the other equity securities that form part of the basket and the derivative would be classified as trading instruments, with fair value changes recognised in profit or loss.

We believe that the above accounting does not reflect appropriately in the income statement the economics of such transactions and would lead to a misleading representation of the effective gain/loss of the bank on the entire transaction.

As a consequence, we propose that, when own shares are reacquired only for a limited period of time for the purpose of arbitrage/trading-type strategies, they are classified in the held-for-trading category.

2. Classification of derivatives that relate to an entity's own shares

We support the Board's decision to provide specific guidance on the classification of derivative on an entity's own equity instruments and we generally agree with it.

However, financial institutions undertake specific trading activities which involve selling derivatives based on their own shares (for which gross settlement is required) or derivatives on baskets of stocks that may include their own shares. We noted that the proposed accounting treatment for derivatives based on own shares for which gross settlement is required is that of an equity instrument unless the issuer is compelled to buy back its own shares.

Again, as mentioned above in respect of the treatment of reacquired own shares, we believe that in the case of specific arbitrage/trading strategies, the above accounting does not reflect appropriately in the income statement the economics of such derivatives and would lead to a misleading representation of the effective gain/loss of the bank. We would therefore ask that when derivatives on own shares that are gross settled are entered into for the purpose of arbitrage/trading-type strategies, they are treated as derivatives, with changes in fair value recognised in profit or loss.

We have also noted that IFRIC is currently discussing the treatment of derivatives on interests in subsidiaries and associates. We would support consistent treatment with the proposed amendments to IAS 32. It is unclear whether the current leaning of the discussions will achieve this objective, particularly for the treatment of derivatives associated with interests in associates.

Question 4. Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard.

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

We support the integration of the two documents into a single document. Any entity subject to one of the documents would by definition be subject to the other. We believe that integrating the two documents will assist in a better understanding of how they interrelate and would facilitate their application.

However, we would recommend that the integrated Standard is drafted in such a way so that there is no confusion about which section of the Standard is or is not applicable to an instrument covered by the scope. We suggest the inclusion in an appendix of a specific table that provides an overview of the application of each section of the revised Standard to various types of financial instruments and other assimilated instruments.

IMPROVEMENTS TO IAS 39

Question 1. Scope: loan commitments (paragraph 1(i)).

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

We agree that loan commitments that cannot be settled net (including situations where the issuer does not have a past practice of selling loan assets shortly after origination) and that the entity does not designate as held-for-trading should be excluded from the scope of IAS 39.

However, we note that no specific guidance is provided for holders of loan commitments.

Additional comments on the scope of IAS 39

1. Scope - Financial guarantees

1.1 Definition of financial guarantees

IAS 39.1(f) requires that *‘financial guarantee contracts (including letters of credit and credit derivative default products) that provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under either the original or modified terms of a debt instrument’* are excluded from the scope of IAS 39 with respect to measurement after initial recognition. Several IGC interpretations (IGC 1-2, 1-5-a and 1-5-b) that are not affected by the proposed amendments also provide guidance about credit default swaps that should be treated as financial guarantees.

Credit default products would qualify for the scope exclusion of IAS 39.1(f) if the contract, as a precondition for payment, requires that the holder is exposed to and has incurred a loss on the failure of the debtor to make payments on the guaranteed asset when due. This implies that:

- the contract would provide for payments only in the circumstance (‘credit event’) where the holder has incurred a loss on the failure of the debtor to make payments;
- the holder holds the asset that is referenced in the contract.

We believe that the conditions that are set out for the scope exclusion of financial guarantees, and especially of credit derivative default products, remain unclear and may lead to potential different interpretations.

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First, credit derivative default products that are commonly used on the market (and incorporate the 1999 ISDA Credit Derivatives Definitions) never provide for a unique credit event such as default to pay. Credit events usually include:

- default to pay;
- bankruptcy;
- restructuring (where such event results from a deterioration in the creditworthiness or financial condition of the debtor).

We believe that in substance those credit events may be assimilated to a ‘default to pay’ circumstance and that, in the case of common financial guarantees such as letters of credit, these circumstances would also allow for the holder of the guarantee to get paid.

Secondly, to monitor the credit risk they incur on specific portfolios, financial institutions enter into credit derivative default products that are based on a reference portfolio, where the guaranteed assets are clearly identified and held on the balance sheet of the guaranteed entity. In certain cases, however, because the assets mature before the credit derivative default product, those assets may be replaced by the bank. The counterparty of the credit derivative default product has nevertheless the right at its sole discretion to accept/reject the proposed changes in the reference portfolio. In this case, we believe that, provided that other conditions are met, these credit derivative default products should be treated as financial guarantees.

As a consequence, we would like the Board to clarify what is the correct accounting treatment for credit derivative default products.

Furthermore, in case such instruments would not get a financial guarantee accounting treatment and be included within the scope of IAS 39, we believe that hedging rules applying to groups of items (see IAS 39.132: *the change in fair value attributable to the hedged risk for each individual item on the group is expected to be approximately proportional to the overall change on fair value attributable to the hedged risk of the group* – which is rarely the case when the risk is managed on that basis of a global portfolio) should be accommodated so as to allow hedge accounting on a portfolio basis. In common loan portfolio hedging strategies including credit derivative default products, we believe it can be demonstrated that credit risk is actually offset on the loan portfolio by the derivative contract.

1.2 Recognition of financial guarantees

We do not support the Board’s proposal in IAS 39.1(f) to initially recognise and measure under IAS 39 those financial guarantee contracts that are subsequently excluded from the scope of IAS 39 (not accounted for as derivatives) and treated under IAS 37, Provisions, Contingent Liabilities and Contingent Assets. We do not understand the rationale for this proposal.

We believe that those financial guarantees, excluding those that arise from derecognition transactions (see our comments at Question 2), should be dealt with under IAS 37 for both their initial recognition and initial/subsequent measurement.

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We believe that the proposed amendments will result in conflicting requirements with the principles set out in IAS 37.

The recognition criteria for a financial instrument under IAS 39 and a provision under IAS 37 are different:

- IAS 39 requires that an entity shall recognise a financial asset/liability on its balance sheet when the entity becomes a party to the contractual provisions of the instrument;
- under IAS 37, a provision is recognised only if *‘it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation’* (probable with the meaning ‘more likely than not’).

Does the proposed amendment mean that if a financial guarantee contract is recognised at fair value, it could be derecognised immediately after its initial recognition under IAS 37 because IAS 37’s recognition criteria for a provision are no longer met? We do not see the benefits of this type of accounting. As result, we support applying IAS 37’s recognition criteria to determine the initial recognition of a financial guarantee.

1.3 Measurement of financial guarantees

The measurement basis for a provision under IAS 37 may differ from a fair value measurement under IAS 39.

For example, to measure fair value under the proposed IAS 39.100C, *“in applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions that market participants would use in setting a price for the financial instrument”*. However, IAS 37.36 requires that *‘the amount recognised as a provision should be the best estimate of expenditure required to settle the present obligation at the balance sheet date’* and under IAS 37.38 *‘The estimates of outcome and financial effect are determined by the judgement of management of the enterprise, supplemented by experiences of similar transactions and, in some cases, reports from independent experts.’*

Therefore, if a financial guarantee contract is initially recognised at fair value and subsequently treated under IAS 37, should an immediate adjustment be recognised because the measurement basis under IAS 37 may differ? We question what would be the logic and the benefits of such accounting. As a result, we support using IAS 37’s requirements for initial and subsequent measurement.

1.4 Need for further guidance on financial guarantees given

If the Board were to decide to keep its proposed requirements for financial guarantee contracts that would be subsequently dealt with under IAS 37, we would recommend that guidance is provided on:

- how to determine the fair value of financial guarantees on initial recognition. For example, on initial recognition, should there be an assumption that the fair value

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of a financial guarantee is equal to the difference between the present value calculation of the premiums to be received under the contract and present value of expected future outflows?

- what should be the subsequent measurement of financial guarantees. How is the amount adjusted and revenue recognised subsequently?

1.5 Financial guarantees received

The treatment of financial guarantees that are received by entities and that are not within the scope of IAS 39 is unclear. Should they also be initially recognised and measured at fair value?

From the Basis for Conclusions (IAS 39.C16 “*the Board decided to propose that issued financial guarantees contracts that provide (...) should initially be recognised and measured in accordance with IAS 39*”), it seems that the Board’s intention was that only issued financial guarantees should be initially recognised and measured at fair value. If this is not the case, specific guidance should be provided for holders of financial guarantees.

2. Scope - Lease receivables

We note that lease receivables recognised by a lessor are excluded from the scope of IAS 39, except for the derecognition requirements. However, we believe that lease receivables that are out of the scope of IAS 39 should be subject to the impairment requirements of the Standard.

Question 2. Derecognition: continuing involvement approach (paragraphs 35-57).

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

We do not support all the outcomes of the proposed “*continuing involvement*” approach, although we support the need to modify the derecognition requirements of the current version of IAS 39, as they are inconsistent and impracticable to implement. We have also identified operational issues when implementing the proposed approach that we list below.

1. Continuing involvement approach

We believe that contractual provisions that may result in the transferor reacquiring control of the transferred asset (through a repurchase agreement or a call or put option) or give the transferor a right to pay and/or receive all subsequent decreases/increases in the value of the transferred asset (for example through a total return swap or a cash settled put or call option) should preclude derecognition of the

transferred asset. We agree that, in such cases, the transaction shall be considered as a “*failed sale*”. As a consequence, it should be accounted for as a collateralised borrowing by maintaining the transferred asset (or a portion of it) on the balance sheet of the transferor and recognising a financial liability for the entirety (or a portion) of the transferred asset that does not qualify for derecognition.

However, we believe that the proposed approach is flawed for transactions where the transferor only retains a limited amount of a specific risk component attached to the transferred asset (for example because it issues a credit risk guarantee) and, as such, has an obligation to pay/receive up to a limited amount subsequent decreases/increases in the value of the transferred asset. In our opinion, the proposed approach:

- leads to the recognition of assets/liabilities, or portions thereof, that would have not otherwise been recognised under alternative approaches and that have no real legal or economic substance. We believe that the approach is not only counter-intuitive but also misleading for the users of the financial statements. According to the proposed approach, a portion of the transferred asset would still be shown in the transferor’s balance sheet although the transferor has lost their contractual rights on the transferred asset and has no means of reacquiring control of this asset. We believe this would lead to some double-counting.

The example provided in IAS 39.B4-B17 of the Exposure Draft shows accounting entries resulting from a transaction where the originator transfers a portfolio of assets and the originator retains an economic interest in the transaction through the purchase of subordinated interests. We understand that the originator will recognise two separate assets in this transaction: a portion of the transferred portfolio that will have failed derecognition through the continuing involvement criterion and the subordinated interests of their fair value. We disagree with the proposed treatment for the following reasons. Maintaining a remaining balance of loans is confusing and misleading for the users of the financial statements. This accounting treatment does not reflect the economic substance of the transaction as the originator exposure is limited to the subordinated interests. Furthermore, the debt arising from the failed sale does not conform to requirements in the Exposure Draft for recognising a financial liability;

- does not allow the proper recognition of certain financial instruments that are created because of the sale transaction, e.g. issued financial guarantees. In order to protect the transferee against the first losses on a transferred portfolio, the originator often grants a guarantee to the SPV securitisation vehicle. This guarantee exceeds the expected default of the transferred portfolio thus providing investors in the transaction with a high level of comfort. This guarantee constitutes a continuing involvement that should be recorded according to IAS 39.39 “*at the maximum amount of the consideration received that could be required to be repaid*”. We do not agree with such a treatment for the following reasons:
 - under the proposed approach, the presentation of the transaction on the balance sheet of the transferor may be confusing for the user of the financial statements and seems rather counter-intuitive as the asset and the related liability have to be viewed together to reflect the value of the issued guarantee; and

- for banks, the gross presentation will increase the risk exposure to be taken into account in the international solvency ratio, as netting of the asset and the related liability will not be permitted.

In order to provide a clear indication of the economic substance of the transaction, we would favour the recognition of the guarantee at its fair value. Under that model, the transferred assets would be derecognised while the retained interests or financial guarantees issued by the transferor, because of the sale transaction, would be recognised and measured separately. It would ensure that the profit or loss on the sale transaction would be recognised only for the amount of the sold assets less the fair value of the retained components.

2. Implementation issues of the continuing involvement approach

We believe that the ‘continuing involvement’ criteria should be further specified for securitisation transactions. The current criteria developed in the proposed Standard are difficult to interpret in situations where the transferor is a SPE that transfers the contractual rights to the cash flows to the investors in the form of securities.

Application of the ‘continuing involvement’ concept to a transfer of a pool of assets

Whilst we understand how the continuing involvement principles will apply to determine the accounting entries for the derecognition of a single asset, we encounter interpretation difficulties for determining the accounting entries that would result from a securitisation transaction that relates to a pool of assets. For example, in a housing mortgage securitisation, the asset transferor often retains the residual interest of the transferred pool of assets either in the form of an excess spread or a deferred consideration. We are unsure about what would be the accounting entries in such a case.

Interpretation of the ‘continuing involvement’ concept in situations where the transferor is a SPE

We are uncertain about all the characteristics of a securitisation transaction that would lead to the conclusion that a SPE has a ‘continuing involvement’ with the transferred assets. For instance, we are unsure about the fact that contractual terms that provide for an early amortisation of the issued beneficial interests in specified situations represent an indication of a ‘continuing involvement’ from the part of the SPE (and demonstrate its ability of *‘reacquiring control of its previous contractual rights’*) as IAS 39.B17 indicates that if *‘the SPE retained a call option on the beneficial interests issued to the investors, the transfer would not qualify as a sale and the entire proceeds would be accounted for as a collateralised borrowing. The call option is a right to repurchase the beneficial interests’*. Indeed, in this case, the SPE could be viewed as retaining a conditional call option on the beneficial interests issued to the investors.

Another example of uncertainties about the consequences of the securitisation transaction on the financial statements of the transferor is where assets are not fully derecognised from the balance sheet of the transferor (e.g., because of a credit

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guarantee issued or of retained interests), i.e. in cases where the transferee recognises a loan to the transferor up to the amount of the 'failed sale' instead of the transferred assets, and the transferee is a SPE that must be consolidated under SIC 12. In this case, is the loan to the transferor recognised on the SPE's balance sheet treated as the recognised transferred receivables and subject to the derecognition requirements of IAS 39?

We believe that it would be helpful to provide a comprehensive example of the accounting treatment of a securitisation transaction involving a transferee, a SPE and investors rather than the example in IAS 39.B4-B17, which only encompasses the accounting treatment at the level of the SPE and does not show the potential impacts on the balance sheet of the transferor.

Pledging of assets back to the transferor

If a transferor of an asset enters into a separate but linked transaction with the transferee in which the transferred asset is repledged by the transferee to the transferor, the transferor would be considered as having a continuing involvement in the asset that will fully preclude derecognition of the asset by the transferor.

We do not support this treatment as the continuing involvement of the transferor is subordinated to the occurrence of the default of the transferee in a separate transaction.

A better representation would consist in recording the two transactions separately, the linked transaction including the valuation of the collateral if the transferee is likely to default.

Servicing assets and liabilities

We believe that, as it is currently written, IAS 39 is not clear and leads to complex accounting. For example, we have difficulty understanding whether the two notions 'fair value' and 'adequate compensation' are supposed to reflect the same thing. We believe that the model should be simplified as follows:

- if the servicing agreement results in an onerous contract, it should be dealt with under IAS 37 and a servicing liability, measured under IAS 37, should be recognised (this view is consistent with our view for the treatment of loan commitments and financial guarantees). In this case, we believe that more guidance is needed on what is meant by 'adequate compensation for the servicing' in IAS 39.48(b);
- if the servicing agreement has been negotiated above fair value, no servicing asset should be recognised (i.e. no gain should be immediately recognised).

We understand that in the USA, there are markets for servicing rights and that it may be appropriate to treat them as financial assets. However, this practice is not common outside the USA. To deal with those specific situations, we would recommend that a distinction be made between these servicing agreements that should be classified as financial instruments and those that should be treated under IAS 37 because they are

onerous contracts (in some way, find an approach similar to that for the distinction of commodities that are dealt with under IAS 39 and those are excluded from the scope).

We also note that subsequent accounting for servicing rights is not addressed. Guidance or reference to another Standard is needed to clarify the subsequent accounting. We believe that such items should generally be amortised over the life of the servicing agreement.

Question 3. Derecognition: pass-through arrangements (paragraph 41).

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

We agree that assets transferred under pass-through arrangements where the cash flows are passed from one entity to another should qualify for derecognition. However, we need clarification on how the pass-through criteria should be interpreted at both an originator and a SPE level. This should be carried out in tandem with a review of SIC 12 so that the mechanisms for deconsolidation are consistent throughout IAS.

We believe that the proposed tests for the ‘pass-through arrangement’ are in some respects unclear, which potentially may lead to divergent results. We indicate below some implementation difficulties that we have identified in trying to apply the notion of the ‘pass-through arrangement’, especially when the transferor is a SPE.

The first condition set out in IAS 39.41(a) (*“The transferor does not have an obligation to pay amounts to the transferee unless it collects equivalent amounts from the transferred assets”*) is difficult to interpret.

First, in many transactions, swaps are contracted by the transferee in order to collect a fixed rather than floating amount for repaying investors. Restrictive application of IAS 39.41(a) would lead to failure of the pass-through test. Similarly, liquidity lines would follow the same treatment. We would suggest an approach where this type of arrangement would not be dequalifying for the pass-through treatment.

Secondly, when SPEs are involved, it is difficult to demonstrate that SPEs created in securitisation transactions do not have an obligation to pay amounts to the investors *“unless they collect equivalent amounts from the transferred assets that qualify for derecognition”*. Indeed, specific protection mechanisms (excess spread, reserve fund, etc.) are set out so as to protect the investors from related risks (and thus create an obligation for the SPE to pay amounts to the investors even if the transferred assets that qualify for derecognition do not pay out). From what we understand of the example given in Appendix B, such types of arrangement meet the ‘pass-through arrangement’ criteria. To avoid confusion, we recommend deletion of *“that qualify for derecognition”* in IAS 39.41(a).

The second criterion set out in IAS 39.41(b) (*‘The transferor is prohibited by the terms of the transfer contract or documents from selling or pledging the transferred asset or otherwise using that asset for its benefit’*) prohibits the selling/pledging of the transferred assets in order to qualify for the ‘pass-through arrangement’. To protect investors, SPEs are often contractually allowed to sell specific (impaired) assets. In our opinion, the criterion would significantly limit the derecognition of assets in a large number of transactions, such as in the case of managed CDO structures. This criterion also needs further explanations as far as the expression *“or otherwise using that asset for its benefit”* is concerned. For example, do we have to consider that the sales of assets that are concluded for the benefit and protection of the investors would not be viewed as a negation of the ‘pass through arrangement’ notion? We recommend that the IASB defines how the criterion in IAS 39.41(b) should apply in the case of SPEs.

As it currently is, the third criteria set out in IAS 39.41(c) (*‘The transferor has an obligation to remit any cash flows it collects on behalf of the transferee without material delay. Transferor is not entitled to reinvest such cash flows for its own benefit’*) would not allow derecognition in a number of common securitisation transactions, such as revolving structures, soft bullet structures... The rationale for such a limitation is not clearly stated and specifically the *“without material delay”* criterion is clearly one issue that needs to be explored/explained further. So far, we understand that reinvestments of the collected cash flows carried out by SPEs (instead of a direct remittance to the investors) would be considered as an obstacle to derecognition whatever the reason for it, be it a way of managing the prepayment risk on the transferred assets or an operational simplification. As an example, trade receivables structures will typically present a delay in repayment of cash flows as they are made at fixed dates compared to a continuous flow received from the transferor. We do not understand the rationale of such a limitation in the above mentioned example.

We recommend that the IASB defines the extent to which SPEs are allowed to reinvest the collected cash flows and that the Standard makes it clear that a reasonable delay in the remittance of cash flows is permitted for SPEs. More specifically, we suggest the following criteria to be taken into account to allow an SPE to use all its available cash flows to make payments, to sell or pledge the assets and hold any cash flows for a period of time:

- such actions are primarily for the benefit of the investors and not the transferors;
- the principles behind such actions are predetermined and set out in the transaction documentation; and
- such actions do not utilise any additional assets or cash flows of the transferor.

Finally, it is particularly unclear how the ‘pass-through arrangement’ criteria apply to revolving structures. Therefore, we believe that additional guidance should be provided in order to identify specific situations preventing derecognition.

Question 4. Measurement: fair value designation (paragraph 10).

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

We strongly disagree with the introduction of an option to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss. We believe that the introduction of such an open option:

- would allow entities to enter into “cherry picking” accounting. It does not meet the IASB’s objectives for the comparability of financial statements for an entity through time, and between entities
- is contrary to the IASB’s policy of reducing options so that the set of Standards produced by the Board is applied consistently, particularly by entities belonging to the same industry
- is contrary to the IASB’s objective to promote convergence, particularly with US GAAP
- is likely to increase the risk of profit manipulation (e.g. in the case of entities having financial difficulties and who may wish to designate financial liabilities as trading liabilities so as to be in the position of recognising gains because of the re-measurement of their liabilities at fair value).

We understand that the option to measure at fair value any financial asset or liability, even if it is not acquired/issued for trading purposes, would ease the application of IAS 39. It would mitigate some anomalies and difficulties present in the current version of IAS 39, especially due to:

- the decision that all derivatives should be held at fair value, irrespective of whether they are hedging positions that are themselves measured at amortised cost or fair value;
- the fact that liabilities funding the trading activities are not considered as part of the trading category;
- specific flaws in the hedge accounting rules.

In our opinion the fair value option should not be seen as an alternative to addressing the problems inherent in the hedge accounting rules.

In order to improve and ease the application of IAS 39 whilst keeping a minimum of comparability of the financial statements, apart from our recommendations relating to hedge accounting, we suggest the following amendments to IAS 39:

- redefine the trading category to allow the classification of liabilities that are used to fund trading activities in financial liabilities held-for-trading
- allow the measurement of any hybrid instrument at fair value at initial recognition, without being required to separate the embedded derivative even if the exercise can be done (i.e. extend the requirement in IAS 39.26 to make it an option).

In addition, , we suggest that the IASB clarifies that entities should not be permitted to take into account their own credit risk in determining the fair value of financial liabilities that are classified into the trading category at inception.

Question 5. Fair value measurement considerations (paragraphs 95-100D).

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft? Additional guidance is included in paragraphs A32–A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

We question the relevance of the guidance in IAS 39 indicating that individual prices should not be adjusted for the potential effects of selling large blocks of financial instruments (IAS 39.99 *‘The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price’*).

The relevance of using a market price when it is known that there will not be enough buyers is questionable. In this case, due to control or liquidity matters, the price of the block will not be the sum of the prices of the individual items. We do not understand why the Standard does not allow entities to estimate the impact of liquidity and control, when many other factors, which cannot be estimated with much more reliability, must be considered in using internal models (see credit risk, marketability, volatility, etc. in IAS 39.A17 – Inputs to Valuation Techniques).

Question 6. Collective evaluation of impairment (paragraphs 112 and 113A–113D).

Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A–113D?

We do not agree with the methodology for measuring impairment in a group of assets found not to be individually impaired as described in IAS 39.113A–113D. If we do not disagree with the principle to measure impairment on a collective basis, we are not in agreement with the proposed method which is effectively based on a fair value approach of credit risk.

Furthermore, when considering the implementation of the proposed approach, we have identified several technical and operational issues that we list below.

1. Measuring impairment in a group of assets found not to be individually impaired

The proposed method for collective impairment requires the recognition of impairment losses on individual loans specifically identified as impaired (IAS 39.111) as well as a collective assessment for impairment of groups of individually non-impaired loans with similar credit risk characteristics (IAS 39.112). We understand that the removal from the portfolio of an individually impaired asset does not automatically lead to a reduction in the impairment calculated on a portfolio basis, which is not consistent with risk management practice.

We would prefer a general approach for determining impairment losses on loan portfolios for the credit risk associated to these portfolios, with first the determination of a global impairment loss calculated on the total loan portfolios (including individually impaired and non-impaired loans). Secondly, impairment losses on individually impaired loans should be calculated. Finally, impairment losses on the non-impaired loans should be calculated by difference between the global impairment loss and impairment losses on individually impaired loans. This approach is consistent with the steps in the Standard to recognise impairment.

We also believe that the assessment of risk premiums as well as estimated cumulative cash flow loss rates per year, being influenced by the short term perception that both the market and those responsible for the internal rating systems hold at a particular period during the economic cycle, would introduce an exaggerated volatility in profit or loss generated by financial institutions, being contrary to the stability needed for the international banking system. Therefore, we recommend that the methodology to assess risk premiums and estimated cumulative cash flow loss rates per year uses an objective internal methodology, which is not influenced by the assessment of risk by the market at any particular point of time, but is based on an observation of an entity's historical average losses experience by group of assets showing similar credit risk characteristics over a long period of time (i.e. for the period to year-end).

2. Technical considerations on the proposed method

Commercial margin on the loans

The contractual interest rate is made up of the risk-free rate, the risk premium and the commercial margin. The weighted average expected interest rate used to compute the expected estimated cash flows is based on the contractual interest rates of the loans after deduction of the estimated cash flow loss rate per year for the considered loan portfolio. By doing so, the weighted average expected interest rate is dependant on the commercial margin of the loans. As a consequence, for loans with a higher commercial margin, the impairment amount will be greater than that for loans with a lower commercial margin, even though all of the loans have the same credit rating (and hence risk premium). Furthermore, this anomaly will be all the more significant for loans with low credit ratings (which generally have high commercial margins). Please refer to the detailed illustration of these points in Appendices 2.1 and 2.2.

Collected Fees

According to IAS 39.113, evaluation of collective impairment is made on the basis of the financial instruments' effective interest rate. According to IAS 18, Revenue, the effective interest used to discount future cash flows includes fees treated as an adjustment to the effective yield. As a consequence, according to the proposed methodology, the proposed methodology for the computation of impairment losses would include fees. This would be appropriate for fees collected over the life of the contract although this would be difficult to do in practice. However, we believe that in the case of fees collected up front, impairment losses should not take into account any amounts that are not at risk, i.e. fees already collected.

Question 7. Impairment of investments in available-for-sale financial assets (paragraphs 117–119).

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

1. Preliminary comment – measurement of equity securities not held-for-trading at fair value

Based on the requirements of IAS 39, changes in the fair value of available-for-sale financial assets must be recorded in equity, including for equity investments even if the underlying strategy of the bank is one of holding those investments for a long period of time. We noted that the only exception to a fair value measurement in IAS 39 relates to investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be measured reliably. In this case, the investments are measured at cost less impairment.

Since the exposure draft states that fair value is supposed to be the last available quoted price, we do not support the principle that requires measurement at a such fair value of strategic equity investments and equity investments in venture capital (they will normally be classified as available-for-sale financial assets and we understand that entities engaged in those activities would normally be expected to be able to determine their last fair value, even if the securities are not quoted). While such an application of the fair value measurement principle to trading activities (for which there is an intention of selling the instruments in the short-term) is considered to best reflect the performance of an enterprise and its management, we believe that the application of a same valuation approach to strategic equity investments and equity investments in venture capital that are held for a longer period of time is inappropriate.

Indeed, the consequences of this principle are likely to be as follows:

- fair value is based on the value of an asset at a given point in time. However, it can fluctuate significantly over a short time period. Periodic stock markets events demonstrate the extreme instability of the stock market prices of certain securities, which is precisely the case at the present time. The application of the fair value measurement principle to all available-for-sale financial assets irrespective of their

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nature and holding period may generate significant differences in the shareholder's equity of financial institutions at only a few days interval, with equity increasing and decreasing according to the valuation of these assets

- as the valuation of financial assets is frequently tied to the economic environment, reflecting the volatility of the stock markets means that the entity's equity would vary according to the performance of the economy. This situation could lead to further increase of euphoria in a financial bubble or panic in a time of crisis
- the fair value of an asset is obviously more difficult to determine than its original historical cost, furthermore in those frequent cases where the asset is not traded/negotiated on a liquid and transparent market. The control of such fair values that will be included in the balance sheet, whether externally by auditors or internally by the finance department, will be difficult. There could be situations where the business line in charge of making these calculations may be tempted to provide more favourable valuations than justified. This could result in a climate of uncertainty and suspicion regarding financial information, being bad for economic development and leading to such situations as we currently see in the United States.

The users of financial statements should be provided with relevant and reliable information. Shareholder's equity represents an essential component of this information. We do not believe that a systematic application of the proposed requirements of IAS 39 for measuring the fair value of strategic equity investments and equity investments in venture capital that are not held-for-trading will meet the objective of relevance and reliability. Therefore, we ask the Board to amend IAS 39 so that strategic equity investments and equity investments in venture capital (either quoted or unquoted) could be valued at a price different from the last available quotation if external assumptions lead to consider the quoted price as being irrelevant. In such a case, other valuation techniques should be considered such as shareholders' equity, profitability, average share price over previous months, or sum of the parts approach.

2. Reversal of impairment losses

We do not agree that impairment losses for investments in debt and equity instruments that are classified as available-for-sale should not be reversed. This would lead to adoption of different accounting treatments for identical financial instruments bearing the same level of risk, according to their classification (originated loans and debt instruments held to maturity vs. available for sale debt instruments). In addition, this principle is not consistent with the current requirements of other IAS standards dealing with impairment.

In addition, in a subsequent period, if the amount of an impairment loss recognised in prior periods decreases (for example if the fair value of an equity instrument subsequently increases), the proposed amendment would lead an entity to recognise a gain in equity, which we believe would lead to an asymmetric and misleading representation of the performance of the entity.

Finally, we question the appropriateness of the supplemental guidance provided in the revised Standard on what constitutes objective evidence of impairment for investments in equity instruments, in particular the fact that a significant and prolonged decline in the fair value of an investment in an equity instrument below its cost would automatically be considered as objective evidence of impairment. We consider that this factor creates a presumption that there is a possible impairment. However, we believe that other factors should be considered before any impairment loss is recognised.

Question 8. Hedges of firm commitments (paragraphs 137 and 140).

Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

See our comments on hedge accounting in Appendix 1.

Question 9. ‘Basis adjustments’ (paragraph 160).

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

See our comments on hedge accounting in Appendix 1.

Question 10. Prior derecognition transactions (paragraph 171B).

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

We believe that prior derecognition transactions that occurred before the revised Standard becomes effective should be grandfathered. In addition, similar grandfathering should be included in the Standard on First-Time Application of IFRS.

As we already expressed in our comment letter on the proposed revisions to the Preface, we disagree with the view expressed in paragraph 21 of the Preface that *‘the fact that financial reporting requirements evolve and change over time is well understood and would be known to the parties when they entered into the agreement. It is up to the parties to determine whether the agreement should be insulated from the effects of a future IFRS, or, if not, the manner in which it might be renegotiated to reflect changes in reporting rather than changes in the underlying financial conditions’*. Renegotiations are not so easy and can be costly to implement, particularly in the case of prior derecognition transactions. To ensure preparers and users are not hindered in negotiations by the possibility that future new or revised accounting standards may change the current accounting treatment, we strongly believe that transactions undertaken within a certain accounting context should not need to be restated upon a change in accounting requirements.

For prior derecognition transactions, we truly believe that the exercise required to assess whether they should be restated would require undue costs and efforts. We believe that it would be very difficult or impossible to determine on a retrospective basis, especially for complex securitisation transactions, what is the fair value of:

- the different components of a transferred asset;
- the servicing asset/liability to recognise.

In addition, in some cases, some securitisation transactions have led to the derecognition of financial assets that are held by funds that are not under the control of our groups. If these prior derecognition transactions had to be restated (because of

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some continuing involvement such as a put option), it may be extremely difficult to obtain information on the carrying amounts of the financial assets that should be restated because the funds are not under the control of the enterprise. Furthermore, they may use accounting policies other than IFRS and have lost track of information that would allow restatement.

If the requirement for a restatement of all prior derecognition transactions was kept, we believe that the Board should consider the adoption of reasonable transitional provisions (nature and timing).

Finally, we understand that recognition/derecognition principles should apply on a consistent basis to both a transferor and a transferee. We believe that the Board should indicate that, if prior derecognition transactions are grandfathered for the financial statement of a transferor, a consistent accounting treatment should apply for the transferee, i.e. prior transactions would not be restated in the financial statements of the transferee.

Appendix 1 : Hedge accounting

The banking book in French financial institutions

This document presents:

1. Banking book activity today and its economic strategy
2. The consequences of the implementation of IAS 39, as amended, on this business
3. Alternative proposals to resolve the shortfalls of this Standard

1. The banking book activity

The banking book activity is a continuous activity involving the collection of savings and the granting of loans. It acts as an intermediary between depositors and borrowers who cannot access the financial markets directly to invest their savings or meet their borrowing requirements, particularly due to the narrowness of their capital base.

It operates in a similar way to a manufacturing activity, with a tool (the various distribution channels generating contacts with customers) and a production activity (granting of loans, collection of funds), which generates a commercial margin.

In line with the going concern principle, its purpose is to generate regular income over time. In this context, the role of asset/liability management (ALM) is to reduce the sensitivity of margins to interest rate fluctuations. To this end, the banking book activity enters into derivative contracts.

From an economic perspective, ALM consists in hedging the refinancing of fixed-rate assets (using floating-rate cash swaps) and the replacement of fixed-rate liabilities (using floating-rate cash swaps). In practice, actual hedging transactions occur on a net asset/liability basis.

Therefore, the banking book activity is obviously not a trading activity.

1.1 The banking book versus the trading book activity

➤ **The specific characteristics of the banking book reside in the nature and objectives of this activity**

- *Income is disconnected from financial markets*

Each institution determines individually the remuneration terms and conditions of its debit and credit account balances, in accordance with bilateral relations developed with customers. Loans are billed along the same lines, to ensure that the interest margin generated covers at the very least the risks to

which the institution is exposed (counterparty, liquidity and operational risks), as well as funding and operational costs. Billing is therefore based on costs which are not closely linked to changes in financial market conditions.

- *Banking book objectives differ from those of trading activities*

Banking book activities are part of a long-term approach, where the strengthening of relations with customers is key to success. Its objectives are therefore diametrically opposed to those guiding market strategies.

- *The behaviour and thinking patterns of banking book players (borrowers and depositors) are different from those of market players.*

As a rule, banking book players do not have to adapt to market condition changes. When rates are lower, borrowers do not systematically repay their fixed-income debt and when rates are higher, lenders do not automatically seek to redirect their cash investments.

The banking book activity cannot be compared to the trading activity

➤ **A different accounting treatment**

Hence, valuing banking book items by reference to the markets is totally illogical. The banking book activity is part of a going-concern strategy, which does not justify stating the items concerned on a net-asset value basis.

Assets and liabilities are recorded at historical cost.

In addition, hedging derivatives are part and parcel of the banking book portfolio. To ensure consistent accounting treatment within a portfolio, all portfolio items, including hedging derivatives are stated at depreciated cost.

As these items hedge assets and liabilities stated at depreciated cost, application of the matching principle to ensure the symmetry of impacts on earnings and shareholders' equity between hedged items (margin) and hedging instruments (derivatives) leads, logically, to the recording of ALM hedging derivatives at depreciated cost.

Valuation at cost of all items included in the banking book portfolio is consistent with the economic strategy underlying this activity and the principle of matching the accounting treatment of hedged and hedging items.

In addition, the importance of demand deposits and their specific features directly impacts the interest rate risk management strategy of banking book activities.

1.2 Demand deposits

➤ **Weight of demand deposits in French bank resources**

Demand deposits constitute a significant portion of the resources of French financial institutions.

Balance sheet of an average retail bank as of December 31, 2001 (in EUR billion):

Assets	Amount	%	Liabilities	Amount	%
Fixed-rate commercial loans	20,9	26.2	Term deposits	23,7	29.7
Floating-rate/regulated commercial loans	19,7	24.7	Regulated savings schemes	44,6	55.9
Fixed-rate real-estate loans	27,1	34	Term deposits	6,8	8.5
Floating-rate/regulated real-estate loans	5,2	6.5	Allocated common stock	4,7	5.9
Consumer loans	6,4	8			
Interbank loans (net)	0,5	0.6			
TOTAL	79,8	100	TOTAL	79,8	100

Hedging swaps	5,8
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Overall, fixed-rate assets account for 68% of total assets and floating-rate assets 32%.

The French banking industry consists in the transformation of stable resources without maturity into vehicles having maturities and bearing fixed or floating interest rates.

The balance sheet of a French bank differs from that of a US bank due to the importance of undated fixed-rate resources.

Such a difference in the asset/liability structure necessarily gives rise to a different type of ALM and to an increased use of derivatives.

➤ **Stability of demand deposits**

Demand deposits may be contractually withdrawn at any time by customers. This possibility results in fluctuations in outstandings over the same period (over the same month when salaries or rents are paid, over the same year when taxes or leisure expenses, etc. are paid), generating a combination of various seasonal factors.

However, the amplitude of fluctuations in demand deposit outstandings can be gauged using historical data and econometric analyses, which can also provide a volatility curve and highlight the remarkable stability thereof.

The economic analysis of demand deposits is therefore far removed from contractual provisions. This analysis is used to support banking activities in France.

➤ **Interconnectivity between risk management and demand deposits**

A bank that does not have a direct reinvestment vehicle must invest demand deposit funds at overnight rates. Bank results are thus exposed to fluctuations in overnight interest rates. The same risk exists in the case of demand deposits that can bear interest (at fixed rates) such as in certain European countries, since the absence of a maturity in this category of vehicle transforms, de facto, the fixed rate into a floating rate.

Demand deposits, bearing no interest, create a rate exposure for banks.

➤ **Interest rate risk management**

ALM relies on the manifest stability of demand deposits to reduce the earnings risk associated with the volume of available demand deposits. It must be possible to place deposits in the resource schedule at conventional periods resulting from the statistical analysis of the stability of outstandings, in order to record the swaps generating future cash flows within the same time horizons.

To manage the overnight interest rate fluctuation risk, given the volumes at stake, the banks transform the income derived from overnight trading by entering into short-term floating rate payer swaps and fixed-rate receiver swaps tied to the maturities resulting from the outstandings volatility curve.

The maturities selected correspond to a high probability requirement based on a set of conservative scenarios relating to the long-term nature of outstandings. They break down according to various time horizons:

- Short-term : to deal with intra monthly fluctuations
- Less than one year : to take into account intra annual seasonality
- More than one year : to take into account the volatility of outstanding amounts over time

From an operational viewpoint, the treasury continues to invest the demand deposit funds in a series of short-term transactions. The interest rate risk on the cash flows is managed using a series of short-term floating rate payer swaps and fixed-rate receiver swaps, based on the structure described above.

Demand deposits are used to support cash flow hedge transactions.

Finally, the interest rate risk hedging of the banking book results, concretely, in internal contracts. These are dealt with below.

1.3 Internal contracts

➤ Why internal contracts

Most financial institutions are organised into departments, divisions or businesses, which constitute internal profit centres. In this context, so that each entity can determine its own results, internal contracts are concluded.

In major banking groups, the entities are specialised, and once they have market access, they are authorised to enter into transactions involving products within their scope while observing allocated limits. These entities comprise departments specialising in interest rate, equity, index derivatives, etc. Certain entities do not have direct market access, such as those belonging to merchant banking sectors. Consequently, in order to hedge their own risks, they systematically enter into hedging contracts with the specialised departments.

The use of internal contracts arises from the organisational structure of financial institutions and their separation into entities with market access, subject to specific control procedures, and entities without market access.

➤ Offsetting on the market

These internal contracts are entered into on an arm's length basis. The specialised departments offset the positions transferred by the various group departments on the market, after internal netting, within the trading limits defined by executive management.

The department with market access enters into group hedging based on the internal contracts concluded, using various instruments with similar characteristics to manage the identified risk.

Given the structure of French banks balance sheets, the interest rate positions generated by banking book ALM are, in comparison with trading limits, of such a level that the department with market access has no alternative but to offset these positions on the market.

It has access to sensitivity and volatility indicators enabling it to confirm, at regular intervals, that the internal contract portfolios transferred to it have been correctly offset on the market.

ALM transactions, although processed internally, must ultimately generate external transactions on the market.

➤ **Control of internal contracts**

Banking authorities pay particular attention to internal control rules governing internal contracts. In France, for example, a regulation authorises the recognition of internal contracts in the accounts and lays down the procedures which must be followed by financial institutions to ensure that these internal contracts are correctly offset by external swap contracts, based on the following principles: independent management of each operational entity, conclusion of contracts on an arm's length basis, limits sufficiently low for entities with market access.

Prevailing French regulations allow internal contracts, subject to stringent rules.

2. Consequences of the application of IAS 39 (as amended) to banking book activities

2.1 The hedging principles laid down in the accounting Standard negate the reality of day-to-day ALM

➤ **Hedging of net positions is not accepted by IAS 39**

IAS 39 allows two types of hedging:

- Cash-flow hedging.
- Fair value hedging.

Neither of these hedging strategies accepts the hedging of net positions, despite the fact that the Standard acknowledges that economic reality necessarily leads to the hedging of a net position. In this type of hedging, part of the components of the gross hedged position is designated as the hedged item. It is on this basis that the effectiveness of the hedge is demonstrated and the hedge recorded (matching in earnings with this component).

In addition, IASB allows hedging of net foreign currency positions, which is not fundamentally different from the hedging of interest rate positions.

➤ **Demand deposits may not be designated as hedged items**

Interpretation IGC 121-2 authorises the inclusion of early repayment, roll-over, or new production assumptions in the future cash flow schedule as part of a dynamic analysis.

The interpretation introduces an ambiguity when it indicates that these deposits do not qualify for future cash flow hedging insofar as they do not bear interest.

This justification we believe to be unfounded and contrary to the above analysis.

➤ **Internal contracts may not be designated as either hedges or hedged items**

The Standard provides that solely derivative instruments which involve a party outside the company may be designated as hedging instruments. As internal (inter-company and intra-group) contracts are eliminated on consolidation, they do not meet the hedge accounting criteria.

➤ **Conclusion**

In view of all the above restrictions, the treatment of ALM derivatives as hedges of future interest rate margins within the meaning of the IAS would be a purely theoretical exercise, far removed from the reality of day-to-day management.

It would be necessary to document and support the effectiveness of a hedging relationship between an external derivative transaction (entered into for the purpose of hedging an internally netted sensitivity) and future cash flows of a sub-category of balance sheet assets and liabilities from which demand deposits, prime contributor to the interest rate risk position, are excluded in practice.

2.2 The accounting treatment of ALM hedging is irrelevant

➤ **All derivatives are recorded at fair value**

The general principle laid down in IAS 39 requires derivatives to be recorded at fair value. All derivative instruments are therefore systematically considered as trading instruments, irrespective of whether they are used for trading purposes or to hedge the banking book.

This basic premise negates the fundamental distinction between two business segments within financial institutions: the banking book and trading activities.

In addition, this accounting principle is in contradiction of other fundamental principles:

- the financial statements should reflect the way companies manage their operations (principle established by IASB itself),
- the financial statements should give a fair view of the financial position and the performance of the company.

Uniform application of fair value measurement does not appropriately reflect the management approach of each financial institution activity.

➤ **ALM swap fair value volatility**

The impact of fair value changes in French bank ALM swap portfolios alone, reaches proportions on an altogether different scale from shareholders' equity and earnings.

The ALM swap portfolio is highly sensitive to changes in interest rates due to:

- swap maturities: as French bank demand deposits are stable, the average life of hedging swaps is 10 years,
- nominal amounts at stake: the balance sheet structure carries a high percentage of fixed-rate items requiring even higher hedging swap nominal amounts.

Conversely, US bank balance sheets are far less sensitive to interest rate fluctuations. As such, while the application of the fair value principle to all derivative instrument has significant consequences for US banks, these are far less than those expected for French banks.

The unique features of the French market make French bank swap portfolios far more sensitive to interest rate fluctuations than US banks.

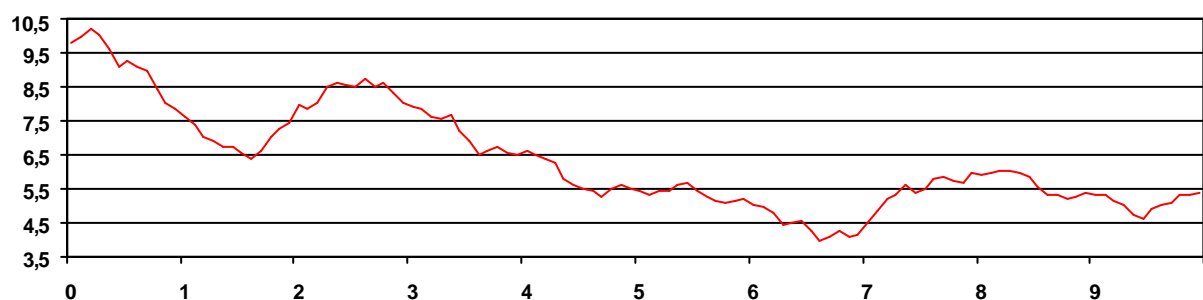
➤ Consequences on the financial statements

A simulation of the application of IAS 39's principles to the banking book activities of a French financial institution is presented below, assuming the application of cash flow hedge accounting.

For the purposes of this example, let's us assume that Bank A has the following balance sheet:

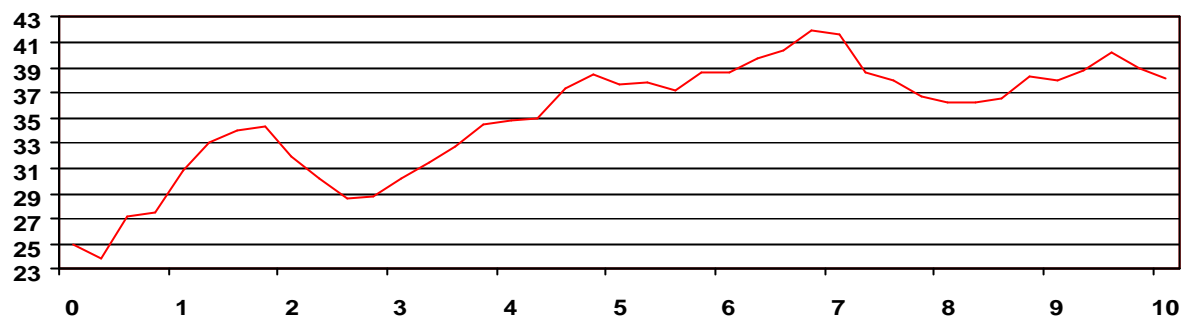
Fixed-rate commercial loans	70	Demand deposits	130
Floating-rate commercial loans	140	Regulated savings schemes	190
Fixed-rate commercial loans	135	Term deposits	30
Floating-rate commercial loans	15	Inter-bank accounts	25
Fixed-rate consumer loans	40	Common stock	25
Total	400	Total	400
Swaps	65	Swaps	65

Swap rates over 10 years, amortised on a straight-line basis, are as follows:



Comments on IAS 39

With the application of cash flow hedge accounting, these interest rate fluctuations would have generated annual volatility in shareholders' equity of 25%, as presented in the following diagram, while revenues remain stable.



The other options offered by the Standard with respect to accounting for the fair value of ALM swaps are:

- fair value hedge accounting: this treatment is not applicable to swaps hedging undated demand deposits; and
- classification of swaps in trading: this classification is totally contrary to the management intention behind the implementation of the swap and implies accounting for swaps at fair value with movements taken to earnings.

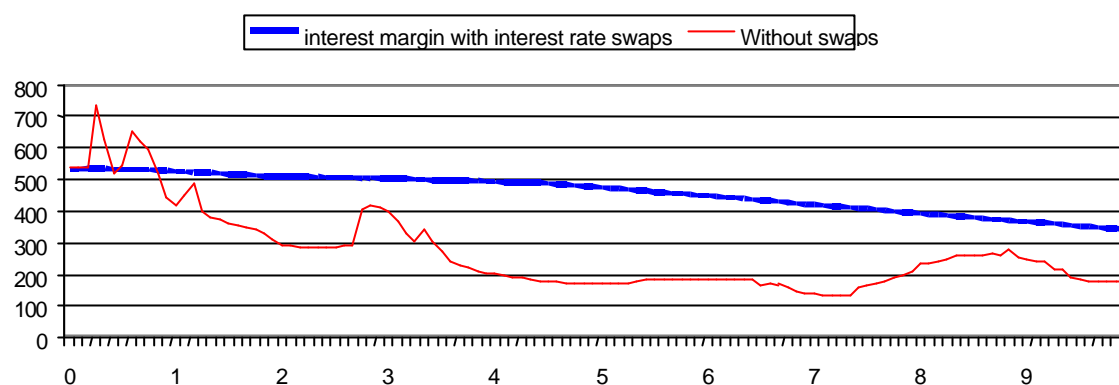
In the latter case, application of IAS 39 generates identical volatility, but this time in earnings while the interest margin remains stable.

None of the options offered by the Standard correctly reflect the reality of the management activity.

- **An institution which does not hedge its future margins presents better financial statements than an institution practising a sound management policy**

It follows from the above conclusions that the hedging of interest rate margins generates significant volatility in the shareholders' equity of the institution concerned.

Conversely, an institution which does not hedge its risk exposure will present highly favourable financial statements, insofar as it will avoid violent volatility in earnings or shareholders' equity. This strategy would not, however, enable the institution to avoid substantial movements in margins in line with interest rates, as illustrated below:



Financial statement users would, therefore, conclude that this institution is more prudent and better managed than an institution which hedges its future margins, whereas the economic reality is the exact opposite.

The accounting translation of the margin hedges misleads the financial statements users.

2.3 Consequences on financial communication

➤ Consequences already observed

It has been concluded after consulting with users – analysts and rating agencies – that only a minority of observers would favour the use of fair value.

For instance, in a survey performed in September 2001, Moody's highlighted the possible impact of the application of FAS 133 (Standard laying down similar derivative accounting principles as IAS 39) on shareholders' equity of US companies and recommended that these adjustments, which complicate the calculation of financial ratios, be restated.

In addition, the US banks which apply FAS 133 are, since January 1, 2001, required to record all derivatives at fair value, with changes in fair value taken to earnings, including in the case of ALM hedge derivatives.

The impact of this change in method obliged the institutions concerned to explain in the Notes to their financial statements not only the accounting policies adopted but also the resulting aberrations.

For example, Fannie Mae presents in its financial statements:

- a highly detailed analysis of its interest rate risk management activities (indicators used, frequency, decision-making process) and the impact of these management activities on the year then ended, demonstrating in this way the prudence with which this risk is managed;
- the consequences of this change in accounting method on financial statement presentation, despite the sound management policy applied.

It is explained that shareholders' equity excludes AOCI (accumulated other comprehensive income corresponding to the fair value of ALM hedge swaps), as AOCI includes unrealised gains and losses on derivatives, but not unrealised gains and losses on mortgaged loans and the liabilities used.

Application of IAS 39 will encourage user suspicion of financial information.

➤ **Consequences on segmental information**

The recognition of internal contracts is indispensable if banks are to meet segmental information reporting requirements by business, with the calculation of results specific to each segment as recommended particularly by IAS 14 (revised).

3. Alternative proposals

3.1 Permit the hedging of demand deposits

It is our wish that demand deposits, viewed as a stable source of funds by financial institutions and for which the modelling is determined based on econometric studies, also be eligible for cash flow hedges for their reinvestment.

We ask that you eliminate the last sentence of paragraph IGC 121-2 *“Note that some banks consider some portion of their non interest bearing demand deposits to be economically equivalent to long-term debt. ~~However these deposits do not create a cash flow exposure to interest rates and therefore, would be excluded from this analyses for accounting purposes.~~”*

3.2 Internal contracts

IAS 39 is based on the principle that financial instruments entered into by a department without market access with a specialist entity must be immediately offset on the market by this latter in order to qualify for hedge accounting.

We wish the IASB to acknowledge the practice of internal contracts so as to enable internal derivatives or cash contracts to be recognised as hedging instruments with the condition of a clear separation of hedging contracts and trading contracts.

In this context, paragraph 126B of the IAS 39 (revised) Exposure Draft should be amended as follows :

“For hedge accounting purposes, ~~only~~ derivatives that involve a party external to the entity ~~or~~ and internal contracts between two separate entities within a consolidated group or two divisions within an entity can qualify for hedge accounting by those entities in their separate financial statements or by those divisions and can be designated as hedging instruments or hedged items. Although

individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any gains or losses on such transactions are eliminated on consolidation. Nevertheless, ~~Therefore, such intragroup or intra-entity hedging transactions do not qualify for hedge accounting in consolidation.~~ allow groups to meet segmental information reporting requirements by business, with the calculation of results specific to each segment.

3.3 Hedging of net positions

We wish the hedging of net positions to be recognised by the Standard and the amendment of IAS 39.127 as follows:

“a hedge item can be:

- (a) a single asset, liability, firm commitment or forecasted transaction; or*
- (b) a group of assets, liabilities firm commitments or forecasted transactions with similar risk characteristics; or*
- (c) a net exposure being for instance determined through interest rate, credit risk or equity sensitiveness”*

This proposal only concerns one paragraph in the Standard and should, therefore, be extended to all other paragraphs whose application results therefrom.

3.4 Valuation of banking book hedge derivatives at historical cost

We would ask you to introduce the option of accounting for derivatives at cost and, in particular, to modify paragraphs 69 and 89A of the Exposure Draft. This proposal should be extended to all other paragraphs whose application results from these paragraphs.

Appendix 2: The relationship between commercial margin and risk premium under IAS 39's proposed approach

1. Risk premium and commercial margin

The use of contractual interest rates to calculate the effective interest rate (which, in accordance with IAS 39.113D is used in the collective evaluation of impairment) results in the computation of risk premium (contractual rate less effective interest rate), which is greater than the risk premium determined at the inception of the contract.

As a consequence, although a group of assets may have the same risk profile, the effective interest rate computation and the risk premium calculated using this effective interest rate - the 'inferred' risk premium - vary in line with commercial margin on the loan. The more the commercial margin increases, the more does the inferred risk premium.

Rating	Maturity	Contractual Rate (a)	Effective interest rate (b)	Risk premium (c)	Inferred risk premium (d)
BB	10	4.0%	3.6267%	0.3426%	0.3733%
BB	10	4.5%	4.1235%	0.3426%	0.3765%
BB	10	5.0%	4.6203%	0.3426%	0.3797%
BB	10	5.5%	5.1170%	0.3426%	0.3830%
BB	10	6.0%	5.6138%	0.3426%	0.3862%
BB	10	6.5%	6.1105%	0.3426%	0.3895%
BB	10	7.0%	6.6073%	0.3426%	0.3927%
BB	10	7.5%	7.1040%	0.3426%	0.3960%
BB	10	8.0%	7.6007%	0.3426%	0.3993%
BB	10	8.5%	8.0974%	0.3426%	0.4026%
BB	10	9.0%	8.5941%	0.3426%	0.4059%
BB	10	9.5%	9.0908%	0.3426%	0.4092%
BB	10	10.0%	9.5875%	0.3426%	0.4125%
BB	10	10.5%	10.0842%	0.3426%	0.4158%
BB	10	11.0%	10.5808%	0.3426%	0.4192%
BB	10	11.5%	11.0775%	0.3426%	0.4225%
BB	10	12.0%	11.5742%	0.3426%	0.4258%

- (a) The contractual rate is the sum of the risk-free rate, the risk premium and commercial margin
- (b) The effective interest rate is adjusted for the risk premium.
- (c) The risk premium is calculated on the basis of annual average loss to maturity (or the loss on default *the annual default rate to maturity on a straight-line basis)
- (d) The inferred risk premium is the difference between the contractual rate and the original effective interest rate.

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Furthermore, the increase in risk premium as a result of increases in commercial margin is even more significant as the credit rating decreases.

The example below shows that the difference between the risk premium calculated using the original effective interest rate and original risk premium (which is calculated on the basis of risk factors only) becomes higher as the credit rating decreases and the contractual rate (i.e. margin) is increased.

		Contractual rate = 5%			Contractual rate = 10%		
Rating	Theoretical risk premium	Original effective interest rate	Inferred risk premium	Inferred risk premium – original risk premium	Original effective interest rate	Implied risk premium	Inferred risk premium – original risk premium
AA+	0.003%	4.996%	0.004%	0.001%	9.996%	0.004%	0.001%
A	0.010%	4.989%	0.011%	0.001%	9.988%	0.012%	0.002%
BBB+	0.030%	4.987%	0.033%	0.003%	9.965%	0.035%	0.005%
BBB	0.065%	4.930%	0.070%	0.005%	9.924%	0.076%	0.011%
BBB-	0.140%	4.849%	0.151%	0.011%	9.837%	0.163%	0.023%
BB	0.480%	4.480%	0.520%	0.040%	9.443%	0.557%	0.077%
B+	1.662%	3.165%	1.835%	0.173%	8.051%	1.949%	0.287%

As a result:

- The calculation of impairment is based on an inflated risk premium rate since it includes a portion of commercial margin;
- The impairment amount will include in part future commercial margin on the loan, which is not the objective of impairment.

2. Collective impairment and commercial margin

As stated in our letter, the dependence of the collective evaluation of impairment as proposed by IAS 39 on the contractual rate implies an inflated risk premium. This is because total yield is used to calculate recoverable amounts, and not solely the risk premium rate for expected losses (whichever method one uses to quantify expected losses, whether by means of internal systems or by deduction of the effective rate at the outset). In this way, the impairment recognised after a year is strongly linked to the commercial margin on the loan (not forsaking the credit risk element within the commercial margin).

If you take as an example a group of 100 loans having the same risk profile (the same counterparty rating – BB, the same yield overall– 40%, the same maturity – 6 years) but with contract rates of 6% and 12% respectively, at the end of the first year, different collective impairment amounts are reached.

Let's suppose in the example that at the end of year 1, no individual asset is identified as being impaired and removed from the portfolio in accordance with IAS 39.112. The loan notes continue to be BB rated. No new loan has been added to the portfolio.

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In accordance with the example in IAS 39, the historic loss rates continue to be applied.

Contract Rate of 6%

At the end of year, one the pattern of future cash flows is as follows:

Year	Contractual cash flows (interest and principal) (a)	Estimated Annual Cumulative Default rate (b)	Estimated cash flows (c) = (a)*(1-(b))	Actual value (using original effective rate of 4.71%) (d) = (c) / (1+4.71%) ⁿ
2	600	1.70%	590	563
3	600	3.10%	581	530
4	600	4.64%	572	498
5	600	6.02%	564	469
6	10,600	7.24%	9,833	7,813
Total				9,874

The difference between the face value of the assets (10,000) and the discounted value of the future cash flows using the effective interest rate for the group of loans (9,874) is 126. At the end of year 1, it is necessary to recognise an impairment loss of 126.

Contract Rate of 12%

At the end of year one, the pattern of future cash flows is as follows:

Year	Contractual cash flows (interest and principal) (a)	Estimated Annual Cumulative Default rate (b)	Estimated cash flows (c) = (a)*(1-(b))	Actual value (using original effective rate of 10.67%) (d) = (c) / (1+10.67%) ⁿ
2	1,200	1.70%	1,180	1,066
3	1,200	3.10%	1,163	949
4	1,200	4.64%	1,144	844
5	1,200	6.02%	1,128	752
6	11,200	7.24%	10,390	6,257
Total				9,868

The difference between the face value of the assets (10,000) and the discounted value of the future cash flows using the effective interest rate for the group of loans (9,868) is 132. At the end of year 1, it is necessary therefore to recognise an impairment loss of 132.

The impairment loss is approximately 5% higher in the second example (contractual rate of 12%) than in the first (contractual rate of 6%).