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Dear Sir David

**Comment letter of the Association of German Public Sector Banks (Bundesverband Öffentlicher Banken Deutschlands - VöB) on the Exposure Draft „Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk“ further to amend IAS 39, Financial Instruments: Recognition and Measurement**

We thank you for the opportunity to comment on the proposed amendments to IAS 39 „Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk“ issued by the International Accounting Standards Board (IASB) for public consultation on 21 August 2003.

## **A. General remarks**

With great interest we have analysed the revision and the amendments concerning hedge accounting proposed by the IASB.

The new proposals on fair value hedge accounting for a portfolio hedge of interest rate risk, outlined therein are certainly a first step into the right direction with respect to the objective to attain a consistency of the accounting treatment with the methodology of interest rate management practised in banks. To that extent we welcome the Exposure Draft as an indication that the IASB

is ready to look further into the modern interest rate risk management in banks than it did in the past.

Basically we still have the opinion that the measurement of all derivatives at fair value detracts from displaying hedge relationships in an economic reasonable manner. Therefore, the "principle" specified by the IASB to fair value all derivatives and recognise the changes in fair value in the profit and loss statement (P&L) makes it from our understanding necessary to search for a pragmatic, manageable and as far as possible the economic reality appropriately displaying provision for hedge accounting of interest rate risk on a portfolio basis.

However, the IASB unfortunately did not dare to take the step to go substantially beyond the narrow framework of a fair value hedge, as it is laid out as a micro-hedge in IAS 39. Rather this fair value hedge accounting approach has been somewhat generalised in its application, whereby this extended approach is still not based persistently on net positions.

Four approaches for designation (approach A - D) are explained in the Exposure Draft, which can be put down to two concepts. The approaches A to C are so-called „layer“-approaches. The approach D suggested by the IASB is a percentage-approach. Approach C is a modification (partial hedge of the net position) of the approach B (see BC19). It is common to the approaches that they are based on a gross view as an allocation of an amount of assets or liabilities to hedging instruments. The Exposure Draft suggests that starting from the formal determination of a net position in a time bucket a monetary amount of assets or liabilities should be designated as the hedged item, not the net position as such. In contrast, risk management is based on the daily determined interest net position. The designation of an in such a way determined net position as the hedged item would therefore be consistent. In addition to the acceptance of fair valuing all derivatives, the suggested gross view is insofar a further concession on part of the banking industry.

The interest rate risk management of a bank can not be presented solely by the hedge models allowed by the IASB. The objective to lock in an interest-rate margin is not reflected adequately through none of the two procedures available (fair value hedge accounting and cash flow hedge accounting respectively).

The renouncement to have to allocate the changes in fair value of an interest rate risk hedged portfolio to individual assets and liabilities respectively and the intention to create a separate balance sheet item (fair value adjustment) instead is a substantial easement.

From our understanding the Exposure Draft is based on the determination of the change in value of a fixed portfolio during the period under consideration and is therefore static. In contrast the bank-internal risk management is based

on the net positions each determined in short time intervals. For example according to the approaches A – D a newly transacted derivative can only be designated at the next cut-off date so that only the change in value of the derivative but not of the hedged item will be recognised in the P & L (see A37).

Insistently, we request the consideration of “core deposits” according to the definition in BC13 as designatable hedged items. Without their acceptance particularly banks with a strong retail business will face substantial competitive disadvantages just because of accounting conventions. However, in our view accounting standards may not influence competition neutrality negatively.

In this context once again we would like to point to a central problem. A change of IAS 39.126B (re-arranged from IAS 39.134 with the Exposure Draft issued in June 2002) is still not addressed in the now issued Exposure Draft. Only derivatives in which an external party not belonging to the entity is involved continue to qualify as hedging instruments for hedge accounting. Internal derivatives are only accepted in case they are passed on to an external partner on an individual basis. Thus the efficiency gains linked with an internal bundling cannot be realised. Internal derivatives are indispensable for the management of the interest rate risk in practice. We therefore make an urgent plea to treat internal derivatives basically like external transactions and accept them for hedge accounting.

Consequently, the proposed changes lead to a clear improvement. However, when taking the critical remarks mentioned into consideration, results which deviate partly from the economic management of banks and thereby provide an unfair view of the financial position and performance to the users of financial statements would still occur. Unchanged, the entities face the problem to have to explain results which did not arise the way presented.

## **B. Answers to the questions**

### *Question 1*

*Draft paragraph 128A proposes that in a fair value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount. For example, it may hedge the change in the fair value of the designated amount attributable to changes in interest rates on the basis of expected, rather than contractual, repricing dates.<sup>1</sup> However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (eg in the light of recent prepayment experience), or actual repricing dates differ from those expected. Draft paragraph A36 describes how the amount of such ineffectiveness is calculated. Paragraphs BC16-BC27 of the Basis for Conclusions set out alternative methods of designation that the Board considered, their effect on measuring ineffectiveness and the basis for the Board's decisions including why it rejected these alternative methods.*

*Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness?*

*If not,*

*(a) in your view how should the hedged item be designated and why?*

*(b) would your approach meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit or loss?*

*(c) under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet?*

(a):

As initially stated, the gross view underlying the approaches A - D does not correspond with the bank's risk management, i.e. the management of a net position. In principle however the selection and the allocation of the hedged item should be in conformity with a bank's risk management.

If one is limited to the explained approaches A - D, we favour approach A. In the result it leads to a substantial simplification of the measurement of ineffectiveness. In that we support the view of the five board members who expressed support for approach A.

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<sup>1</sup> The repricing date of an item is the date on which the item will be repaid or repriced to market rates.

As a compromise also the combination of the approaches B / C would be justifiable. This also corresponds with the view of the five board members, who would likewise accept these approaches. Besides the arguments already specified in the Exposure Draft, it speaks particularly for B / C that ineffectiveness is considered only if it is due to derivatives (overhedge). To that extent B / C points a high consistency to the IAS 39-„philosophy“. From our judgement, an „underhedging“ (e. g. if a part of the net position in a time bucket is left consciously open) does not lead to ineffectiveness to be recognised in the P&L. A risk position resulting from „Loans and Receivables originated by the entity“, „Available for Sale“ assets and „Other Liabilities“ without the transaction of derivatives will finally not affect net income.

To avoid a purely static view over a comparison of the historical portfolio at the beginning of a period with the portfolio still existing at the current measurement date, we suggest a modification to the „layer“-approaches:

According to a dynamic view the measurement at fair value of the designated assets or liabilities (hedged items) including new transactions should already be permitted at the current measurement date and not at the end of the next period. The comparison of the portfolios from measurement date to measurement date considers thereby all changes, i. e. scheduled and unscheduled repayments as well as new transactions. The recognition of the changes in fair value in the P&L of the hedging derivatives as well as of the „hedged items“ corresponds with the actual risk management of banks.

The suggested modification would lead to the same result as a de-designation and re-designation of hedges on a daily basis and measuring ineffectiveness daily respectively, which are admissible according to the Exposure Draft but would lead to extremely high EDP-systems changes.

Approach D is in its handling – particularly over several periods and with changing assets and liabilities respectively – more complex and regarding the display of the actual interest rate risk management as well as the extent of resulting ineffectiveness conceptionally not superior to the other approaches (see also under (b)).

In consequence within the limits of the proposed approaches we favour approach A because of practical reasons, but would also accept the combination of the approaches B / C.

(b):

We agree, that any material ineffectiveness has to be identified and recognised in the P&L. However, we doubt whether this „principle“ implicates that ineffectiveness results from both under- and overhedging. This understanding of a linearity of risk (i.e. uniform distribution of positive chance and negative risk) is the basis of approach D.

From our understanding it is the aim and the purpose of hedge accounting under IAS 39 to consider ineffectiveness in the P&L to the extent it is due to the hedging instruments (negative risk with an „overhedge“). Thereby, consciously open left positions (positive risk with an „underhedge“) do not lead to ineffectiveness to be recognised in the P&L as it would equally be the case with positions without the transaction of derivatives.

In addition, the thesis of a basic linearity of risk can be disproved by the fact that written options (put position) can not be used as hedging instruments according to IAS 39. According to IAS 39 a written option is not seen as an effective means for risk reduction with respect to the period's profits, since the possible loss from written options can be substantially higher than the profit from the assigned hedged item. The same applies to derivatives that effectively constitute a „net written option“

The proportional allocation to an entirety of either assets or liabilities, suggested by the IASB in the context of the approach D, leads to an one-sided view. The change in fair value of the other side, i. e. either the liabilities or the assets contained in the hedged net position, remains unconsidered. This proceeding leads to make the determination of ineffectiveness practicable, the in such a way determined measure has however only limited significance related to the actual effectiveness of the hedging relationship. This problem is common to all gross views.

In consequence, with regard to measuring ineffectiveness we do not consider the approach D conceptually to be superior to the approaches A and B / C respectively. Within our proposed modification of the “layer“-approaches ineffectiveness resulting from matured transactions and new transactions would be recognised in the P&L. Besides this change in fair value is recognised immediately and not at the end of the subsequent period.

(c):

Within each approach for designation at each measurement date a complete derecognition of the fair value adjustment would take place followed by a new recognition.

## Question 2

*Draft paragraph A30 (b) proposes that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair value hedge accounting if they had been designated individually. It follows that a financial liability that the counterparty can redeem on demand (i.e. demand deposits and some time deposits) cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. Paragraphs BC13-BC15 of the Basis for Conclusions set out the reasons for this proposal.*

*Do you agree that a financial liability that the counterparty can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment?*

*If not,*

*(a) do you agree with the Board's decision (which confirms an existing requirement in IAS 32) that the fair value of such a financial liability is not less than the amount payable on demand? If not, why not?*

*(b) would your view result in such a liability being recognised initially at less than the amount received from the depositor, thus potentially giving rise to a gain on initial recognition? If not, why not?*

*If you do not agree that the situation outlined in (b) is the result, how would you characterise the change in value of the hedged item?*

We share the view of the IASB that "core deposits" as defined in BC13 should not be measured in the balance sheet at an amount less than the one which is payable to the counterparty on demand. However, we are not of the opinion that "core deposits" cannot qualify for fair value hedge accounting beyond the shortest time bucket in which the counterparty could demand repayment.

From our point of view "core deposits" which are included in the time buckets on the basis of expected repayment dates according to an entity-individual statistical model must be designatable as hedged items, too. For practical and conceptual reasons we demand a permission of fair value hedge accounting for portfolios of "core deposits" as well.

We justify our view essentially as follows:

- Banks involved in retail business carry in their financing structure a stable layer (basic level) of long-term low or non interest-bearing customer deposits. It can be statistically proven that this layer is actually available over a long-term period. In view of the practice it can be stated that "core deposits" often are not called and replaced with new ones but are available until further notice. To that extent it is not a hedge of „forecasted transactions“.

- It is economic reality that the market value of this layer changes subject to interest rate movements. If the interest rate rises, the value of a low interest-bearing deposit will increase. A market price of a portfolio consisting of "core deposits" can develop only between licensed deposit-takers. It is however indisputable that such sales take place at prices, which deviate from the nominal values of the transferred liabilities. This is substantially due to the buyer's estimate of the probable repayment dates by the counterparty.
- In the banks' risk management practice "core deposits" are an integral component of the portfolio hedging of interest rate risks. The exclusion of "core deposits" from the portfolio hedge model would mean that a number of banks would not be able to use fair value hedge accounting on a portfolio basis.
- While on the asset side behavioural assumptions (expected repayment periods) may be used and the assets included in such a way may also be designated as hedged items, according to the IASB's view an asymmetrical treatment should be applied for liabilities. Though "core deposits" may be included in the time buckets they may not be designated as hedged items. To our judgement this is inconsistent.
- With a stronger acknowledgement of the practices of the internal risk management for external accounting also aimed at by the IASB (see BC9) "core deposits" have consequently to be accepted as designatable hedged items. Similar to „prepayments" on the asset side model risks can be managed by regular backtesting. Besides the statistical models applied are subject to monitoring by auditors and by banking supervision.
- Also "core deposits" are subject to a risk of change in interest rates. The argumentation of the IASB (BC14) completely ignores the objective of the formation of portfolios to hedge interest rate risks in practice, which is not aimed at hedging a fair value risk but at locking in an interest rate margin.
- In principle, a measurement of "core deposits" in the balance sheet at fair value would not be necessary. The problem only arises from the obligatory measurement of hedging instruments at fair value required by IAS 39. Volatile periodic results arise from the asymmetrical measurement of the hedging instrument at cost and the hedging derivatives at fair value with recognition of the fair value changes in P&L while from an economic point of view the (interest -) margin per period is constant. With the admissibility of fair value hedge accounting on a portfolio basis and the recognition of the fair value adjustment<sup>2</sup> on "core deposits" in a separate balance sheet item (see IAS 39.154 new) the asymmetrical measurement becomes a parallel one with the result that also in the IAS-P&L the economically existing constant margin per period is presented. By consideration of the fair

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<sup>2</sup> The fair value adjustment equals the change in fair value due to the hedged risk.

value adjustment on “core deposits” the otherwise artificial IAS-P&L volatility caused by the one-sided fair value measurement of the derivatives will be eliminated and further reduced respectively.

- The view according to which the fair value adjustment within fair value hedge accounting on a portfolio basis is not an individual-transaction related value adjustment but rather a portfolio-related equalisation of distorting measurement results on the basis of the risk management can also be derived from the inclusion of “Available for Sale”- assets in the portfolio permitted according to the Exposure Draft. In these cases a proportionate adjustment of the fair value reserve is neither envisaged in the Exposure Draft nor workable without serious system adjustments.
- A use of the “core deposits” within cash flow hedge accounting does not appear to make sense. The coexistence of a portfolio based fair value hedge accounting and cash flow hedge accounting respectively for the same economic issue does not contribute to an improved information benefit in the sense of „decision usefulness“ for the users of financial statements.

Within banks there are different approaches which – along the lines of risk management – for accounting purposes consider on the one hand the customer behaviour by valuation models for “core deposits” and on the other hand the assets concluded on the basis of the availability of the “core deposits”. In the enclosure you find an example that contrasts the economic result of an inclusion of “core deposits” into the portfolio hedging of interest rate risks with the results pursuant IAS 39 in its current and future version respectively.

It is to state that because of the non-consideration of “core deposits” the artificial volatility in the IAS-P&L is substantially higher than it would be if for accounting purposes the actual customer behaviour was – along the lines of risk management – considered by models.

## **C. Comments concerning individual paragraphs**

<b>Paragraph</b>	<b>Comment</b>
A26 (b) in conjunction with A32	<p>We interpret the wording „based on expected, than on contractual, repricing dates“ in such a way that the Exposure Draft grants a right to include financial instruments on the basis of their expected repricing dates or their contractually agreed maturities into time buckets. The inclusion into time buckets can therefore be done in accordance with the entity-individual risk management. This view is also supported by the wording in A32 („permits“) and IAS 39.128A respectively („may hedge... on expected, than contractual“). Besides the inclusion on the basis of expected volumes is to create an easement (see BC 9).</p> <p>We welcome that the Exposure Draft does not contain provisions regarding the structuring of the time buckets and requirements on the homogeneity of assets and liabilities to be included in the portfolio. The monthly time buckets specified in IE2 are to be understood as non-obligating examples. We suggest to clarify that the provisions contained in IAS 39.132 regarding the homogeneity of portfolios (proportional reaction of aggregated assets and liabilities to same risk) are not applicable to macro-hedging. Otherwise the usability of the Exposure Draft would be substantially impaired.</p>
A26 (e) in conjunction with A31 and ED IAS 39.126F	We evaluate the possibility of including derivatives with risk positions moving in opposite directions into the portfolio of hedging instruments as a great progress. According to our understanding this possibility is not limited to macro-hedging, but applies also to micro-hedging, since IAS 39.126F generally stipulates the designation of hedging instruments.
A26 (f) in conjunction with A32 and A34	We welcome that the Exposure Draft does not prescribe an explicit procedure for the determination of the change in fair value of the hedged item and we do not see any need for it. In that, according to our understanding entity-individual methods can be applied.
A26 (h) in conjunction with A35 and IAS 39.142 (e) in conjunction with IAS 39.146	From our understanding the requirements for a prospective as well as a retrospective effectiveness test through the 80 - 125 % range are not applicable to fair value macro-hedging.

	<p>The expectation of prospective effectiveness results from the documentation of the hedged net position with the time buckets.</p> <p>The requirement for an additional retrospective effectiveness test through the 80 - 125% range with regard to whether hedge accounting may be applied at all, contradicts the requirement set in A26 (h). According to it any ineffectiveness is to be recognised in the P&amp;L as the difference between the change in fair value of the hedged item and the hedging instrument. In addition, a specific ineffectiveness test for fair value macro-hedging is stipulated by A36. Besides, the portfolio view of a cash flow hedge in accordance with Question &amp; Answer 121-2 is not based on a range view. A clarification by the IASB would be welcomed.</p> <p>We point out that a linguistic inconsistency exists between A26 (h) and A35. In accordance with A35 „all material ineffectiveness“ is to be recognised in the P&amp;L. In contrast, A26 (h) speaks of „any ineffectiveness“. Besides, the phrasing „but only if derivative are involved“ should be inserted in both wordings. This is consistent with the principles of the IASB and clarifies that ineffectiveness can only result in the P&amp;L as far as derivatives are involved.</p>
A29	<p>From our understanding, the sentence beginning with „For a group of similar items... “ permits a proportional allocation of similar assets and liabilities respectively to time buckets and represents a substantial easement. We welcome this.</p>
A31	<p>We ask to explain the term „similar derivatives“ in more detail and, if necessary, give explanatory examples, for instance in the case of swaptions concluded to hedge prepayment risk on a portfolio basis.</p>

## **D. Issues requiring further clarification or additional guidance**

With respect to the following issues the IASB is requested to support further clarification or additional guidance.

### ***1. Amortisation and / or derecognition of the fair value-adjustment***

According to IAS 39.157 a fair value adjustment of the carrying amount of a hedged item is to be amortised through the P&L. It remains open in the Exposure Draft whether this provision is to be applied also to portfolio-hedging. The risk management of interest rate changes on a portfolio basis is a dynamic process, to which the provisions of IAS 39.157 do not accommodate from our point of view. The associated technical requirements appear considerable and are not in line with the objective of the Exposure Draft of opening a way to enable hedge accounting on a portfolio basis by usage of the data of the internal risk management without substantial system adjustments.

An allocation of the fair value adjustments to individual assets and liabilities respectively included in the portfolio is not feasible. To that extent we ask for clarification that IAS 39.157 is not applicable.

### ***2. Development of a fair value macro hedging over time***

For a better understanding of the suggested provisions we regard it reasonable to extend the illustrative example and display the development of a fair value macro hedge over time. For example, this could be done by expanding the illustration to three time buckets and their change over various reporting periods.

## **E. Important demands so far not accepted by the IASB**

We would like to take the opportunity to re-address important issues we had included in our comment letter on the June 2002 Exposure Draft proposing amendments to IAS 39, particularly because some issues have to been seen in direct conjunction with the suggested hedge accounting on a portfolio basis.

### *„short cut“-method*

Under IAS 39.147 in conjunction with Question & Answer 147-1 the „short cut“-method continues not to be admissible. This unnecessarily exacerbates the effectiveness test. We consider this requirement inadequate and recommend the „short cut“-method to be permitted under the conditions referred to in IAS 39.147 and IAS 39.148 and in view of US-GAAP, with IAS 39.147 also adapted in line with SFAS 133.68. This would be a further step towards a convergence of international accounting standards.

### *„Held to Maturity“-financial instruments*

Under IAS 39.127 „Held to Maturity“-financial instruments can only be hedged with respect to credit risk or exchange rate risk. Financial instruments categorised as „Loans and Receivables originated by the entity“ are not affected by this restriction. We reject this differentiation. Hedging the interest rate risk should also be permissible for „Held to Maturity“-financial instruments. The aim of such hedging is to lock in the interest rate margin and not to hedge the capital proceeds from sale. We therefore propose to delete the last two clauses in IAS 39.127 completely.

### *Financial guarantees*

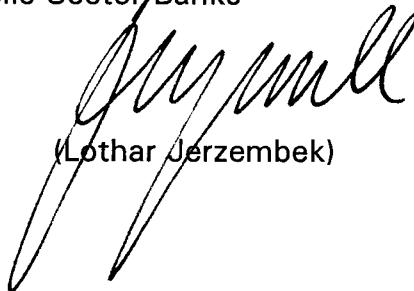
Broadening the scope of application of IAS 39 to include financial guarantees with regard to their initial recognition and measurement should be avoided by deleting the first half of the clause in IAS 39.1(f) of the Exposure Draft issued in June 2002. The recognition of a liability at inception is not justified in our opinion since a financial guarantee does not automatically lead to an obligation to be shown on the balance sheet in conjunction with a future outflow of assets. Under any circumstances however the demanded initial recognition at fair value should not lead to a counterentry in the P&L. If the IASB sticks to its view we urgently request an example to clarify the accounting treatment.

In case you might have any further questions or discussion points with regard to our notes and suggestions, please do not hesitate to contact us. We send copies of this letter to the German Accounting Standards Board and the European Financial Reporting Advisory Group (EFRAG).

Yours sincerely  
Association of German Public Sector Banks



(Karl-Heinz Boos)



(Lothar Jerzembek)

**Enclosure**

## Example for portfolio hedging and inclusion of "core deposits"

### 1. Initial situation ( $t_0$ )

In  $t_0$  Bank A has the following balance sheet structure

Bank A							
Assets				Liabilities			
Product	Volume	Product interest rate	Remaining time to maturity	Product	Volume	Product interest rate	Remaining time to maturity
5-Y-Receiver-Swap (Float 3M)	20	4.90	5	Savings deposits	100	1.55	3 M- notice period before repayment
5-Y-Receiver-Swap (Float 3M)	20	4.80	4				
5-Y-Receiver-Swap (Float 3M)	20	4.00	3				
5-Y-Receiver-Swap (Float 3M)	20	4.20	2				
5-Y-Receiver-Swap (Float 3M)	20	4.85	1				

According to the statistical model of the floating average<sup>1</sup> the savings deposits are included in the gap analysis. In this example case the interest rate risk of the savings deposits is hedged by a floating 5-years asset portfolio (proven through statistical analysis).<sup>2</sup> The interest rates of passed periods as well as of the following period  $t_1$  are displayed in the following chart:

date	$t_4$	$t_3$	$t_2$	$t_1$	$t_0$	$t_1$
1-year rate	4.20	3.90	3.70	4.20	4.20	4.10
2-years rate	4.30	4.00	3.90	4.50	4.60	4.50
5-years rate	4.85	4.20	4.00	4.80	4.90	4.60

<sup>1</sup> The floating average is determined by replicating the portfolio of "core deposits" by a portfolio of money market and capital market products. In doing so, the demand and savings deposits' slow-acting adjustment behaviour to interest rate changes is emulated by revolving financial investments in the individual time buckets.

<sup>2</sup> Simplified presentation, which however in principle changes nothing in the issue presented above. It was assumed that the actual and the basis volume (base level) are identical. In practice there is an appropriate buffer. In addition, it was assumed that the investment has only been made through derivatives (and the cash invested as 3-months deposit). Usually the treasurer finds fixed interest assets ( e. g. loans) and liabilities.. Besides in this example it was assumed that treasury brings in a neutral interest opinion at the interest management

## 2. Reporting date (t<sub>1</sub>)

For hedging purposes in t<sub>1</sub> bank A concludes another 5-Y-Receiver-Swap (prolongation of the swap with a time to maturity of 1 year in t<sub>0</sub>). In t<sub>1</sub> the (partial) portfolio of bank A looks as follows:

Bank A							
Assets				Liabilities			
Product	Volume	Product interest rate	Remaining time to maturity	Product	Volume	Product interest rate	Remaining time to maturity
5-Y-Receiver-Swap (Float 3M)	20	4.60	5	Savings deposits	100	1.50	3 M- period notice of repayment
5-Y-Receiver-Swap (Float 3M)	20	4.90	4				
5-Y-Receiver-Swap (Float 3M)	20	4.80	3				
5-Y-Receiver-Swap (Float 3M)	20	4.00	2				
5-Y-Receiver-Swap (Float 3M)	20	4.20	1				

The average interest rate of this floating asset portfolio was 4.55 in t<sub>0</sub> and in t<sub>1</sub> it is 4.50. Therefore it has decreased by 5 bases points (bp).

In t<sub>1</sub> Bank A has made an adjustment of the interest rate on the savings deposits in line with the 5 year floating, i. e. has decreased the product interest also by 5 bp. Bank A therefore earns a constant margin of 3 % (4.55 to 1.5 in t<sub>0</sub> and 4.5 to 1.50 in t<sub>1</sub> respectively). in t<sub>0</sub> as well as in t<sub>1</sub>.

The change in value of the derivatives portfolio on the asset side has completely been handed over to the customers of the savings deposits. Bank A has taken effective means to hedge for risks resulting from changes in interest rates.

	FAIR VALUE				CHANGE IN FAIR-VALUE		
	Assets		Liabilities		Delta (Assets)	Delta (Liabilities)	Delta (Total)
	t <sub>0</sub>	t <sub>1</sub>	t <sub>0</sub>	t <sub>1</sub>	[t <sub>0</sub> , t <sub>1</sub> ]	[t <sub>0</sub> , t <sub>1</sub> ]	[t <sub>0</sub> , t <sub>1</sub> ]
Economic result <sup>3</sup>	99.6	100.2	88.6	89.2	+0.6	+0.6	0.0
Result according to IAS 39 <sup>4</sup>	99.6	100.2	100.0	100.0	+0.6	0.0	+0.6

<sup>3</sup> Economic result: The same would be achieved with an IAS-P&L if demand and savings deposits would be included in the fair value hedge accounting on a portfolio basis on the basis of their economic period of interest rate fixation (and not their legal one) as stipulated in our comment letter.

### 3. Conclusion

Savings deposits can be steered, i. e. hedged against risks of changes in interest rates. The change in fair value is measurable.

Would savings deposits, independent of any market developments, be accounted for at cost ( $AC = 100$ ), the one-sided recognition of economic appropriate hedges would display a distorted picture.

In the above example the results from trading would increase by 0.6 even though Bank A has completely hedged the interest rate risk under the premises of the model.

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<sup>4</sup> Result according to IAS 39: Thos would be the result of IAS-P&L on the basis of the current standard as well as according to the exposure drafts issued by the IASB to amend IAS 39 (June 2002 and August 2003 respectively)