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**Sir David TWEEDIE**  
**IASB**

**30 Cannon Street**  
**UK – LONDON EC4M 6XH**

**CL 52**

Re : Exposure Draft of Proposed amendments to IAS 39 Financial Instruments : Recognition and Measurement ; Fair value hedge accounting for a portfolio hedge of interest rate risk

Dear Sir David,

On behalf of the Conseil de la Comptabilité, I am writing to comment on the above Exposure Draft.

The Conseil de la Comptabilité welcomes the IAS Board's decision to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. I am pleased that a considerable progress has been made on a conceptual basis in recognising Asset - Liability Management practices as eligible to the definition of hedging for accounting purposes, even if hedging an overall net position that results from a global portfolio containing assets and liabilities is still not authorised.

Nevertheless, I regret that some of the rules defined still follow the « form over substance » principle, particularly regarding core deposits. I strongly disagree with the fact that demand deposits cannot qualify for hedge accounting of an overall net position. The Board can't ignore the economic and financial reality of credit institutions, i.e. statistical stability of core deposits over time, and must recognise the consequences of those in the proposed accounting rules. Besides, I consider that the eligibility of demand deposits to the portfolio hedge should not affect their recognised amount at their nominal value. I think that specific rules should therefore be introduced in IAS 39.

.../...

As the Exposure Draft introduces the possibility of hedge accounting for a portfolio hedge of interest rate risk, I think it is irrelevant to preclude designating internal contracts as hedging instruments, the use of internal contracts arising from the need to transfer interest rate positions from the banking book to the ALM Department. Consequently, I urge the Board to re-examine this fundamental question, recognising that no profits or losses should be incurred on these internal contracts.

Regarding ineffectiveness, I agree with your arguments for approach C which is the most appropriate way of designating the hedged item; I do not support approach D which spreads artificially partial hedging on each designated item.

You will find enclosed our detailed comments on the Exposure Draft.

If you have any questions regarding these comments, do not hesitate to contact me.

Yours sincerely,

**Antoine BRACCHI**

## Question 1 – Hedge designation and the resulting effect on measuring ineffectiveness

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 only 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 (the repricing date of an item is the date on which the item will be repaid or reprice to market rates). However, the Board concluded that ineffectiveness would arise 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-BC26 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 ?**

**(a) If not, in your view how should the hedged item be designated and why ?**

### *General comments on designation of the hedged position*

We agree with the Board's proposal not to require individual assets or individual liabilities to be designated as the hedged item. Nevertheless, we think that this designation based on a portion of either the assets or the liabilities is not consistent with Asset - Liability Management practices, the role of which is to hedge the overall net position that results from a global portfolio containing assets and liabilities.

As the objective of the Asset and Liability Management is to reduce the effects of changes in interest rates, interest rate risk derived from the net hedged position should be designated as the hedged item. The application of fair value hedge and cash flow hedge models as defined by the Standard are not able to capture and to reflect in accounting terms the characteristics of macro-hedging. Hedging an interest rate risk derived from a net assets/liabilities position in order to reduce the sensitivity of interest margins is different from hedging fair value changes of those assets or liabilities. Macro-hedging also doesn't aim at hedging the variability in cash flows attached to variable rate assets and liabilities. The proposed designation is not consistent with existing ALM systems and will entail additional systems costs, and thus, for no accounting benefits.

As observed in paragraph BC 11, some Board members favour the designation of a net position. We agree with these dissenting views and we consider that the hedging rules of IAS 39 are not appropriately defined for macro-hedging.

### *ALM risk management is based on a portfolio approach*

The general objective of Asset and Liability Management is to reduce the exposure to interest rate risk of a certain amount of the assets/liabilities over time. The ALM hedging strategy is to time schedule gross fixed rate assets and liabilities into time periods and, for each time period, to assess the interest rate risk exposure on the fixed rate gap. Prepayment risk is taken into account in the construction of the time maturity schedule. Moreover, in practice, the net gap of fixed rate assets or liabilities is never hedged in its entirety. The ALM manager monitors this gap over time, follows movements in the gap (due for example to prepayments) and controls that there are sufficient aggregated fixed-rate assets or liabilities to establish that the amount as being hedged will never be lower than the nominal of the hedging derivatives entered into to offset the interest rate risk, and to justify the hedging relationship.

In this way, ALM risk management is based on a portfolio approach and, as a consequence, the assets and liabilities that constitute the fixed rate gap are considered to be fungible.

### *The four approaches of designation and our arguments for approach C*

The four approaches of designation described in paragraph BC 19 represent two ways of designation :

- designation of a layer of assets (or liabilities) in approaches A, B and C ;
- designation of a percentage of assets (or liabilities) in approach D.

As already mentioned, the ALM manager incorporates the effect of prepayment risks in scheduling fixed rate assets and liabilities to determine the net position to be hedged. Only if the hedged item decreases, for example in the event of prepayment earlier than expected, ineffectiveness will arise. If the net position increases, due to prepayments that occur later than expected, there is no ineffectiveness.

**Consequently, we consider that approach C (and approach B only slightly different from approach C) is the appropriate way of designating the hedged item.**

**We do not support approach A, because it assumes that any prepayment would be related first to the unhedged portion even though assets and liabilities are naturally hedged.**

**We are strongly opposed to approach D (see question 1 b.), because it leads to account ineffectiveness in the case where the entity is underhedged.**

Approaches B and C are very similar. In approach B, the entity hedges an amount of assets equal to the entire net position. In approach C, the entity hedges a part of the net position. If we support approaches B and C, we consider that approach C corresponds more to the economic reality of hedging as, most of time, practices of banks is to hedge only part of the global position.

In approach C, when there are prepayments, the reductions are assumed to come first from the unhedged risk of the net position, and then from the hedged risk of the net position. We agree with the fact that prepayment does not lead to ineffectiveness if the amount prepaid does not exceed the unhedged risk associated with the hedged amount. In the case of assets prepaid later than expected so that entity revises upwards its estimate, it is normal that no ineffectiveness arises, because it is only a revision of a date that is later than previously expected.

We agree with the arguments in paragraphs BC 20 and BC 26, consistent with risk management strategy.

Other reasons for our support for approach C are the following :

- it recognises the possibility of partial hedging,
- it is consistent with the manner in which ALM Departments manage interest risk,
- it is consistent with the view that the entity is hedging interest rate risk rather than prepayment risk,
- it captures all ineffectiveness on the hedged portion.

### *Our arguments against approach A*

We do not support approach A for the following reasons.

This method is based on the premise that the derivative instruments are effective provided there is a sufficient pool of assets (or liabilities) to cover the hedging instruments. It assumes that any prepayment would be related first to the unhedged assets (or liabilities). We do not agree with this, because in our view, this approach represents the overall hedging strategy as effective when it is not.

Part of assets and liabilities are naturally hedged by each others. In case of prepayments, if the net position disappears, ineffectiveness arises and has to be accounted in profit and loss.

#### *Additional comments on interest risk and prepayment risk*

Regarding interest risk and prepayment risk, we do not agree with Board members who concludes in paragraph BC 21 e, it is not appropriate to separate those two components so closely interrelated.

- The ALM Departments don't hedge changes in the fair value of the prepayment component attached to the assets and liabilities scheduled by time periods ; they hedge the risk that interest margin decreases because of fluctuations in interest rates.
- The ALM departments hedge each risk component by different ways : interest rate risk is hedged by interest rate swaps, and prepayment risk by other derivatives, as options.
- Furthermore, changes in prepayments are not highly closely related to fluctuations in interest rates in all cases, because of the non rationale behaviours of clients. Some prepayments don't depend on interest rate level.
- Finally, the Standard allows to hedge only one risk component of a financial instrument : it is possible to hedge interest rate risk without hedging prepayment risk.

This is the reason why only the interest rate risk component must be taken into consideration to assess ineffectiveness.

We don't agree with the Board who noted in paragraph BC 23, for approach C, that it would need to introduce an arbitrary rule to prevent the « cushion » from becoming too large. We consider that the IAS 39 requirements on documentation to qualify for hedge accounting don't necessitate such rules. Furthermore, we don't understand the concept of cushion. The unhedged part of interest rate risk depends on management decisions, not accounting strategies. Banks use underhedging as an easy way to buy back prepayments options embedded in assets, while using plain vanilla instruments or dealing with uncertainty inherent to the « behaviouralisation » of core deposits.

#### *Additional comment on designation of the hedging instruments and netting of derivatives*

Paragraph 126 F permits, under certain conditions, that two or several derivatives may be jointly designated as the hedging instruments, including where the risks arising from some derivatives offset those arising from others. Therefore, when a derivative, and in particular a swap, is designated as a hedging instrument across a number of time periods, we understand it will be possible to analyse it into a series of different 'swaplets' in order to be able to measure effectiveness for each time period, provided that each 'swaplet' corresponds to a market equivalent swap. Otherwise entities would be obliged in practice to negotiate N successive swaps (of which N-1 with forward start dates) instead of one complete swap covering all periods from 1 to N.

Consequently, when for a given maturity time period the hedge relationship is not effective, the derivative is not disqualified for all the maturity time periods it hedges, but solely for that time period.

- (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 and loss ?**

*Our arguments against approach D*

We do not support approach D which doesn't recognise the possibility of partial hedging.

In this approach, ineffectiveness is recognised both in the case where the entity is over-hedged and when it is under-hedged. We think that symmetry is not a principle ; over-hedging and under-hedging don't have the same economical consequences, and therefore cannot be recognised in profit or loss in the same way.

Approach D leads to inappropriate amounts of ineffectiveness through the use of the percentage calculation. For instance, in the case of fully hedged net risk position, prepayment that occurs earlier than anticipated would result under approach D in ineffectiveness, but in a lower amount than the one that should have been calculated on approach C.

When estimated prepayments decrease, resulting in more assets in a particular maturity time period, approach D also leads to ineffectiveness. But in this case, the hedge remains effective : it becomes only partial.

Finally, we fully support arguments against approach D described in paragraph BC 25.

*Sources of ineffectiveness should be limited to the cases where the nominal amount of the hedging derivatives are higher than the amount of the hedged position.*

We consider that as long as the amount of the hedged item is higher than the amount of the hedging instrument, there is no ineffectiveness. On the contrary, ineffectiveness will arise when :

- repricing dates are different from those expected (i.e. changes in the effects of prepayments for example). If prepayment rates decrease (i.e. expected maturities increase), no ineffectiveness will arise as long as the hedgeable amount for a given maturity time period continues to be higher than the nominal amount of the derivative hedging instruments. If, on the other hand, prepayment rates increase, ineffectiveness will arise to the extent that the hedgeable amount falls below the nominal amount of the derivatives.
- hedged assets are derecognised or impaired. In this case, ineffectiveness will only arise to the extent that the hedged amount falls below the nominal amount of the hedging derivatives.

We consider that other causes of ineffectiveness as mentioned in paragraph A 35 should be negligible.

Finally, we agree with the alternative view of the five Board members (§ AV2) who think that ineffectiveness must be recognised only when the net position in the portfolio is overhedged.

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

We consider that the fair value adjustments would be removed from the balance sheet when the hedged amount falls below the nominal amount of the hedging derivatives in case of ineffectiveness.

As stated in paragraph 154, this item shall also be removed from the balance sheet when the assets and liabilities to which it relates are derecognised.

For as long as the amount of the hedged item is higher than the amount of the hedging derivatives, there is no reason to derecognise these adjustments which remain in the

balance sheet. The only fair value changes are recorded in profit and loss between one period and the next.

When a separate item arises in relation to a hedge of assets, and this is matched by the fair value of the hedging derivatives, the fair value of the derivatives will decline to zero over this period and the fair value of the loans will also converge to their principal amount over this period.

#### **Question 2 – The treatment of core deposits**

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 (ie 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 BC11-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?**

*No viable solution for demand deposits has been found yet*

The basic business of credit institutions is to transform stable resources into assets with maturities. To be consistent with this economics, the Board has to recognise that liabilities payable on demand have to be integrated in the resource schedule at periods resulting from the statistical analysis of the stability outstanding. Demand deposits create a real rate exposure for banks even if they bear no interest. Thus, the objective of the Asset and Liability Management is to monitor and reduce the effects of changes in interest rates on the net interest margin of credit institutions. That is why banks include demand deposits in the portfolio hedge by scheduling them to the date when they expect the total amount to be due because of net expected withdrawals. This scheduling authorises banks to determine the net position to be hedged by maturity time period.

A viable solution able to accurately reflects the economics of demand deposits would involve both accounting for demand deposits at their nominal value at origination, and include them in the hedge portfolio. This has not yet agreed upon until now.

*We do not believe that the Board, in modifying fair value hedging rules, has met the objective to define accounting rules that totally reflects the economic and financial reality of interest rate risk management.*

The Board decided to explore whether and how IAS 39 could be amended to enable fair value hedge accounting to be used more readily for portfolio hedges, to permit an accounting treatment more in line with the economics of banking and therefore to reduce volatility due to the fact that all derivatives are accounted for at their fair value. However, the fact that core deposits can't be included in a net position to be hedged will result in increased volatility, because even though core deposits are hedged by Assets-Liabilities Management, this hedging relationship can't be recognised in the books.

As mentioned in paragraph BC 17, the Board recognised that the proposed method of designation in this Exposure-Draft would not fully resolve the core deposits issue. But there should be no situation left alone, where the accounting rules proposed by the Standard are not compatible with risk management rules. Indeed, a problem does arise where the demand deposits in a particular maturity period exceed assets, because, regarding the IAS 39 rules, it is not possible to designate an amount of those demand deposits that is subject to a fair value hedge.

*Core deposits are an important source of interest rate risk on a portfolio basis. Immediate settlement approach is based on a wrong assumption.*

Demand deposits may be contractually withdrawn at any time by customers. This possibility results in fluctuations in accounts outstanding happening at regular periods (over the same month when salaries are paid, etc.), generating a combination of various seasonal factors. The amplitude of fluctuations in demand deposits can be gauged using historical data and economic analyses. Statistical data show a very stable volume of deposits over the long term. Indeed behavioural patterns for deposit-making and taking activity can be observed and experience to date demonstrates that a part of the overall average balance is stable over several months and decreases gradually over several years as some deposit-makers close their account. Furthermore, on a portfolio basis, amounts spent on one account may be received on one other.

This is one of the analyses carried out by the ALM function required by banking regulators. Using financial risk theory, it is possible to model withdrawal patterns for existing deposits and to assign probabilities to various possible outcomes for these existing balances. It is due to the fact that, as the number of demand deposit accounts is large, one can demonstrate that the existing deposit balances will remain above a certain threshold for specific future maturities with a high level of confidence. This is the application of the Law of large numbers and of the central limit Theorem : the uncertainty associated with one account balance decreases as the number of accounts increases and the effective mean of deposit balances converges to the theoretical expected mean.

Economic analysis is therefore far removed from contractual provisions. Asset and Liability Management relies on the stability of demand deposits and places them on the resource schedule at maturity time periods resulting from the analysis above mentioned.

We are concerned that the Board's arguments do not take into consideration any form of this portfolio approach. The risk inherent in the portfolio is not the sum of the risks on all individual items.

Any efficient risk management strategy must encompass all interest rate risk exposure arising from the full scope of the banking book components. To include positions derived from assets and liabilities with maturities and those of demand deposits is a key component of the gap measurement process. That is the reason why **we believe that a portfolio of demand deposits could qualify for hedge accounting for the interest rate risk component derived from this portfolio.**

We also would like to mention that when a transaction arises between two licensed deposits takers, the price of the transaction includes other elements than the benefit that will arise from the acquisition of low cost funding (core deposits intangibles). However, the existence of these other elements does not preclude an evaluation of the value of the interest rate position induced by the deposits.



*Moreover, we do not agree with the comparison made in paragraph BC 14 between core deposits and a portfolio of trade receivables.*

To us, the main difference is that, in the case of trade receivables, the existence of the portfolio depends on future events (i.e. sales). We do not consider it is the case with demand deposits. Once a new account has been opened, it automatically generates future flows of cash, in and out (in the case of retail banking, wages being paid on the accounts on a monthly basis, money being spent on that monthly basis). These flows are certain as long as the account stays in the bank. We are therefore of the opinion that, on an accounting point of view, demand deposits are not related to future events (the actual cash flows coming in and out), but to past events (the opening of the bank account).

*Including demand deposits in a fair value hedge relationship is in line with rules of banking regulators*

This approach would be in line with generally accepted business policies and interest rate risk management approved by banking supervisors and the Basel Committee. Pillar 2 of the Basel agreement calls for a limitation of interest rate risk assumed by a bank. Under this text, the interest risk measurement process must encompass all sources of risks, including demand deposits.

Prohibiting the inclusion of hedged demand deposits in a hedge portfolio would lead to artificial volatility in the income statement as the hedging derivatives would be accounted for at their fair value, and the changes in fair value accounted for in profit and loss.

Furthermore, if core deposits are excluded from derivatives hedging, we believe that this could have the adverse effect of leading certain institutions to use for their hedging needs cash instruments that do not have such accounting limitations, but bear additional liquidity and credit risks.

*As mentioned in paragraph BC 13, to include core deposits in a portfolio hedge based on expected repayment dates is consistent with the treatment of prepayable assets, i.e. based on expected rather than contractual maturities.*

As with assets, expected maturities for liabilities is based on the historical behaviour of customers. There is no conceptual reason to exclude this for portfolios of liabilities, even those with a demand feature.

*Considering the arguments above, the CNC wishes to propose the following accounting treatment for demand deposits, when they are part of a macro hedge of interest rate risk by credit institutions*

If demand deposits are included in a portfolio hedge relationship, they are assumed to bear the swap rate on the inception date, as for all assets and liabilities that are part of the process. As such, no profit or loss is recognised on inception of the hedge. Only the changes in fair value of the interest rate component are accounted for in profit or loss. When demand deposits are not hedged, they are accounted at their amortised cost like other assets and liabilities of the banking book.

Because the hedging derivative instruments are accounted at their fair value, in order to come up with an accounting treatment both compatible with IAS 39 and the financial reality of the operations, **we propose that the changes of fair value of the hedged instrument which corresponds to the fair value of interest rate risk position created by the demand deposits should be accounted for in the balance sheet as a valuation adjustment in order to balance the revaluation of the hedging instrument.**

We understand that, in such a system, it is of the highest importance to be able to judge the reality of the hedging, and moreover, the reality of the hedged position.

To insure the reality of the hedging, we recommend that :

- the hedged instrument should be designated as such at inception,
- no reclassification of derivatives as macro-hedging instruments should be allowed,
- the same rules regarding ineffectiveness of the derivatives should be implemented in case of hedging of net liabilities, as in case of hedging of net assets.

**(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?**

Yes, we agree with the fact that core deposits have to be accounted for at their nominal value. But it doesn't mean that core deposits have to be excluded from the hedge portfolio. Even if they are accounted at their nominal value, we consider that they have to be scheduled over several maturity time periods to determine the net position to be hedged as previously described. Credit institutions hedge the interest rate risk inherent to the portfolio of demand deposits, not their entire fair value changes.

The fact that a core deposit is recorded at its nominal amount without any premium does not lead to the conclusion that the fair value of core deposits portfolio is the sum of its individual balance nominal.

**(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?**

No, we consider that including core deposits in a hedged portfolio doesn't give rise to a gain on initial recognition, because hedged core deposits bear the derivative interest rate at initial recognition. Furthermore, at inception, the nominal value is equal to the cash given by the depositor. These amounts are recorded at proceed and no gain or loss have to be accounted.

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

In case of a net hedged position derived from demand deposits, the changes of fair value of the hedging derivatives offset the changes of interest rate risk position created by the demand deposits portfolio. We propose, that as an exception, a valuation adjustment on demand deposits would be recognised. As a result, both would be balanced off against each other in the income statement.

*Additional comment : cash flow hedging is inapplicable in the context of demand deposits*

We consider that the cash flow hedge approach as a means to manage the core deposit issue is not appropriate for the following reasons :

- If some credit institutions are always liabilities sensitive due to their large core deposits base, most of them are, for numerous maturities, asset sensitive or liability sensitive depending on their production. Operationally, certain derivatives that were previously designated in a fair value hedge relationship for time bands where

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fixed rate assets were in excess over fixed rate liabilities would have to be re-designated in a cash flow hedge relationship for those time bands where demand deposits are effectively in excess of our fixed rate assets. This seems very burdensome as the changes in fair value of these swaps would first be recognised in profit or loss and then after re-designation of the hedge relationship, in equity. In this case, we believe this would lead to translate differently into the financial statements the same economic transaction (hedging of interest rate on a portfolio basis) depending on the time band.

- Cash flow hedges applied to existing fixed rate items generate false volatility in equity : a perfect hedge is recorded only for the derivatives market value changes in equity. The symmetric changes in hedged items' fair value is not accounted for anywhere. This accounting treatment is meaningful for forecasts transactions, but not for existing ones. Therefore, if cash flow hedge accounting is applied to core deposits, gains or losses reported in equity has to be qualified in management discussion and analysis. This leads to confusion.
- Replacement is managed on a daily basis by the Treasury function in the short term and tracking would be problematic.

Finally, because the interest rate risk position is based on fixed rate gaps, the adoption of a cash flow hedge approach for certain time periods would result in a divorce between economics and accounting. Indeed, documentation of a cash flow hedge relationship would require to transform the fixed rate interest rate gap build for management purposes into a variable rate gap to obtain hedge accounting. This methodology would require to artificially manipulate the way the risks are hedged for accounting purposes and would incur additional operational risks.