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The Deputy Director General

Friday, November 14th 2003

**FBF response to ED6 "AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF INTEREST RATE RISK".**

Dear Sir David,

**The French Banking Federation is pleased to have the opportunity to comment on Exposure Draft 6 "AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF INTEREST RATE RISK".**

We are satisfied to note that some improvements had been made with respect to 'macro-hedging', such as the removal of the requirement to designate individual assets or liabilities as the hedged item.

Nevertheless, we believe that the Board has not gone far enough in its conceptual examination to determine the objectives of Asset and Liability Management as related to hedging, which are not directed at protecting the fair value of assets or liabilities, but instead consist in monitoring and reducing the impact of changes in interest rates on net interest income.

In particular, we consider it very regrettable that the Board's proposals still do not take on board European generally accepted best banking practices, which furthermore are recommended by the Basle Committee.

These proposals therefore do not properly reflect the economic reality of European banking institutions, which in some areas can differ substantively from that of their North American counterparts.

With regard to the consultation itself, we have three major concerns:

- Basing the designation of the hedged item on a portion of a portfolio of either financial assets or financial liabilities does not correspond to the current ALM practices of European banks.

**Sir David Tweedie, Chairman**  
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Banks actually hedge their net positions (including the prepayment risk effect) using a portfolio approach, which means that they do not need to hedge their entire net exposure.

- Demand deposits do not qualify for hedge accounting. We reiterate our proposal in this respect: a portfolio of demand deposits could qualify for hedge accounting for the interest rate risk component derived from this portfolio. This proposal is in line with the best practices for interest rate risk management promoted by banking supervisors around the world.
- Designation of the hedged item and measurement of ineffectiveness. We support approach C which is: closer to the economic reality in designating the hedged item, consistent with ALM practices, appropriate for capturing ineffectiveness on the hedged items. Our position appears to be in line with the alternative view of the five dissenting Board members set out in AV2, which is that the approach for assessing effectiveness should only lead to the recognition of ineffectiveness when the net position in the portfolio has become over-hedged.

Other issues raised by IAS 32/39 but not covered again.

The FBF urges the IAS Board to make some improvements to address these major areas of concern: debt/equity definition issues (shares of co-operative banks), internal contracts, impairment, effective interest rate calculations, derecognition, disclosures, financial guarantees, loan commitments, fair value option, amongst others issues.

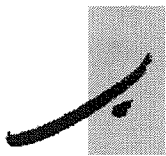
We believe that the IASB should publish an exposure draft of the new complete IAS 32 and IAS 39, including the proposed changes and leaving a short period for response, at the start of 2004.

You will find our detailed responses to the questions raised by the exposure draft in the attached appendix.

Yours sincerely,



Pierre de Lauzun



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## Appendix

### 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?**

We do not agree with the proposed designation and the resulting effect on measuring ineffectiveness.

a) Designation of the hedged item

#### *General considerations*

Although we consider it is an improvement to be able to designate the hedged item in terms of an amount of asset or liabilities, we are still concerned by the fact that objectives of the Asset and Liability Management are not well reflected by the Board's proposal to base designation on a portion of a portfolio of either gross financial assets or gross financial liabilities.

We wish to remind the Board that objectives of ALM policies are not directed at protecting fair value of assets or liabilities, but consist in monitoring and reducing the effect of changes in interest rates on net interest income and therefore on bank's earnings.

These objectives rely on the following principles:

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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.

- Firstly, as interest rate risk in a banking book arises only from repricing mismatches of assets, liabilities and off balances sheet positions, banks hedge net positions (including or not<sup>2</sup> the effect prepayment risk), not assets or liabilities or a portion thereof. The designation process in a fair value hedging approach must accommodate with this reality.
- Secondly, in practice, ALM Departments do not always hedge the net exposure (which is the net of fixed rate assets and liabilities) in its entirety. They only aim to make sure that, over time, there are still sufficient fixed-rate assets or liabilities underlying the amount hedged to follow changes in the fixed rate gap (for example in case of a prepayment). In order to do that, ALM risk management has to be based on a portfolio approach and therefore the assets and liabilities which compose the fixed rate gap are considered to be fungible or substitutable assets/liabilities.

*Our position on the four approaches of designation : we favour approach C*

The first three approaches (A, B and C) aim at designating a layer of assets or liabilities. The fourth (D) relies on designation of a percentage of assets or liabilities.

We do not agree with approach A, because its treatment of prepayment is set upon a wrong hypothesis (prepayments would be related first to the unhedged portion).

As we already explained it, the effect of prepayment risks is frequently incorporated in the hedging policy in the construction of the time maturity schedule.

We therefore support approach C (and in a second position comes approach B, which is not very different from approach C : approach C is more flexible insofar as it allows the entity to hedge a portion of the net position, whereas approach B implies the hedging of the entire net position), which seems to be closer to economic reality in designating the hedged item and is consistent with ALM practices.

Moreover, it seems to us that approach C is appropriate for capturing ineffectiveness on the hedged items.

#### *The case of prepayment risk*

In approach C, which we support, prepayments are anticipated and managed by under-hedging the net position, which in turn incorporates a non hedged portion. As long as the prepayments' amounts are not greater than this portion, there is no ineffectiveness, because ineffectiveness can not flow from items which are not included in the hedging relationship.

#### **b) Identification and recognition of ineffectiveness in profit or loss**

We think that ineffectiveness should only be recorded when the hedging relationship is no more effective, that is to say when the hedging instruments are in excess of the hedged item.

Hence, we do not support approach D, because it leads to a symmetrical recognition for over- and under-hedging, although they do not imply the same economic consequences : over-hedging is a failure of the hedging objective, whereas under-hedging may be part of the hedging strategy. In other words, under approach D, bank strategy for dealing with uncertainty on some portfolio items is not recognized.

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<sup>2</sup> Some banks hedge the prepayment risk by underhedging systematically their loans portfolio, others manage separately this risk by buying swaptions

We note that the Exposure Draft requires the separate calculation of the fair value of the hedged item and of the hedging instruments (See Appendix A33 of the Exposure Draft : "It is not appropriate to assume that changes in the fair value of the hedging instrument equal changes in the value of the hedged item.").

We disagree with this requirement because as long as the swap's amount is strictly equivalent to the amount of the hedged position (i.e. without sources of ineffectiveness) the fair value changes in the hedged item are, by design, equal to the fair value changes in the hedging instrument.

#### c) Impact on the balance sheet

Under the approach we would recommend, the fair value adjustments are not linked to specific assets or liabilities but to a specific hedged amount.

Therefore, fair value adjustments due to ineffectiveness would be automatically removed from the balance sheet as soon as the hedged amount falls below the amount of the hedging instrument.

Consequently, only fair value adjustments due to changes in interest rates between one period and the next. would be recorded in profit or loss.

#### 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 counter-party 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 counter-party 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 counter-party can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counter-party 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 would first like to mention that the issue of demand deposits raised only because the Board decided to explore the feasibility of a fair value approach for recording the so called macro hedging strategies, used essentially by financial institutions to manage their banking book's interest rate risk.

The banks reluctantly accepted to examine the compatibility of the basic IAS 39 requirements for fair value hedge accounting with policies that are admitted as sound management practices on a world-wide basis by supervisors and central bankers.

Though, obviously, the proposed treatment does not reflect appropriately these risk management practices (neither fair value hedging nor cash flow hedging is applicable to demand deposits), it seems that a practical compromise can be achieved on this basis as, when interest rates change, the calculated value of assets, liabilities and off balance items changes accordingly as in some cases the cash flows associated with these items. To some extent, the two approaches, by the interest margin or by the fair values can be viewed as two points of view of the same economic reality.

But, in order to get the same result whichever way to go about it is favoured, the premises must be the same:

- The designation process in a fair value hedging approach must allow the designation of the hedged item in terms of net position, in order to be consistent with ALM best practices.
- Any efficient risk management strategy must encompass all interest rate risk exposure arising from the full scope of the banking book components. The integrity of data on current on and off balance sheet positions is a key component of the gap measurement process. It includes positions stemming from items with stated maturities, but also positions where behavioural maturities differ from contractual maturities. Excluding some sources of interest rate risk leads to recognise as an efficient hedge some policies that conversely increase this risk.

Relying on these principles, our main concern is the following :

**We consider that core deposits are an important source of interest rate risk on a portfolio basis. We therefore believe that immediate settlement approach, which does not acknowledge this reality, is based on a wrong assumption about depositors' behaviour.**

Though any amount on an individual basis can be withdrawn at short notice, statistical data show a very stable volume of deposits over the long run. These fixed rate liabilities (which bear a zero rate or a proxy zero rate) generate an exposure to rate changes exactly as a zero coupon bond does.

This assertion relies on the fact that :

- The portfolio risk is not the sum of all individuals risks. The immediate settlement value approach neglects this fact; it assumes that, as any customer can withdraw its balance with no notice or at short notice, all customers will withdraw also their deposits within a few days. This implicit behavioural assumption that underlines this conclusion is denied by the analysis of statistical data relative to deposit amounts. This is a fatal flaw in the reasoning. No bank in the world has sustained a massive deposits withdraw within a few days except when rumours of failure are going around. Conversely, the actual behaviour of the depositors can be observed and measured.
- Financial theory makes it possible to model the deposits withdrawals and to assign probabilities to various possible outcomes of the existing balances. The expected balance of one deposit account for any period (the most likely outcome for the existing bank liability over this period) can be characterised by its mean and its dispersion expressed by its standard deviation, calculated from past observations.  
Considering only one account, a prudent asset liability manager will probably decide not to hedge the resulting interest rate risk exposure as a total withdraw of the amount on the account within five days is a possible outcome with a non inconsiderable assigned probability.

Nevertheless, the effective risk for the bank is not on one account, but on the deposits portfolio. Therefore, to determine how to manage risk, it is necessary to explore the risk provided by combinations of risky liabilities.

As the number of depositors' accounts is large, one can demonstrate that the existing liabilities balances will remain over a certain threshold for specific futures maturities with a probability over 97.5%. 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 account increases and the effective deposits' balances mean converges to the theoretical expected mean. So far, part of the global average balance is stable over several months and decreases gradually over several years as some depositors close their account. Core deposits are slotted into the time-bands structure according to their assumed maturities

- When a bank hedges these positions, it does not hedge a future transaction (which cannot be elected to fair value hedges).  
The object of the macro hedge is the existing balances that decline over time due to the deposit accounts attrition. These balances meet the definition of a financial instrument. Future accounts are not included, nor any potential increase of these balances. Their stability over some future period is proved by statistical data. There is no conceptual basis for considering future outflows on these accounts while neglecting future inflows on the same accounts. Considering the stability of exiting balances with their attrition characteristics due to the depositor run off over time is equivalent to consider net cash outflows and inflows over their expected maturities, but without reflecting expected growth in account balances or in customers base. Existing balances are not future transactions. Futures inflows and outflows in existing balances are future events affecting current liabilities, exactly as prepayment is a possible outcome on current assets. There is no logic for considering one and rejecting the others.
- Banks hedge the interest rate risk generated by core deposits accounts, not the intangibles that are associated with them.  
In the full fair value of a demand deposit portfolio, there are aspects beyond the liabilities that add value to the contracts. These aspects are related to future cash flows expected from customers' relationships and cross selling strategies. But, as no contractual right entitle the bank to receive effectively those cash flows, these increments are not financial in nature and are not part of the macro hedge relationship.

*Additional comment : A core deposits portfolio is different from a trade payable portfolio:*

We disagree that a portfolio a core deposits is similar to a portfolio of trade payable. Each trade payable has its own characteristics (rate, maturity), therefore trade payable are not fungible. Moreover, new balances, even highly probable, are not existing ones.

So, we do not view the problem of hedging the interest rate risk stemmed by core deposits linked to the fact that the fair value of a standalone deposit can or cannot be different from par.

**a) Do you agree with the Board that the fair value of a financial liability that the counter-party can redeem on demand is not less than the amount payable on demand?**

We agree that a bank can extinguish its obligation towards the depositor by giving back to him a sum equal to the existing balance of its account. But, this not a transaction of the account; It is an event on the account, its closing. Any withdraw corresponds also to an event on the account, it is not representative of the consideration given by reference to a transaction price. As Deposit taking is a monopoly of specific institutions, transactions on deposits, like branch purchases, deposits transfers or deposits assumptions from failed banks can be observed only between two or more financial institutions.

Therefore, the fact that a deposit amount is recorded in a bank book for its nominal amount, without any premium, does not lead to the conclusion that the fair value of core deposits portfolio is also inevitably the sum of its individual balances' nominal values.

**b) Would your view result in such 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?**

The deposit taken by the banks are accounted for their nominal value, equal to the sum of money given by the depositor. These amounts are recorded at proceed and no gain or loss is recognised as a consequence of this event.

If these deposits are behaviouralised in order to be included in a macro hedge relationship, as all assets and liabilities that are part of the process, they are assumed to bear the swap rate on the inception date. No result is recognised at the inception of the hedge. Only the changes in fair value during the period are accounted for in P&L. In a perfect hedge with a plain vanilla swap, these fair values changes of the cash positions are perfectly offset by derivatives' value changes.

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

As we stated above, the risk of a portfolio is not the sum of the risks of its individual components. It is a specific risk, which has to be monitored and limited. 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.

Only the subsequent changes in fair value of the interest rate hedged component would be recognised in profit or loss. As for other fixed rate assets and liabilities that contribute to the interest rate risk hedging process, we would characterise the changes in value of the hedged item as changes in fair value of the interest rate component.

*Cash flow hedging cannot be applicable to demand deposits*

The qualification of deposits macro hedges as cash flow hedges is not an operational solution, even if the resulting equity volatility is neglected. As assets and liabilities change at each period's end, the same swap, qualified as cash flow hedge because it hedges a net deposits' liability mismatch during one period, has to be transferred as fair value hedge for



the next period, because it is part of a derivatives' position that offsets now a net assets position. Though, in theory, this problem can be solved with a complex accounting treatment, in the real world, no solution cannot be workable with thousands of derivatives and millions of cash positions in a banking book

If core deposits are not eligible for hedging on a portfolio basis, the problem of macro hedging remains unsolved for most European institutions.