

14 November 2003

FINANCES DEVELOPPEMENT GROUPE

3, Rue d'Antin
75002 PARISSir David Tweedie
International Accounting Standards
Board
30 Cannon Street
London EC4M 6XH
United Kingdom

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,

We are pleased to provide our comments on the above exposure draft which reflect joint deliberation between ourselves and Société Générale.

We believe that the publication of the Exposure Draft represents a conceptual step forward to the extent that :

- The Board has proposed an alternative to « micro hedging » (according to which hedging relationships must be documented by reference to individual assets or liabilities) by developing an overall approach, by reference to a portfolio of interest rate risk-bearing assets or liabilities;
- The Board accepts that the/any methodology proposed should be in accordance with entity's risk management procedures and objectives;
- Accordingly, the Exposure Draft has been drafted with the aim of limiting the impact on operations, systems or organisational structure of credit institutions without contravening the 'fundamental' principles of IAS 39¹. In this respect, the recognition of fixed rate

¹ (1) Derivatives are measured at fair value, (2) any material ineffectiveness must be recorded in income and (3) only assets and liabilities can be recorded in the balance sheet.

interest gaps, the analysis of fixed rate assets and liabilities into maturity time periods based on their expected maturity (rather than contractual maturity)... are major sources of progress;

- The designation of two or several offsetting derivatives in combination at the hedging instrument is permitted.

Nevertheless, this step forward has not achieved the Board's expressed objectives of providing a solution that will work in practice, most notably because demand deposits are excluded from the approach.

Firstly, we would like to recall that macro hedging of interest rate risk aims to hedge a risk on the interest rate margin inherent in assets and liabilities as structured on entities' balance sheets. Macro hedging as it is currently widely performed is closely monitored and approved by our regulators and strongly recommended by the Basle Committee. In this regard, macro hedging does not aim to hedge fair value changes in assets or liabilities in the balance sheet. Nor does it aim from a practical application perspective to hedge the variability in cash flows attached to variable rate assets/liabilities.

The pure application of the fair value hedge and cash flow hedge models as defined by the Standard are not able to capture and reflect in accounting terms the characteristics of macro hedging.

As a consequence the European Banking Federation (EBF) proposed an approach "Principle for hedge accounting with derivatives – on 4 April 2003", according to which the macro hedging derivatives are accounted for at amortised cost, such that the accounting principle applied to the hedging instrument would be the same as that applied to the hedged items belonging to the Banking Book.

We do not believe that the Board, in turning down this conceptually sound approach and modifying instead the pure fair value hedging model for the purposes of hedging interest rate risk on a portfolio basis in a fixed rate environment, has met its own expressed objectives, for the following reasons :

- One of the objectives of the publication of this Exposure Draft as asserted by the Board is to reduce volatility linked to the fact that all derivatives are accounted for at fair value with fair value changes recorded in profit or loss (see paragraph BC2) or in equity (as in the solution proposed in IGC 121-2).

However the exclusion of demand deposits from the items that qualify for inclusion in the hedged position will result in artificial volatility as the macro-hedging derivatives must be treated as held for trading. Indeed the consequence for banks with large amounts of demand deposits is that they will have no means to hedge this substantial portion of their balance sheet under IAS 39 as neither cash flow hedges nor fair value hedges are applicable in this case or provide an adequate answer (see our more detailed answer to question 2).

- The Board in fact recognises that the proposed solution can only be used by banks having a net asset position (« Asset sensitive » - see paragraph BC 17) in each of the relevant maturity time periods. In effect, entities that have an excess of demand deposits over fixed

rate assets in some time buckets (defined as “maturity time periods” in the Exposure Draft) will not be able to use the solution as proposed in the Exposure Draft.

As a result, neither IAS 39 in its current form, nor the Exposure Draft provide a practicable solution for entities that have a net liability position (i.e. said to be « liability sensitive »). Again this renders the proposed approach useless for net liability sensitive banks.

- It is also indicated in the Exposure Draft that the Board wanted the application of its proposed solution to aim in as much as it could to limit the impact on operations, and/or management systems, of the use of fair value hedge accounting (see paragraph BC5 b + c).

The Exposure Draft notably allows entities to refer to the data captured for risk management for the purposes of documenting the hedging relationship and introduces a little more flexibility in the use of fair value hedge accounting, notably in permitting entities to designate hedged assets/liabilities as an amount of assets or liabilities (see paragraph 128A) or to make one overall adjustment on the face of the balance sheet for assets/liabilities hedged for changes in fair value.

However, in spite of these points, the proposed methodology for the calculation of ineffectiveness undeniably contradicts this objective and requires in practice identification of the hedged assets/liabilities on an individual basis within the hedged portfolio, which undermines the concept of portfolio hedge accounting. See our response to question 1.

- The objective of constructing an accounting approach which is consistent with risk management practice has not been met.

Firstly, the Exposure Draft will require assets and liabilities to be ‘fair valued’ whereas our current risk management practices do not use these ‘fair value’ metrics, which are meaningless.

Secondly, it requires the hedging relationship to be designated by reference to a gross proportion of assets/liabilities whilst the “Asset and Liability Management” function operates on a net position basis.

Thus, we believe that the objectives of the ALM function have not been understood since they have been interpreted as seeking to hedge a percentage of a gross exposure. A consequence of this is a definition of effectiveness which does not reflect the intended objectives in reality and therefore creates artificial sources of ineffectiveness.

In our opinion, the objective of hedging a fixed amount, that represents a subset of the net position, should be acknowledged as well as the fact that ineffectiveness only arises if the net position is over-hedged.

Furthermore the Board restricts the use of the approach developed in the Exposure Draft to the hedging of interest rate risk only (see paragraph BC 4).

We encourage the IASB to consider that a similar approach to that presented in the Exposure Draft should equally be studied in the context of other types of risk (credit, inflation, etc. ...)

Appendix 1 sets out our answers to the questions raised in the draft Standard.

If you have any queries regarding our comments, please do not hesitate to contact me at 33 (01) 40 14 29 28.

I remind you that we insist you should reexpose for comments the whole IAS 32-39 new version, as several points remain very controversial (see list in appendix 4).

Sincerely,

**Philippe Bordenave
Chief Financial Officer**

cc : Conseil National de la Comptabilité

Appendix 1

Question 1.

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 on 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 for the following reasons.

1. Designation of the hedged item

We would like to recall the fact that the objective of ALM management is to minimise the effect of future interest rate changes on the interest margin and not to hedge changes in fair value of net assets and liabilities. To reduce the uncertainty of the effects of interest rate changes on the interest margin the decision is taken to hedge a specified amount per time bucket. This decision does not take into consideration all risk exposures inherent in the assets and liabilities. The decision to hedge or not to hedge includes the effects of prepayment on the interest rate margin but does not refer specifically to this risk as explained below.

The ALM hedging strategy is to time schedule gross assets and liabilities into time buckets and for each time bucket to assess the interest rate risk exposure, in that time bucket, to the effects of future interest rate changes. Prepayment risk is already taken into account in the construction of the time maturity schedule as assets and liabilities are allocated into time buckets according to their expected maturity. Moreover, in practice, the net exposure (the net of fixed rate assets and liabilities) is not always hedged in its entirety. What the ALM function monitors over time, is that, following changes in the fixed rate gap (for example as a result of prepayment risk) there are still sufficient fixed-rate assets or liabilities underlying the amount hedged. In this way, risk management is based on a portfolio approach and, as a consequence, the assets and liabilities which make up the fixed rate gap are considered to be fungible or substitutable assets/liabilities.

In short, the objective is not to hedge a proportion of all the risks inherent in the fixed rate gap, but to reduce the exposure to interest rate risk of a certain amount of the assets/liabilities within that gap over time.

Consequently, our approach, consistent with risk management, would be to show that there exists sufficient aggregated fixed rate assets/liabilities to establish that the amount designated as being hedged will always be greater than the amount of the hedging swaps entered into to offset the designated hedged interest rate risk, which we believe is consistent with the portfolio approach recognised in IGC 121-2 where hedged cash flows are considered to be fungible or substitutable.

Firstly, we believe that this approach is not different from that of a cash flow hedge where, for example, an entity decides to hedge the first 50 cash flows of its forecasted USD sales (estimated highly probable budgeted sales are 100) with forward contracts (with the same maturity as the budgeted sales). In this example, no ineffectiveness will be recorded in profit or loss should budgeted sales prove to be in excess of 100.

We believe a similar reasoning could be applied to the fair value approach developed by the Board, since the objective is to hedge a subset of the net position. And as such, we believe that there is no ineffectiveness to be recorded in profit or loss when, for a given maturity, the total amount of fixed rate assets or liabilities included within the fixed rate gap increases above the amount that was designated as being hedged (i.e. an amount of the net position).

Secondly, this approach also seems excessively restrictive to us, because it actually conflicts with other paragraphs and interpretations of IAS 39. We understand from other paragraphs within the Standard that an entity is not obliged only to hedge a 'proportion' of an asset or liability. Paragraph 128 of the Standard indicates in fact that **a portion of cash flows or fair value** of a financial asset or liability can be the hedged item.

Thus, we understand that it is always possible to hedge a portion of a cash flow or a portion of fair value, and therefore it is always possible to hedge a proportion of an asset or a liability, or indeed a part of its cash flows or to carry out a fair value hedge for a shorter period than the contractual period of the instrument.

IGC 128-2 provides an example that it is permissible to hedge an instrument for a shorter period than its contractual maturity. In this example to hedge itself against fair value exposure on a 10 per cent fixed rate government bond (with a remaining maturity of ten years), a company designates a five-year pay-fixed receive-floating swap as the hedging instrument of the fair value exposure of the interest rate payments until year five and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap. We believe this is the type of hedging strategy an entity would adopt if the instrument is prepayable and historical data demonstrates that it will prepay in 5 years' time.

In this example, if the instrument was prepaid in year six, this would not result in the recognition of any hedge ineffectiveness since the decision was taken to hedge the first five years of the ten years remaining to maturity. However if the instrument were to prepay in year four, this would obviously result in ineffectiveness, since the hedging swap can no longer be designated as a hedge of the bond in year five. We maintain that the approach in this IGC is no different to the analysis into time buckets of fixed rate assets and liabilities

on the basis of their expected lives. The ALM function incorporates the effect of prepayment risk into the construction of the fixed rate asset and liability schedule to determine the amount of the net position to hedge. Only if the hedged item decreases in relation to the hedging instrument, for example in the event of prepayment earlier than expected, will ineffectiveness arise. If the net asset/liability exposure increases, for example, prepayment occurs later than expected, this will not give rise to ineffectiveness.

In short, the consequences of IGC 128-2, applied to prepayable assets/liabilities is that the prepayment option is not a source of ineffectiveness to the extent that it does not affect the amount hedged for the period designated as hedged.

Furthermore, in our opinion, the approach chosen by the Board is inconsistent, to a certain extent, with the treatment of ineffectiveness put forward for fair value hedges. IGC 144-3 (see Appendix 2) in fact demonstrates that ineffectiveness in respect of fair value hedges is not necessarily assessed on a «proportional» basis; it can equally be assessed by reference to a specified amount only. In this way, as in the case of IGC 144-3, the risk is only hedged from the moment the quoted price of the asset falls below 90. In the case of a hedge of interest rate risk on an overall risk management basis, it should therefore be possible to consider that the risk hedged is a specified level of «interest margin at risk».

To conclude, ineffectiveness should only be recognised when the hedging objective is not met, i.e. when the hedging derivatives are in excess of the hedged item (which is a fixed amount or a subset of the net position).

2. Designation of the hedged risk

As stated above, current risk management's objective (in accordance with prudential regulation) is to hedge a fixed amount or layer of the net asset or liability position, rather than all the components that constitute the net asset or liability position, i.e. including prepayment risk.

Since the Exposure Draft's approach insists that only a proportion of the amount of fixed rate assets or liabilities appearing in the risk management maturity time period schedule can be designated as the hedged item, an entity is obliged, if using the approach, to record any ineffectiveness arising on the hedged item in respect of the prepayment risk even though it does not hedge actually prepayment risk but includes the effects of prepayments on the fixed interest rate gap in the way it manages overall interest rate risk.

We understand that this is because the approach developed in the Exposure Draft in respect of the calculation of ineffectiveness has as its starting point the principle that:

- The fair value of a loan with a prepayment option is equal to the fair value of the sum of a standard loan (without the prepayment option) and the fair value of the prepayment option.
- It is the fair value changes of these two components as a result of fluctuations in interest rates over time that is designated as the hedged risk. As a result, it is necessary to note that if prepayments do not occur in reality as originally estimated by the entity or there

is a subsequent change in these estimates, then this will result in ineffectiveness, whether prepayments rates have increased or decreased.

We reiterate that this approach does not reflect our risk management practice and conflicts with other areas of the IAS 39 Standard, to the extent that:

- ALM management's aim is not to hedge changes in fair value of the prepayment options attached to the assets/liabilities appearing in the maturity time period schedules but only their effect on interest rate margin
- In our economic environment, changes in interest rates and changes in prepayment risk are not highly correlated in all cases, notably as a result of the impact of a number of other behavioural factors.

By way of illustration, in the extreme case of no change in interest rates between two maturity time periods but in the event of significant changes in behavioural patterns, the approach developed in the Exposure Draft would result in the entity recording ineffectiveness in profit or loss which is in no way linked to changes in the benchmark interest rate of the hedging swaps, i.e. changes in the hedged interest rate, which seems, conceptually unsound.

- The proposed approach results in fact in systematic separation of the prepayment option from the host contract whilst this separation is not systematically required by IAS 39 (see Appendix A paragraph A4g) and the Board acknowledges that the valuation of these prepayment options is extremely complex.

As a consequence, the application of the Exposure Draft would force credit institutions to recognise in profit or loss the effects of fair value changes of a risk that is not the risk they hedge in ALM (i.e. the risk of changes in fair value due to prepayment versus interest margin risk). Moreover, this is likely to have an adverse/unfavourable effect; in fact, for two comparable credit institutions which have the same fixed rate asset and liability balance sheet structure, only the institution that hedges its risk exposure is impacted (as a result of the recognition in profit or loss of fair value changes of prepayment options embedded in its fixed rate assets).

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

The hedged item could be designated as a fixed amount of fixed rate assets or liabilities (whichever methodology the entity chooses so as to determine this fixed amount) identified at the beginning of the hedge relationship and re-designated at each balance sheet date in case of changes to the hedged position (in case of either narrowing or widening of the gap). This would be equivalent to approach A as illustrated in the Exposure Draft's Basis for Conclusions. However we believe that approach C would be very similar in substance and could also provide us with adequate treatment.

(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 on profit or loss?

Yes, it would. Ineffectiveness would be recorded if the hedging relationship is no more effective, i.e. in case the hedging instruments are on a certain time band in excess of the fixed amount of assets or liabilities that is hedged. Indeed, from the moment that the hedge relationship is designated by reference to a fixed amount of fixed rate assets or liabilities, sources of ineffectiveness are de facto reduced and would not in fact be material as long as the hedging instruments are not in excess of the hedged item:

- Different repricing dates from those expected. (i.e. changes in the effects of prepayments for example) would not create ineffectiveness unless they cause the hedged item to fall below the amount of the hedging derivatives. Indeed, we believe that if expected prepayment rates decrease (i.e. expected maturities increase), no ineffectiveness will arise as long as the hedged amount for a given maturity time period continues to be higher than the derivative hedging instruments. If on the other hand, expected prepayment increase, ineffectiveness will arise to the extent that the hedged amount falls below the amount of derivatives.
- If the assets are derecognised or impaired, ineffectiveness will only arise to the extent that the hedged amount falls below the amount of the derivatives.
- We consider that other sources of ineffectiveness (such as changes in the credit spread of the derivatives over time or different payment dates on derivatives and on hedged items, ...) would be negligible, especially if the maturity time periods used by the ALM risk management function are sufficiently narrow, as suggested in the example used in the Exposure Draft.

In this way, on the basis of the comments above, sources of ineffectiveness for a given maturity time period should normally be limited to only those instances when the amount of the hedging instruments (the swaps) is higher than the amount of the hedged item.

We note that the Exposure Draft requires the separate calculation of the fair value of the hedged item and of the hedging instruments. Appendix A33 of the Exposure Draft specifically states that “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.”

However this point is conceptually disputable, to the extent that, in the absence of sources of effectiveness (i.e. as long as the swap’s amount is strictly equivalent to the amount of the hedged position) the fair value changes in the hedged item are, **by design**, equal to the fair value changes in the hedging instrument.

As demonstrated above, in case of ineffectiveness arising from a surplus of hedging instruments over the hedged amount/item, the amount of ineffectiveness to be recorded in profit and loss can be derived from the changes in fair value of the hedging derivatives. For example, in case of over-hedging in a specific time bucket generated by only a fraction of a derivative (and not by the derivative in its entirety) we believe that changes in fair value of that fraction could be determined by reference to the fair value of the hypothetical derivative that would have to be entered into so as to close out the position exactly.

Furthermore, for practical considerations and in order to reduce the workload and to avoid unnecessary changes to systems or solely for accounting reasons, it would be advisable to consider allowing both calculations to be performed using the features of the hedging derivatives, rather than having to manage parallel synthetic assets (i.e. the assets included in the defined hedged portfolio and for which the interest rate hedged is designated to be the benchmark rate at which the hedging swaps were negotiated) in the information management systems of credit institutions.

Additionally, we consider that the need to track over time as many sub-portfolios of synthetic assets as generations of swaps negotiated (for swaps having been negotiated under different market conditions) is extremely burdensome over time and punishing in operational terms. As a reminder, transactions are not managed in this way today. In the long term, as a result of the layering of hedged sub-portfolios, we do indeed consider that this approach is not workable.

- (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?**

Under the approach we would recommend, the fair value adjustments are not linked to specific assets or liabilities but to a specific hedged amount. As long as the amount of the hedged item is higher than the amount of the hedging swaps, there is no reason to remove these adjustments from the balance sheet (see appendix). On the contrary, they would be automatically removed from the balance sheet as soon as the hedged amount falls below the amount of the hedging swaps (in event of ineffectiveness). However fair value adjustments recorded on the face of the balance sheet will vary between one period and the next due to changes in interest rates. These changes would be recorded in profit or loss.

Other difficulties generated by the designation of the hedge relationship: netting of hedging derivatives

Paragraph 126 F permits, under certain conditions, the designation of two or several offsetting derivatives in combination as the hedging instrument of a given position.

Therefore to apply the Board's approach, we understand that it will be possible, when a derivative is designated as a hedging instrument across a number of the maturity time buckets, to analyse the instrument into a series of 'swaplets' in order to be able to determine effectiveness for each time bucket, (provided that for each 'swaplet,' it can be verified by reference 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 (i.e. if the hedging ratio is outside of the 80-125% range) the derivative is not disqualified for all the maturity time periods it hedges, but solely for that time period.

Question 2.

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, this 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?

General comment

First of all, we would like to highlight the fact that the issue of demand deposits is raised only because the Board decided to adapt fair value hedge accounting in order to provide a workable solution for entities managing the interest rate risk generated by their banking book on a global/portfolio basis (i.e. using macro hedging).

Such a policy for managing risks is closely monitored and approved by regulators as well as promoted by prudential authorities. However, we believe that when applying the approach exposed in the ED we would not be able to comply with the Basel Committee recommendations in respect of interest rate risk management (see Consultative document issued by the Basel Committee on Banking Supervision in September 2003 "Principles for the management and supervision of interest rate risk").

Additionally, the aim of the ALM function is to monitor and reduce the effect of changes in interest rates on net interest income and therefore on the bank's earnings. We want to reassert that these strategies and policies do not aim in any way to protect the full fair value of demand deposits or of other assets or liabilities. As such the European Banking Federation reluctantly accepted to examine the compatibility of IAS 39's basic requirements for fair value hedge accounting with banks' ALM policies.

As a reminder, European savings banks generally have a financing structure of stable, long-term low cost or zero cost funds. For us, demand deposits constitute a significant/substantial proportion of these low cost funds and are currently included in the fixed rate gap we manage. We believe this may not be generally the case for financial institutions in the U.S. and as such that the context for European savings banks is specific and needs to be understood and differentiated so that their macro-hedging issues can be addressed in an appropriate manner.

As a result of our balance sheet structure, we are currently in a net fixed rate liability position in certain time bands, and we hedge the resulting interest risk exposure (which is for the most part generated by demand deposits) with long-term swap instruments. Our aim is to reduce for these time bands the variability of the interest rate margin on the day to day replacement of these demand deposits.

It has to be noted that neither the cash flow hedge accounting approach, nor the fair value hedge accounting approach proposed in the Exposure Draft permits the use of hedge accounting for this type of hedging strategy.

Cash Flow hedging is inapplicable in the context of demand deposits

Firstly, we understand that the cash flow hedge accounting model cannot be used to hedge demand deposits when these are either non-remunerated or carry a low fixed rate of interest. As stated in IGC 121-2 "[non-interest bearing demand] deposits do not create a cash flow exposure to interest rates and, therefore, would be excluded from this analysis for accounting purposes." A significant part of our demand deposits are comprised of non-remunerated deposits or deposits that carry a low fixed rate.

Secondly, existing balances of demand deposits are not anticipated transactions and as such do not qualify for a cash flow hedge relationship.

Thirdly, from a practical point of view it would not be possible to document in a hedge relationship the replacement of the demand deposits as:

- replacement is managed on a daily basis by the Treasury function in the short term and tracking would be problematic
- it would be impossible to make measurable and reliable assumptions regarding the roll over of short term variable rate assets over the long term
- as time elapses, certain derivatives that were previously designated in a cash flow hedge relationship (for the time bands where demand deposits are effectively in excess of our fixed rate assets) would have to be re-designated in a fair value hedge relationship (when for these time bands fixed rate assets become in excess over fixed rate liabilities). This seems to us very burdensome and completely

inappropriate 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 us to translate the same economic transaction differently into our financial statements (hedging of interest rate on a portfolio basis) depending on the time band we are currently hedging...

- it would be very burdensome to document and follow the hedging documentation over time as certain derivatives would have to be designated as fair value hedging instruments for a certain time period and as cash flow hedging instruments for the remaining part of their life or the reverse.

Furthermore, we believe that as we manage our global interest rate risk based on fixed rate gaps, the adoption of a cash flow hedge approach for certain time bands would result in a divorce between economics and accounting. Indeed, documenting derivatives within a cash flow hedge relationship would require us to transform the fixed rate interest rate gap we build for management purposes into a variable rate gap to obtain hedge accounting.

Additionally, when applying this methodology we would incur additional costs. And these additional costs would not be compensated by a strengthening of our risk management practices. This methodology would require us to artificially modify the way we are currently hedging our risks for accounting purposes only and we believe that because of this we would incur additional operational risks.

Finally, the use of cash flow hedging for macro-hedging strategies may result for us in transfers in or out of our reserves which are substantial. As the total amount of the derivatives used in macro-hedging is very significant, it is likely that the fair value changes of these derivatives that are recorded in equity will also be very significant. An unexpected change in interest rates could lead to movements in equity that could represent not only a material change in equity but also one half or one third of the annual net income of our entity.

The fact that cash flow hedge accounting does not provide a viable solution for us as well as for other European financial institutions that hedge interest rate risk on a portfolio basis is one of the reasons why the European Banking Federation approached the IASB and asked whether an alternative solution could be found.

The exclusion of demand deposits from the hedged item rules out the use of fair value accounting for a portfolio hedge of interest rate risk

We believe that the solution proposed by the IASB cannot work for us, as a group of banks, as for a large number of European financial institutions particularly as it is indicated that demand deposits cannot be designated as the hedged item. We do not agree with the reasons given for the exclusion of demand deposits from the proposed hedged accounting model.

Firstly, we note that demand deposits taken as a whole generate an exposure to interest rate changes as for all fixed rate financial instruments, due to the fact that the interest rate risk profile of a portfolio of demand deposits is not equal to the sum of the risk profile of each individual demand deposit on a stand-alone basis as explained below.

Accordingly, we concur with the Board's view that "the issues that arise for a portfolio hedge of interest rate risk are different from those that arise for hedges of individual items

and for hedges of other risks” (see BC4(b)). Nonetheless the Board does not seem to have considered all the implications of this line of argument.

It is a fact that any amount on an individual basis can be withdrawn at short notice. This possibility results in fluctuations over the same period (over the same month when salaries are paid, etc.), reflecting a combination of various seasonal factors. However, the amplitude of fluctuations in demand deposits can be gauged using historical data and economic analyses. Historical data shows that there is a very stable volume of deposits over the long term. Indeed behavioural patterns for deposit-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 paid out on one account may be received in another. This is one of the analyses carried out by the ALM function which is precisely 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.

This is possible 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.

In the light of all of these points it is clear that the risk inherent in the portfolio is not the sum of the risks on all the individual items and we believe that a portfolio of financial liabilities that counterparties can redeem on demand such as demand deposits could qualify for hedge accounting for time periods beyond the shortest period in which the counterparties can demand payment.

Secondly, we do not agree with the comparison made in the ED (paragraph BC 14) between demand 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. future sales). We do not consider this is the case with demand deposits. Once a new account has been opened, it automatically generates future cash flows, in and out (in the case of retail banking, wages being paid on the accounts on a monthly basis, money being paid out on that monthly basis). These flows are certain as long as the account stays in the bank. We are therefore of the opinion that, from 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).

Finally, we understand that the Board’s aim, as expressed in the Exposure Draft, was to develop an approach that allows data captured for risk management to be used in preparing financial statements. Data captured for risk management today incorporates demand deposits in the determination of the fixed interest rate gap to be hedged. 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 expected maturities differ from contractual maturities. For this reason we believe that, in excluding demand deposits from the proposed approach, the Board has not met its own expressed objectives.

No viable solution for demand deposits has been found yet

Effectively, the exclusion of demand deposits from the hedged item rules out the use of fair value hedging of interest rate risk, when fixed rate liabilities (including demand deposits) exceed fixed rate assets, i.e. when an entity is net liability sensitive. As cash flow hedging is not a viable alternative either we believe that this will lead to increased volatility in profit or loss for financial institutions that hedge their demand deposits in accordance with current and sound risk management practice and policies as recognised by regulators and central bankers. In our view this proposed approach would penalise those entities that hedge their demand deposits for no sound reason.

Specific answers to questions (a) and (b)

Firstly, we do not believe that it is relevant to ask if we agree with the Board's decision that the entire fair value of financial liabilities that the counterparty can redeem on demand is not less than the amount payable on demand.

As a reminder we would like to reassert that banks do not ask to account for demand deposits at fair value. In fact, they intend to hedge a component of their portfolio of demand deposits (the interest rate risk generated by that portfolio), not the entire fair value changes that are associated with them.

Additionally, as discussed above, statistics demonstrate that it is possible to model with a high confidence level the withdrawal pattern (i.e. expected maturities) of a portfolio of existing demand deposits. In that respect a portfolio of demand deposits does behave like other fixed rate liabilities regarding interest rate risk.

Furthermore, we understood from previous decisions taken by the Board that it is accepted that the entire fair value of a debt instrument issued by an entity such as a long term fixed rate borrowing could be different from (and so under certain circumstances lower than) the amount that has to be repaid at maturity date (i.e. surrender value) by the entity. Thus, in certain cases, we believe that the fair value of a financial liability can be lower than the amount repayable.

In the light of both of these latter comments, we do not understand the reason why portfolios of demand deposits should be treated differently from other financial liabilities.

Secondly, we do not believe either that including demand deposits in the hedged portfolio would lead to the recording of a gain on initial recognition of the demand deposits.

Indeed, in our view, if demand deposits are permitted for inclusion in a macro hedge relationship, we see no reason why they should not be treated as all other fixed rate assets and liabilities that are part of the macro-hedging process.

As such, no profit or loss would be recognised on inception of the hedge. Only the subsequent changes in fair value of the interest rate hedged component would be accounted for in profit or loss. As for other fixed rate assets and liabilities that are part of 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.

Appendix 2 : our proposed ineffectiveness measurement

In this appendix, we show how our method would deal with ineffectiveness on a prepayable loan.

This method enables the calculation of all fair value hedge accounting entries, including the ineffectiveness to be reported in P&L, without having to calculate the fair value of the hedged items.

We believe this method to be consistent with our current practice, consistent with the principle of the exposure draft and far simpler to implement.

Let us consider a 100 M€ 6-year fixed rate prepayable loan originated at 5 % (interbank interest rate component).

Initially, due to uncertainty regarding future interest rates, the expected maturity date of the loan is 4 years. So, a 100 M€ 4-year 5 % payer swap is entered into to hedge the loan. The entity enters into a partial term hedging hedge relationship.

At origination date, the fair value of the interest component of the loan is 0 and, when entered into, the swap market value is 0.

One year later, we consider 3 interest rates scenarios :

One year later, rates have not changed (still at 5 %):

	Fair Value	Year 2	Year 3	Year 4	Year 5	Year 6
Rates		5%	5%	5%	5%	5%
Discount Factors		0.952	0.907	0.864	0.823	0.784
Loan (*)		100	100	100	100	100
Expected loan (*)		100	100	100		
Swap (*)	0.00	100	100	100		

(*): amounts are the notional outstanding during “Year y”.

Since the prepayment expectations are not revised, the hedging is perfectly effective, and the carrying amount of changes in fair value of the hedged item is equal and opposite to the changes in fair value of the swap : 0.00 in this case since market rates have not changed.

One year later, rates have increased to 6 %:

Prepayment expectations are revised so that prepayment will occur later than initially expected :

	Fair Value	Year 2	Year 3	Year 4	Year 5	Year 6
Rates		6%	6%	6%	6%	6%
Discount Factors		0.943	0.890	0.840	0.792	0.747
Loan		100	100	100	100	100
Expected loan		100	100	100	100	
Swap	2.67	100	100	100		

As the hedged item defined as a portion of the loan (ie: a 4year portion in a 6year loan) still exists, the hedge is perfectly effective. Hence, there is no ineffectiveness in case of prepayment later than initially expected.

The change in fair value of the swap is 2.67 M€, and, since the hedge is effective, the change in fair value of the hedged item is - 2.67 M€

One year later, rates have decreased to 4 %:

Prepayment expectations are revised so that prepayment will occur sooner than initially expected :

	Fair Value	Year 2	Year 3	Year 4	Year 5	Year 6
Rates		6%	6%	6%	6%	6%
Discount Factors		0.943	0.890	0.840	0.792	0.747
Loan		100	100	100	100	100
Expected loan		100	100	0		
Swap	- 2.78	100	100	100		
Over-hedging swap	- 0.89	0	0	100	0	0

And so, in year 3, the loan will be entirely repaid.. This means that a portion of the swap (year 4) cannot be accounted for as a hedging instrument (it is a trading instrument). The other part of the swap fulfils its hedging objective.

The change in fair value of the hedged item can be deducted from the change in fair value of the swap minus the over-hedging portion :

Change in fair value of the hedged item = - (change in fair value of swap – change in fair value of over-hedging portion of swap)

In our case, this gives : - (- 2.78 – (- 0.89)) = 1.89 M€

The ineffectiveness results from the discrepancy between the change in fair value of the hedged item and the change in fair value of the entire swap: + 1.89 + (-2.78) = - 0.89.

The ineffectiveness comes from the portion of the swap that is over-hedging the loan.

Appendix 3 : Demand deposits

This appendix aims at showing that a portfolio of demand deposits has a different behaviour from the simple sum of individual demand deposit accounts.

Ultimately this comes from two results from the theory of econometrics :

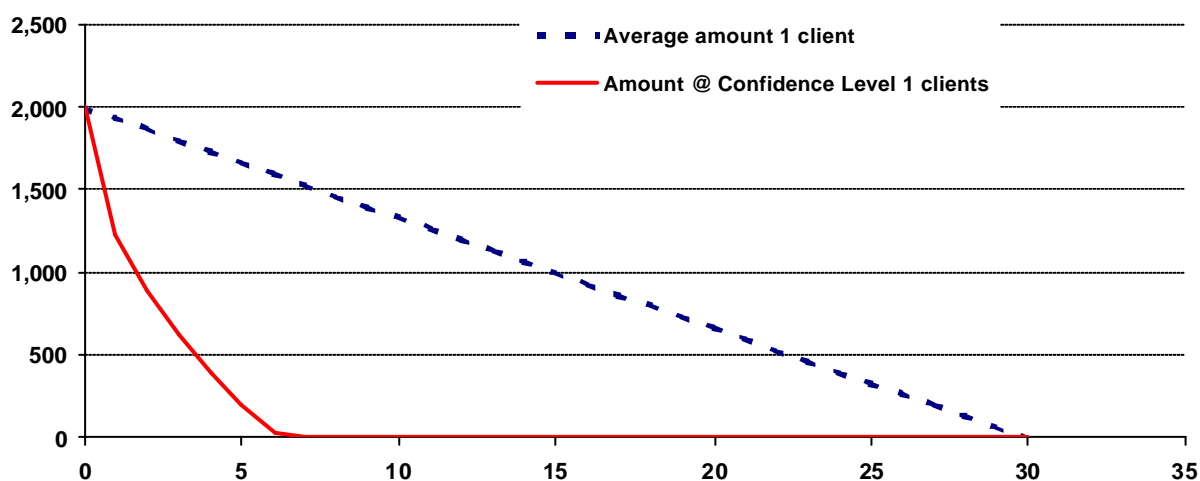
- **Law of Large Number** according to which the empirical mean converge almost certainly to the theoretical mean;
- **Central Limit Theorem** according to which the speed of this convergence depends on the number of observations.

We illustrate this coming from a very simplified elementary account description :

- each month, a client has a single cash inflow and a single cash outflow;
- the cash inflow takes place always the same day of the month;
- the uncertainty is relative to the date of the cash outflow : each day has the same probability $1/30$
- at the end of the month, ie just before the next cash inflow, the client has spent all what he has received.

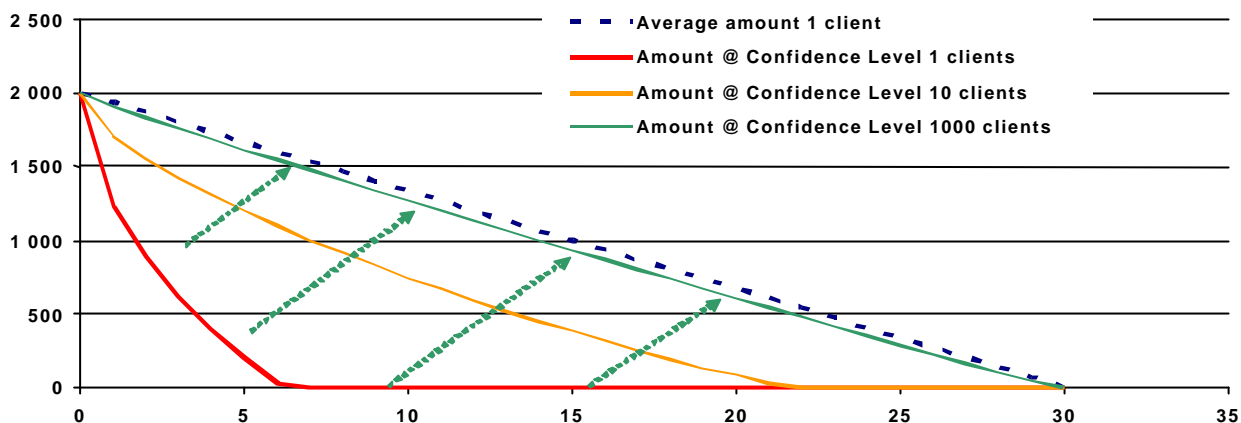
Considering one single client receiving its inflow, 2 000 €, the first day of the month, the average amount on its account decrease linearly through time.

As this scheduling is uncertain, we can draw the profile corresponding to any confidence level (95 % below) :



With only one client, even though the duration of the mean profile is 15 days, the bank would consider the uncertainty around this mean and would not invest on any maturity longer than 4 to 5 days.

Though, when considering an increasing number of clients, the Central Limit Theorem enables to narrow the uncertainty around the mean profile :



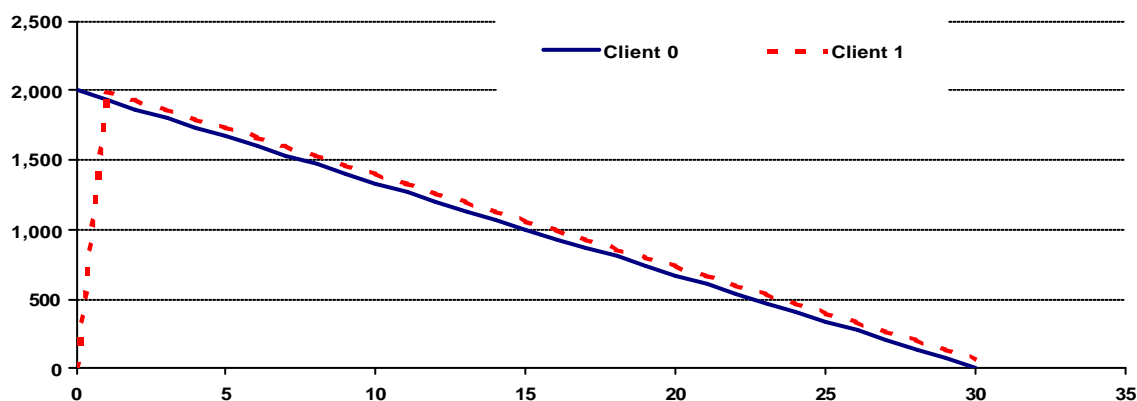
(Rem : the amount have been normalized by the number of clients).

This shows that, with a sufficiently high number of clients, it is valid to consider amounts on core deposits as being stable through time as their mean profile.

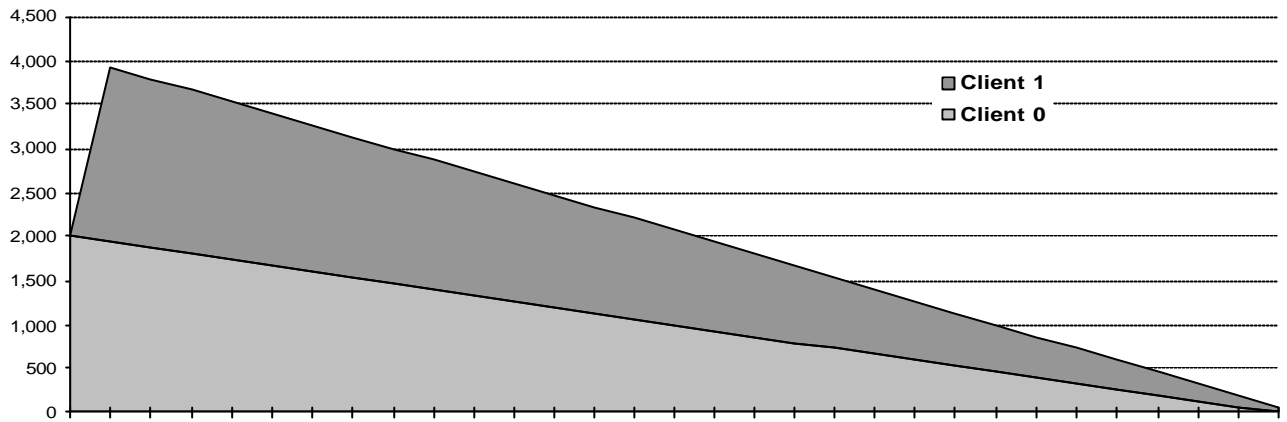
Hence, thanks to diversification effects, a portfolio of core deposits can be dealt differently from a single core deposit. This enables the amounts on core deposit to be scheduled through time according to their mean profile.

Let us consider a second “typical” client whose cash inflows takes place the second day of the month.

The two mean profiles become :

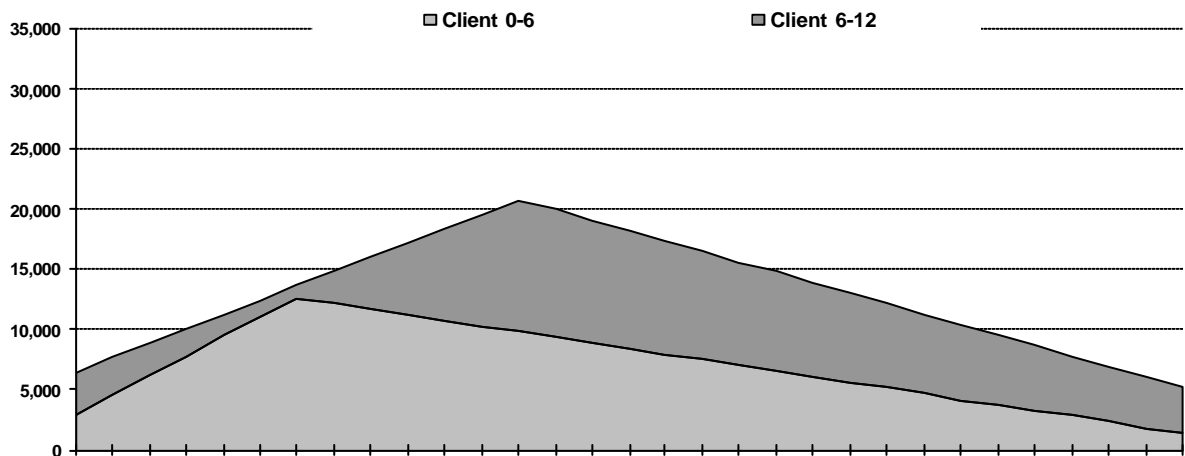
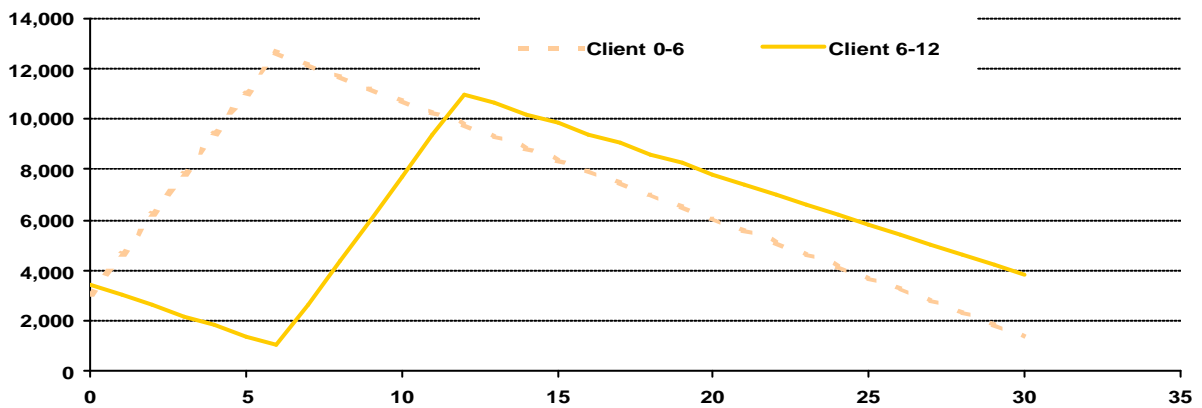


And the sum of the two mean profiles is :

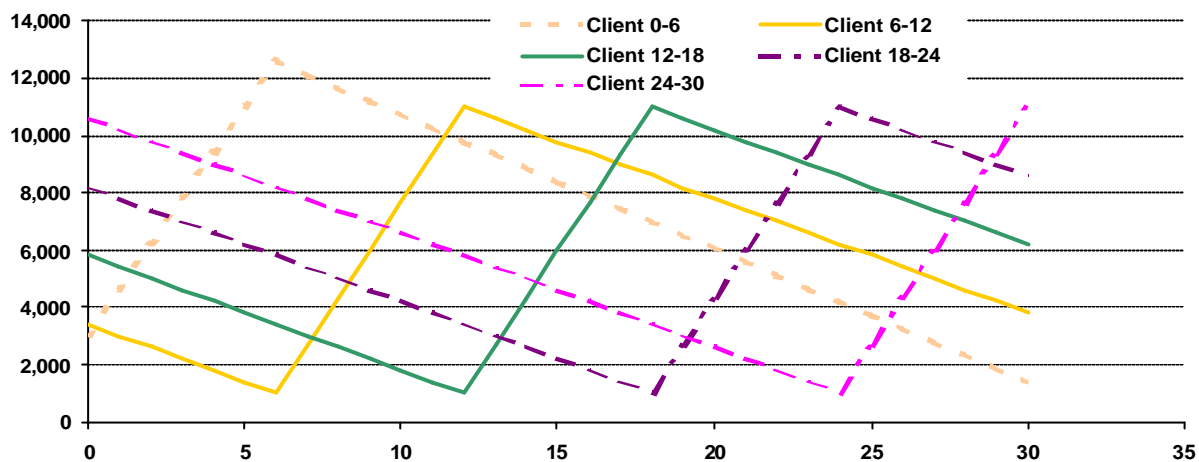


Due to diversification effects and the high number of clients, this mean profile represents the risk associated to the core deposits then their scheduling through time.

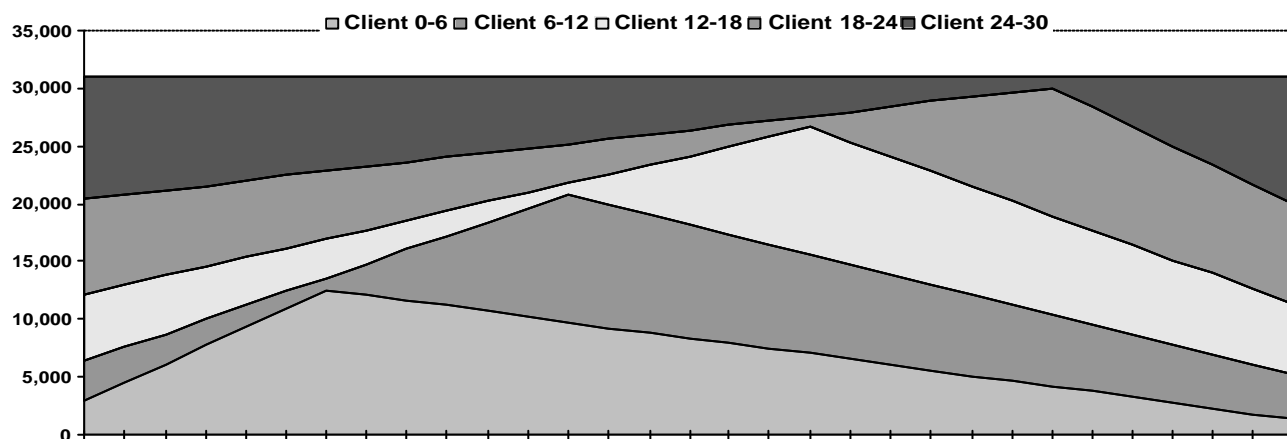
Adding up clients receiving between day 0 to 6 and between day 6 to 12, the profiles become :



When considering that clients receiving their cash inflow at day1, 2..., this leads to the mean profiles :

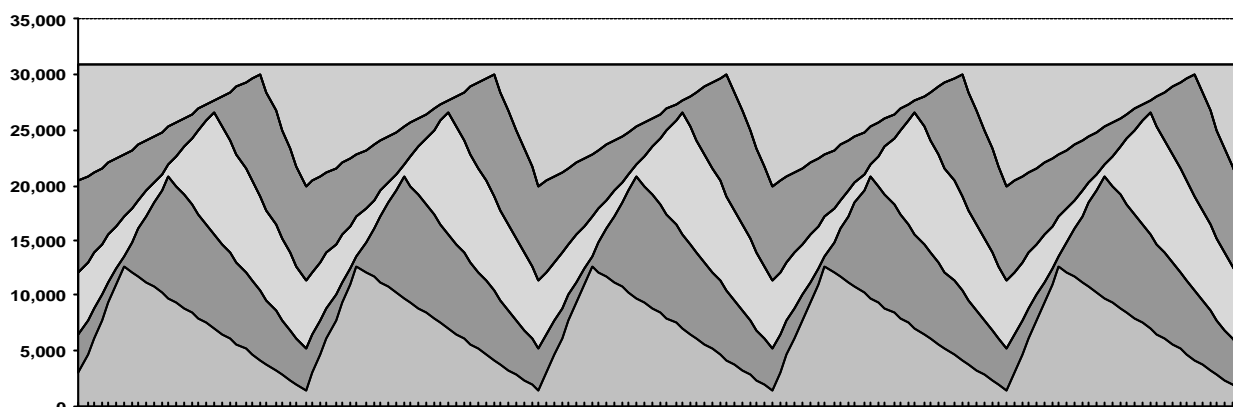


...and to the sum on all core deposits :

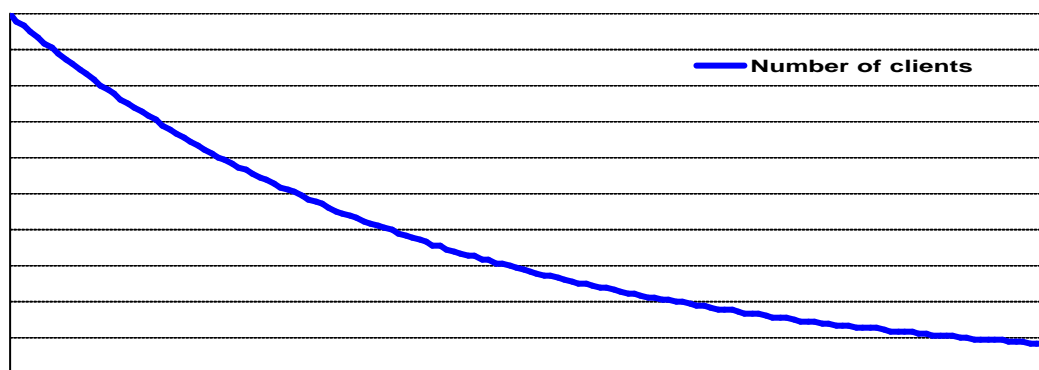


Hence, **diversification effects enable to start from a totally uncertain profile to end to an almost surely stable amount throughout the month !**

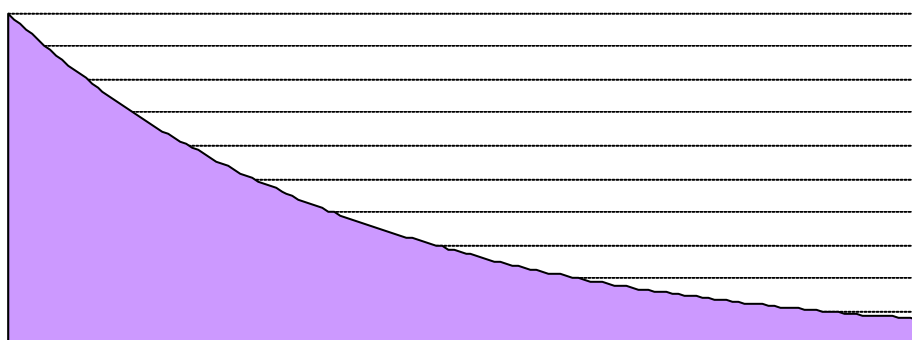
Considering the renewal of inflows the month after, this analysis can be extended to lead to an almost surely stable amount throughout many future months :



Should this analysis be extended, a bank would expect a decreasing number of clients through time :



and a typical mean amount profile on its core deposits of the form :



This model is obviously over-simplified but shows how the diversification effects make a portfolio of core deposits significantly different from the simple sum of elementary core deposits.

Usually, the scheduling of core deposits through time uses historical data to fit econometrical models that enables to analyse core deposit stability through time. The Law of Large Number and the Central Limit Theorem always underlie those models and make it possible to use diversification effects.

Appendix 4 : other significant issues

The IASB has been informed that the FBE has other major concerns with the existing standard (See paper entitled « Other significant problems arising from IAS 32 and 39 » which has been forwarded to Sir David Tweedie on 4 April 2003). These major concerns include the following issues :

- ✓ Internal contracts
- ✓ Impairment
- ✓ Derecognition
- ✓ Cash instruments as hedges of interest rate risk
- ✓ IAS 32 disclosures (changes in accounting policy)
- ✓ Other disclosure issues
- ✓ Scope (exclusion of insurance investment products)
- ✓ Financial guarantees
- ✓ Loan commitments
- ✓ Effective interest rate calculations
- ✓ Transactions costs Purchased loans
- ✓ Initial measurement of financial instruments
- ✓ Fair value hierarchy
- ✓ Repurchase or induced early conversion of convertible debt
- ✓ Puttable instruments
- ✓ First Time adoption, including transition rules for entities that already apply IFRS
- ✓ Fair value option
- ✓ Debt/equity issues
- ✓ Offset
- ✓ Loan servicing rights

We conclude from the Board's preliminary decisions on these issues that some progress would seem to have been made. Nevertheless, aspects of the standards remain that are ill-adapted to business process and may give rise to unwelcome economic consequences, other are still unsolved.

Because of the fundamental nature of the proposed changes and their potential impact, we believe that the IASB should publish its proposed changes to IAS 32 and IAS 39 and provide the public with an opportunity to comment upon them, albeit within a short time-frame.

