

## CL 128

*Re: Exposure draft of proposed amendments to IAS 32 and IAS 39 Financial Instruments.*

Dear Sir David,

The French Banking Federation welcomes the opportunity to comment on the exposure draft improvements to IAS 32 and 39.

From the outset, French banks support the effort to harmonise accounting standards, allowing cross border comparisons and promoting confidence in financial reporting. But they have serious grounds to believe that new proposals are self defeating.

The result is a loss of symmetry and an increase, not economically justified, of the volatility of the balance sheet and profit and loss account which produces inaccurate information in the financial statement.

Furthermore we think that the fair value principle may be dangerous when there is no actual market price as was experienced recently.

Considering this background, we think IAS 32 and 39 must be changed in a more radical way than the proposed. We have understood that the IASB was in favour of a principles-based approach and we think that most of the proposed amendments are rule-based.

Our more significant remarks to the exposure draft are summarised thereafter.

- As you are aware the banking industry considers the proposed rules on hedge accounting as prejudicial to sound asset and liability management practises. Accounting rules have to support the best practises of the industry and have not to change the way in which a bank is managed. So hedging accounting rules have to take into account:

- internal contracts,
- demand deposits,
- hedging by non derivative instruments,

and to apply the accounting rule of the hedged item to the hedging instrument; for the banking book, the rule of the hedged item is the amortised cost method.

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**Sir David TWEEDIE**

Chairman

International Accounting Standard Board

30, Cannon Street

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- The new approach for credit risk provisioning has to be improved, for example taking into account the Basle Committee requirements.
- We disagree with your proposal which authorises to measure any financial asset at fair value. This proposal is going on the opposite side you promote: comparability. But we could agree with a proposal tending to authorise an entity to measure all trading operations (including financing liabilities) at fair value.

**You** will find in annex the detailed package of our answers and proposals.

We do think it will be possible to include the above improvements in the standard. If you would like further clarification on the points raised in this letter I would be happy to discuss these further with you.

Yours sincerely,



Michel PEBEREAU

## **Invitation to Comment IAS 32**

### **ANSWERS OF THE FRENCH BANKING FEDERATION**

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

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

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

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

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

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

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

We agree with the proposed amendment.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We support a proposal which conducts to a reduction of the requested disclosures.

For the financial industry the link between IAS 32 and IAS 30 will have to be carefully thought over. An other major request of our industry is that the disclosures requested by the accounting rules (IAS) have to be tightly joined up to the one's requested by the pillar III of the Basle capital accord.

## **Invitation to Comment IAS 39**

### **ANSWERS OF THE FRENCH BANKING FEDERATION**

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

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

We agree.

However, a consistent application of accounting principles regarding impairment of instruments bearing the same type of risk as loans (irrevocable loan commitments and guarantees) should be required (paragraphs 109)

Other comments on scope and definitions:

#### **Lease receivables:**

We consider that the impairment rules set out for other financial instruments in the Standard should apply to lease receivables.

#### **Financial guarantees:**

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

#### **Question 2. De-recognition: continuing involvement approach (paragraphs 35-57).**

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

We do not support the outcomes of the proposed "*continuing involvement*" approach. We support the need to modify the de-recognition requirements of the current version of IAS 39 and consider that a lot of works should be done again, to obtain recognition/de-recognition accounting rules for financial assets in phase with economic reality and industry's best practises.

#### **Question 3. De-recognition: pass-through arrangements (paragraph 41).**

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

The definition of a “pass through arrangement” raises questions, notably when applied to SPE. If it were applied as described in the example B4, the new definition of pass through arrangements would empty SPE from most of their assets. This would be a major change on a very sensitive issue. We believe that such a change cannot be made without a complete due process on its implication.

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

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

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

- would allow entities to enter into “cherry picking” accounting. It does not meet the IASB's objectives for the comparability of financial statements for an entity through time, and between entities;
- is contrary to the IASB's policy of reducing options so that the set of Standards produced by the Board is applied consistently, particularly by entities belonging to the same industry is contrary to the IASB's objective to promote convergence, particularly with US GAAP.

The option can lead to dangerous accounting practices and does not comply with the objectives defined by the IASB in terms of financial statements' comparability; for example, such a rule permits an entity to report increased profit when its creditworthiness deteriorates.

We support a definition for trading activities which allow the classification of liabilities that are used to fund trading activities as well as some hybrid instruments for which a separate accounting for the underlying instruments would be too hard to implement.

This definition for trading activities permits to clarify the hedge accounting rules which should be applied to an other part of the activity of the financial industry : the banking book. We enclose in annex the proposals of the French banks for their major activities.

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

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

We disagree on one issue, and consider that a second needs additional information:

- We consider that liquidity factors have to be taken into consideration when assessing the price of financial instruments. It cannot be denied that owning a large block of a financial instrument has an effect on the total value of the block. The price of the whole block cannot be considered to be the price of an individual component of this block, as stated by the market, multiplied by the number of items held by the company. Simultaneously, owning a large block of instruments will definitively influence the price of each item. The impact on the price can either be negative (liquidity effects) or positive (control stake effect). This is the main reason why some advocate that the impact “of large blocks” should not be taken into consideration when evaluating the price of financial instruments. However, we consider that this impact can be so large, in some cases, that it cannot be ignored if a true and fair view of the financial situation of the company is to be reached. Moreover liquidity risk is a component that is included in the valuation of financial instruments as interest rate swaps derivatives. The relinquishment of this practice would be a regression towards current practices.
- It is not clear what valuation model companies should use when they have the choice between an internal model that they consider more efficient and another model widely used in the industry. The standard should be made clearer on this point.

#### **Question 6. Collective evaluation of impairment (paragraphs 112 and 113A-113D).**

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

We do not disagree with the newly introduced principle for collective impairment. However, we consider that the proposed accounting treatment should lead to reflect the effective expected level of risk with each financial instrument and could be improved on some issues.

At principle level, the suggested approach for assessing impairment of financial assets carried at amortised cost using the “original effective interest rate” is acceptable. Certain elements and the example given appear misleading. The example given in B32 to B36 is based on estimated expected cash flows discounted using the “weighted average original expected interest rate” to compute impairment losses on non individually impaired group of loans. The rate to be used should be the original effective interest rate less the credit premium related to the rating of the borrower.

For similar credit risk characteristics, if borrowers have the same rating, impairment loss should be the same.

The example given in B32 to B36 is also based on an “estimated cumulative cash flow loss rate per year” which remain unchanged once one element has been individually identified as impaired and is removed from the group that is collectively assessed for impairment (B35). That is not correct. Excluding individually assessed assets from the basis used for collective assessment implies that expected cash flows are modified: in general, anticipated losses on the remaining part of an homogeneous population decrease in line with the occurrence of impairment of individually identified assets within the population. The need for the modification of expected cash flows taking into account revised anticipated losses should be made clear and the example should be modified or eliminated because over simplification can be counter productive or misleading.

Furthermore, IAS 18 Revenue, indicates that the effective interest used to discount future cash flows includes fees treated as an adjustment to the effective yield. Regarding, we consider that it is conceptually sound to include in the interest rate fees collected over the life of a contract, although this may be hard to implement. It is not sound however to include fees that are collected up-front in the effective interest rate used to calculate impairment.

Another approach for assessing impairment of these assets exists. This approach, based on “the risk premium”, has been developed earlier by the “Conseil National de la Comptabilité” and is now envisaged at the Basle Committee level. Simulations show that this approach leads to results that are similar to those obtained via the “original effective interest rate” approach once expected cash flows have been modified, as suggested above. The risk premium approach is based upon the fact that contractual interest rate includes a risk premium that cannot be recognised as profit. Therefore, it must be set aside to provide for specific losses when they occur.

Once this risk premium has been set aside, contractual cash flows can be discounted using contractual interest rates. If expected risk deteriorates, the amounts set aside must be adjusted immediately.

Revised IAS 39 should offer the possibility to use one of these approaches or any solution ending at similar results and furthermore should apply to lease receivables, loan commitments, financial guarantees, at the present time out of the scope of IAS 39.

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

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

We disagree.

We do not see any reason why a specific treatment should be set in force for “available for sale” financial instruments regarding impairment. Therefore the interdiction of reversal should be deleted.

Other comments:

We consider that valuation at the lower of cost or market price would be a better alternative for the valuation of available for sale financial instruments with an information in the notes on the global amount of latent gains on the available for sale financial instruments latent gains.

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

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

We do not agree with the proposed amendment and believe that in all cases the accounting for a hedging instrument should follow the accounting for the hedged item and not vice versa. Please refer to our proposals given in annex.



**Question 9. 'Basis adjustments' (paragraph 160).**

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

We do not agree.

Please refer to our proposals given in annex.

**Question 10. Prior de-recognition transactions (paragraph 171B).**

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

In some cases, the proposals in paragraph 171B are impractical and an application without undue cost and effort must be required. In this case, the exemption would be accompanied by disclosure.

## Invitation to Comment IAS 39

### ANSWERS OF THE FRENCH BANKING FEDERATION

#### Annex: Hedge accounting

#### The banking book in French financial institutions

This document presents:

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

#### **1. The intermediation activity or banking book**

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

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

In line with the going concern principle, its purpose is to generate a steady income stream over time. In this context, assets and liabilities management (ALM) aims at securing margins in different interest rates environments and reducing their sensitivity to interest rate fluctuations. It uses mainly derivatives for this purpose.

From an economic viewpoint, ALM aims at hedging fixed rate assets and fixed rate liabilities, both of them being sensitive to movement in variable rates. In practise, real hedging operations are based on the net exposure between assets and liabilities.

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

#### **1.1. Banking book versus trading book specificity**

##### **❖ banking book's specificities rely on this activity's nature and purpose**

- financial instruments used are disconnected from market making activity

Interest rates for loans and deposits are set up independently by each credit institution, based on their own bilateral customers relationship. Loan interest rates are thus determined, in order to obtain an interest margin at least exceeding costs on saving accounts and on of some loans that are not market related liquidity, credit and operational costs. Interest rates on loans customer depend therefore also on costs that are not closely related to financial market conditions.

- banking book activities and trading book activities are not run for the same purpose

Intermediation activities have a long-term logic, where customers' relationships are a key success factor. Trading book activities are undertaken generally for short-term gains.

- participants (depositors and borrowers) behaviour and logic differ those of trading activities

Generally, no automatic adaptation to market conditions variations is noticed. If interest rates decrease, borrowers do not immediately repay fixed rate loans. If interest rates increase, lenders do not immediately change their investment portfolios.

***Intermediation activities cannot be compared to trading activities***

➤ **different accounting presentation**

Consequently, measuring banking book items with financial market data is totally illogical. Intermediation activities are based on a long term logic and on going concern basis, this market value measurement is not appropriate.

Assets and liabilities are measured at historical cost.

Derivative instruments used for hedging purpose are included in banking book portfolios. Given that in a same portfolio, accounting policies must be consistent, all items of this portfolio, including hedging derivatives, are now measured at historical cost.

Lastly, applying historical cost measurement to ALM hedging derivatives complies with hedge accounting policies and recognises the offsetting effects of the net profit and loss and on shareholders' equity.

***Measuring all banking book items at historical cost complies with this activity's economic substance and the hedge accounting principals recognise the symmetry between the effects of hedged items and hedging items.***

**Moreover, in intermediation activities, interest rate risk management is directly linked to demand deposits outstanding and to this instrument specificity.**

**1.2. Demand deposits**

➤ **Demand deposits' impact on French banks' funding**

Demand deposits constitute a significant portion of French credit institutions' funding, as shown below:

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

For example : Average figures as at 12/31/01 for a typical French bank (in billions of euros) are

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

Hedging swaps	5,8
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Intermediation activities aim at transforming stable and mainly fixed rate funding without maturity into funding sources having maturities and bearing fixed or floating interest rates.

***Considering the large portion of fixed rate resources without maturity, French banks' balance sheets differ structurally from most of American banks' balance sheets.***

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

#### ➤ **Stability of demand deposits**

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

However, the amplitude of fluctuations in demand deposit outstandings can be gauged using historical data and econometric analyses, underlining the perfect stability of these deposits.

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

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

A bank that does not have a direct reinvestment vehicle must invest demand deposit funds at overnight rates. Bank results are thus exposed to fluctuations in overnight interest rates.

The same risk exists in the case of demand deposits that can bear interest (at fixed rates) such as in certain European countries, since the absence of a maturity in this category of vehicle transforms, de facto, the fixed rate into a floating rate.

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

#### ➤ **Interest rate risk management**

Assets and liabilities management relies on demand deposit stability in order to reduce the income risk related to demand deposits outstandings.

It is therefore possible to behaviouralise demand deposits into various future maturities identified them and match these maturity schedules by swaps to hedge the return of these funds.

To manage the overnight interest rate fluctuation risk, given the volumes at stake, the banks transform the income derived from overnight placing by entering into short-term floating rate pay swaps and fixed-rate receive swaps tied to the maturities resulting from balance sheet and off balance sheet gaps.

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

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

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

***Demand deposits can thus support interest rate cash flow hedges.***

A last, hedging interest rate risk in a intermediation activity leads to contracts for internal operations. These operations will be described as follows.

### **1.3. Internal contracts**

#### ➤ **Why internal contracts**

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

In major banking groups, the entities are specialised, and once they have market access, they are authorised to enter into transactions involving products within their scope while observing allocated limits. These entities comprise departments specialising in interest rate,

equity, index derivatives, etc. Certain entities do not have direct market access, such as those belonging to merchant banking sectors. Consequently, in order to hedge their own risks, they systematically enter into hedging contracts with the specialised departments.

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

#### ➤ **Offsetting positions on the market**

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

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

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

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

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

#### ➤ **Control of internal contracts**

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

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

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

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

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

IAS 39 allows two types of hedging:

- \* Cash-flow hedging.
- \* Fair value hedging.

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

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

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

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

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

***This justification is unfounded and relies only on a contractual terms analysis and not on an economic analysis***

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

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

➤ **Conclusion**

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

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

## **2.2. The accounting translation of ALM hedging is irrelevant**

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

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

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

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

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

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

### **➤ ALM swap fair value volatility**

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

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

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

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

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

### **➤ Consequences on the financial statements**

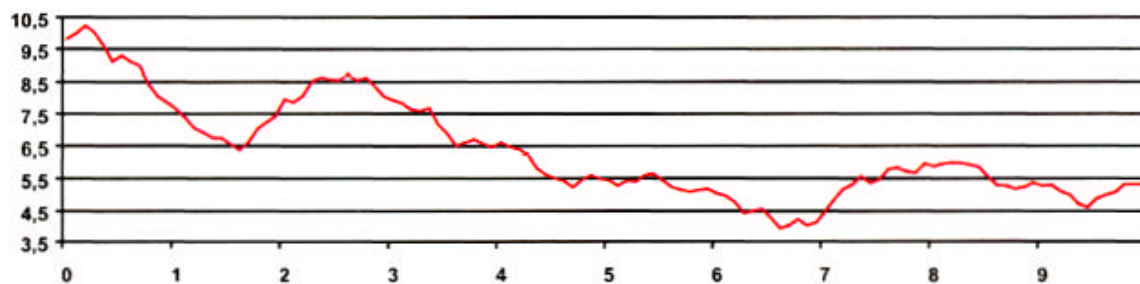
A simulation of the application of IAS 39's principles to the banking book activities of a French financial institution is presented below, assuming the application of cash flow hedge accounting.



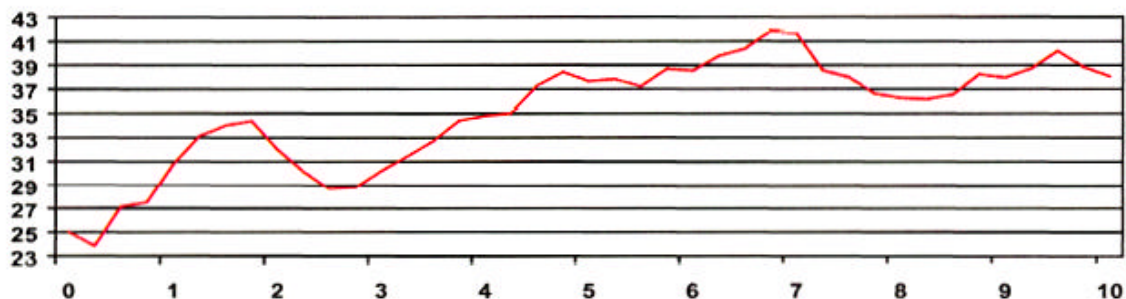
For the purposes of this example, let's us assume that Bank A has the following balance sheet:

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

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



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



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

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

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

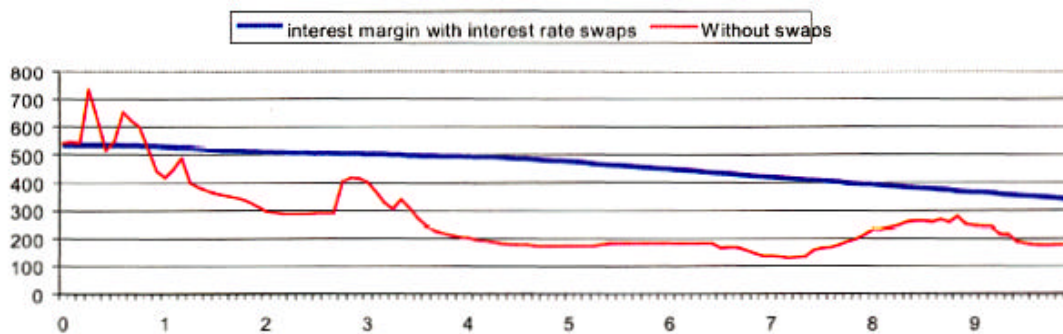
***None of the options offered by the Standard correctly reflect the reality of the management activity.***

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

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

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

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



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

### **2.3. Consequences on financial communication**

- **Consequences already observed**

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

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

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

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

For example, Fannie Mae presents in its financial statements:

- \* a highly detailed analysis of its interest rate risk management activities (indicators used, frequency, decision-making process) and the impact of these management activities on the year then ended, demonstrating in this way the prudence with which this risk is managed;
- \* the consequences of this change in accounting method on financial statement presentation, despite the sound management policy applied;
- \* It is explained that shareholders' equity excludes AOCI (accumulated other comprehensive income corresponding to the fair value of ALM hedge swaps), as AOCI includes unrealised gains and losses on derivatives, but not unrealised gains and losses on mortgaged loans and the liabilities used.

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

#### ➤ **Consequences on segmental information**

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

### **3. Alternative proposals**

#### **3.1. Permit the hedging of demand deposits**

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

#### **3.2. Internal contracts**

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

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

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

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

*“For hedge accounting purposes, ~~only~~ derivatives that involve a party external to the entity or and internal contracts between two separate entities within a consolidated group or two divisions within an entity can qualify for hedge accounting by those entities in their separate financial statements or by those divisions and can be designated as hedging instruments or hedged items. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any gains or losses on such transactions are eliminated on consolidation. Nevertheless, ~~Therefore,~~ such intra group or intra-entity hedging transactions ~~do not qualify for hedge accounting in consolidation~~ allow groups to meet segmental information reporting requirements by business, with the calculation of results specific to each segment.”*

### **3.3. Hedging of net positions**

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

*“a hedge item can be:*

- (a) a single asset, liability, firm commitment or forecasted transaction or*
- (b) a group of assets, liabilities firm commitments or forecasted transactions with similar risk characteristics; or*
- (c) a net exposure”*

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

### **3.4. Valuation of banking book hedge derivatives at historical cost**

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