E U R O P E A N   S A V I N G S   B A N K S   G R O U P
GROUPEMENT EUROPEEN DES CAISSES D'EPARGNE
E U R O P Ä I S C H E   S P A R K A S S E N V E R E I N I G U N G

CL 65

Sir David Tweedie
International Accounting Standards
Board Chairman
30 Cannon Street
London EC4M 6XH
United Kingdom

CRO(0588.03)

Re: Response of the European Savings Banks Group (ESBG) to the 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 Tweedie,

Please find enclosed the comments of the European Savings Banks Group (ESBG) on the Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – Fair Value Accounting for a Portfolio Hedge of Interest Rate Risk.

In this context, the ESBG would like to appeal to the IASB to re-expose the complete revision of IAS 39 for comprehensive consultation for the following reasons:

First, several amendments, which have so far not been published, have been integrated in the original standard. Re-exposure of the entire standard would therefore provide a good opportunity to highlight these amendments.

Second, re-exposure and further comprehensive consultation of the standard will improve due process and allow the IASB to take note of the views of the industry on the final standard.

Third, re-exposure of the entire standard is furthermore required in light of the significant amendments made to the original standard, which will have a major impact on the accounting rules applied by banks and the need to bring accounting standards in line with risk management regulations such as the new Basel Accord and the revised Capital Adequacy Directive, respectively.

We remain at your continued disposal should you wish to discuss the issues addressed in the position paper.

Yours sincerely,

Sig
Chris DE NOOSE
Chairman of the ESBG Management Committee

c.c.: Mrs. Sandra Thompson, Senior Project Manager

Doc. 0984/03 Brussels, 14 November 2003
Vers. 1.3 CRO/MIK

THE EUROPEAN SAVINGS BANKS GROUP

STATEMENTS ON

INTERNATIONAL ACCOUNTING STANDARDS BOARD

EXPOSURE DRAFT

OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS:

RECOGNITION AND MEASUREMENT

FAIR VALUE HEDGE ACCOUNTING FOR A

PORTFOLIO OF INTEREST RATE RISK

Profile European Savings Banks Group

The European Savings Banks Group (ESBG) represents 26 members from 26 countries (EU countries, Norway, Iceland, Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic) consisting of nearly 1000 individual savings banks with around 67,000 branches and nearly 730,000 employees. At the start of 2001, total assets reached almost EUR 2800 billion, non-bank deposits were standing at over EUR 1675 billion and non-bank loans at just under EUR 1550 billion. Its members are retail banks that generally have a significant share in their national domestic banking markets and enjoy a common customer oriented savings banks tradition, acting in a socially responsible manner. Their market focus includes amongst others individuals, households, SMEs and local authorities.

Founded in 1963, the ESBG has established a reputation as the advocate of savings banks interests and an active promoter of business cooperation in Europe. Since 1994, the ESBG operates together with the World Savings Banks Institute (WSBI, with 109 member banks from 92 countries) under a common structure in Brussels.

INTRODUCTION

The European Savings Banks Group (ESBG) appreciates the opportunity afforded by the International Accounting Standards Board (IASB) to comment on the 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. In particular, the ESBG welcomes the opportunity to respond to the questions raised in the IASB document and to express its views on subjects of particular importance to the European retail and savings banks' domain.

Before doing so, the ESBG would however like to urge the IASB to re-expose the complete revision of IAS 39 for comprehensive consultation for the following reasons:

First, several amendments, which have so far not been published, have been integrated in the original standard. Re-exposure of the entire standard would therefore provide a good opportunity to highlight these amendments.

Second, re-exposure and further comprehensive consultation of the standard will improve due process and allow the IASB to take note of the views of the industry on the final standard.

Third, re-exposure of the entire standard is furthermore required in light of the significant amendments made to the original standard, which will have a major impact on the accounting rules applied by banks and the need to bring accounting standards in line with risk management regulations such as the new Basel Accord and the revised Capital Adequacy Directive, respectively.

Based on the Regulation of the European Parliament and Council on the application of International Accounting Standards[1] and dependent on the decision of their respective national regulators, European savings and retail banks will start applying IASs at different points in time: while some will apply the standards as of 2005, other will implement by 2007. Though the timing of the savings banks across Europe may vary, they share common convictions which are reflected in the below list of statements with respect to the use of fair value hedge accounting for a portfolio hedge of interest rate risk.

Question 1:

Draft paragraph 128A proposes that in a fair value hedge of interest rate risk associated with a portion of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount. For example, it may hedge the change in the fair value of the designated amount attributable to changes in interest rates on the basis of expected, rather than contractual, repricing dates. However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (e.g. in the light of recent prepayment experience), or actual repricing dates differ from those expected. Draft paragraph A36 describes how the amount of such ineffectiveness is calculated. Paragraphs BC16-BC27 of the Basis for Conclusions

[1] COM 2001/80, Official Journal C 154E/285 of 29.05.2001

set out alternative methods of designation that the Board considered, their effect on measuring ineffectiveness and the basis for the Board's decisions including why it rejected these alternative methods.

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

The ESBG agrees with the current proposal of the IASB to designate the hedged item in terms of an amount of assets and liabilities rather than as individual assets or liabilities or the overall net position. In light of the difficulties encountered in accommodating hedge accounting of net risk positions in line with the prescriptions of IAS 39, the current proposal can be considered as a pragmatic solution. The ESBG, however, is of the opinion that most current risk management practices based on evaluating the net risk position are not fully reflected in this methodology.

In this context, European retail and savings banks favour a "principle based" approach rather than a "rules based" approach because, in the ESBG's opinion, a "principle based" approach better reflects the current economy and corresponds to the current practices used by banks in their risk management function. The ESBG therefore suggests that the IASB's proposals should not be too prescriptive in order for banks to adapt the measurement of ineffectiveness to their risk management practices.

Against this background and in view of the different approaches proposed by the Board, the ESBG would in general favour a "layer" approach (Approaches A, B and C) but would reject the proposed "percentage" approach (Approach D). European savings and retail banks strongly believe that "layer" approaches are more appropriate for portfolio hedges of interest rate risk, regardless of whether fair value hedge accounting or cash flow hedge accounting is chosen.

Amongst the "layer" approaches proposed, the ESBG would, however, not select approach "A" as it does not reflect the reality. Under this approach, prepayment relates first to the un-hedged position and, therefore, ineffectiveness would only be considered in extreme circumstances.

In the view of the ESBG, approaches "B" and "C" are very similar. The difference resides in the fact that approach C reflects a partial hedging position. A combination of approaches "B" and "C" would therefore only produce ineffectiveness in case of over-hedging, which is in line with the general hedging and designation requirements of IAS 39 for portfolio hedges. This is to be explained by the fact that if prepayments are made <u>before</u> the expected date, the cash flows must then be reconsidered, as they will be less important (numerous) than originally expected. The hedged item will then decrease and this will, therefore, give rise to ineffectiveness. In contrast, this situation will not arise in case repayments are received <u>later</u> than the expected date, because this would result in an increase of cash flows and would be translated by showing more assets and liabilities in the time bucket. As this increase in cash flows was not originally expected, they will not be part of the hedge and will, therefore, not produce ineffectiveness. For these reasons, he ESBG would favour a combination of approaches "B" and "C".

If not,

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

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

The ESBG believes that the issue of "de-recognition" arises similarly when applying a combined B/C approach as when applying other approaches. An item will be derecognised on re-measurement or when the hedged item is derecognised.

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?***

Question 2:

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

While it should be recognised that some progress has been made as regards portfolio hedging, current proposals still do not go far enough. This is particularly important for entities that have a net risk position of core deposits.

As stated in the EFRAG draft comment letter, "*Certain financial institutions (such as savings banks in Europe) have a financing structure of stable, long-term low cost funds. Economic reality is that a layer of such liabilities is at the disposal of the entity, and the market value of that layer changes according to the movements in interest rates. Indeed, when interest rates go up, the value of a low carrying interest rate account will increase for the financial institution. This value component is economically linked with the core deposits and underlies the commercial substance of the bank's business. We, therefore, can see good reason to recognise the economic value on the hedged position within a portfolio hedge of interest rate risk."*

European savings and retail banks would support such a statement.

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?***

The ESBG agrees with the Board's decision that the carrying amount of a core deposit redeemable on demand cannot be inferior to the amount payable on demand.

b) ***Would you view result in such a liability being recognised initially at less than the amount received from the depositor, thus potentially giving rise to a gain on initial recognition? If not, why not? If you do not agree that the situation outlined in (b) is the result, how would you characterise the change in value of the hedged item?***

As stated above, the ESBG rejects the proposition made by the Board to exclude the demand deposits from a fair value hedge on a portfolio basis as institutions use their macro hedging strategies to monitor and decrease the interest rate risk on their earnings and not to manage the fair value of core deposits on other asset or liability.

The ESBG does not consider that the inclusion of core deposits in a fair value hedge on a portfolio basis will lead to a gain on initial recognition of demand deposits because, under the proposed designation, assets and liabilities will enter into the designation at their carrying amount. This will not result in an adjustment of the carrying amount or in a gain on the inception of the hedge.

The ESBG is, however, convinced that the IASB should allow institutions to use, as a pragmatic solution, fair value hedge accounting in the case of the creation of an effective fair value hedge, where moves in the fair value of core deposit are obviously linked to moves in the fair value of the hedging instrument.

Moreover, the ESBG is of the opinion that, by promoting different recognition profiles to offset gains and losses in function of the institution's position (asset heavy or liability heavy), the Board favours institutions funding themselves with volatile and higher cost sources. Asset heavy institutions will be required to recognise gains and losses in the profit and loss account under fair value hedging, while liability heavy institutions will have to recognise these gains and losses in equity under cash flow hedging.