European Association of Public Banks

- European Association of Public Banks and Funding Agencies -

CL 72

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- EAPB Opinion -
on the IASB Exposure Draft „Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk“ further amending IAS 39, Financial Instruments: Recognition and Measurement

Dear Sir David,

The European Association of Public Banks (EAPB), which represents the interests of approximately 100 public banks and funding agencies of the European Union, would like to thank the International Accounting Standards Board (IASB) for giving it the opportunity to comment on the proposed amendments to IAS 39 „Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk“.

The EAPB recognises the significance of the IAS/IFRS and therefore attaches the greatest importance to have practicable, high quality and understandable accounting standards. Since the adoption of regulation No 1606/2002 on the application of international accounting standards, the European Union has clearly opted for IAS/IFRS as a global set of accounting standards. However, improvements need to be done especially on IAS 32 and IAS 39. The EAPB expresses its concerns on IAS 39, considering that the valuation at fair value of all derivatives must be accompanied by improvements with regard to hedge accounting of net positions of the banking book. "Macro-hedging" is therefore essential for hedging against interest rate risk and to make IAS 39 workable. The need for improvement concerning IAS 32 and IAS 39 was also recognised by the European Commission, when it endorsed all the existing IAS excepting IAS 32 and IAS 39 (Commission regulation No 1725/2003 of 29 September 2003 adopting certain international accounting standards).

On 21 August 2003, the International Accounting Standard Board (IASB) published an Exposure Draft „Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk" further amending IAS 39, Financial Instruments: Recognition and Measurement. In this document, the IASB decided to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. We would therefore be grateful if the IASB could take into account the following remarks, which are based on the practical experience gathered by our members. We are convinced that these comments could contribute to provide a fair view of the financial position and performance to the users of financial statements.

- **General comments**

The EAPB welcomes this Exposure Draft as being a first step in the right direction. Indeed, it is essential to better take into account the modern interest rate risk management in banks. The proposals on fair value hedge accounting for a portfolio hedge of interest rate risk, represent a notable contribution in this perspective. By issuing these proposals, the consistency of the accounting treatment with the methodology of interest rate management practised in banks would be enhanced. However, we remain critical regarding several points which must be improved in order to avoid an unfair view of the financial position and performance to the users of financial statements. If these problematic points remain unchanged, the entities concerned will still have to explain results which do not correspond to the economic reality.

We maintain our concerns regarding the measurement of all derivatives at fair value which detracts from displaying hedge relationships in an economic reasonable manner. However, if all derivatives must be fair valued and the changes recognised in the profit and loss statement (P&L), some improvements are necessary with regard to the provisions for hedge accounting of interest rate risk on a portfolio basis. We regret that the IASB remains too timid regarding the narrow framework of a fair value hedge, as it is currently laid out as a micro-hedge in IAS 39.

Moreover, the IASB presented in this Exposure Draft four approaches for designation (approach A - D). The approaches A to C are so-called „layer"-approaches while approach D suggested by the IASB is a percentage-approach. Moreover, approach C is a modification (partial hedge of the net position) of the approach B. All these approaches are based on a gross view as an allocation of an amount of assets or liabilities to hedging instruments. However, these approaches do not correspond to modern risk management in banks which is based on the daily determined interest net position. It must be stressed that the banks' interest rate risk management is difficult to present only by the hedge models allowed by the IASB (through fair value hedge accounting or through cash flow hedge accounting).

We consider the proposals regarding the determination of the change in value of a fixed portfolio during the period under consideration as too static compared to the bank-internal risk management which is based on the net positions each determined in short time intervals.

A substantial ease is to create a separate balance sheet item (fair value adjustment) and to renounce to the compulsory allocation of changes in fair value of an interest rate risk hedged portfolio to individual assets and liabilities respectively.

Most importantly, the EAPB would request the consideration of "core deposits" as designatable hedged items. Otherwise, banks with a strong retail business will have to cope with tremendous competitive disadvantages. We do not understand the reason why the IASB seems inflexible on this perspective.

Finally, we greatly miss the inclusion of internal derivatives in this Exposure Draft. Internal derivatives are of paramount importance for the management of the interest rate risk in practice. In our view, internal derivatives should be treated basically like external transactions and we urge the IASB to accept them for hedge accounting.

- **<u>Answers to the questions</u>**

Question 1

The gross view underlying the approaches A - D does not correspond with the bank's risk management which remains problematic, as the selection and the allocation of the hedged item should be in conformity with a bank's risk management. Within the limits of the proposed approaches, the EAPB rejects approach D, as being too complex and without any superiority compared to the other approaches.

Concerning our preferences, we would rather opt for approach A which would induce a substantial simplification of the measurement of ineffectiveness. The EAPB could also consider the combination of the approaches B / C as a workable compromise solution. This latest solution would also be consistent with the overall philosophy of IAS 39.

Question 2

The EAPB shares the IASB view that "core deposits" should not be measured in the balance sheet at an amount less than the one which is payable to the counterparty on demand. But we do not share the view that "core deposits" cannot qualify for fair value hedge accounting beyond the shortest time bucket in which the counterparty could demand repayment.

On the contrary, we consider that "core deposits" which are included in the time buckets on the basis of expected repayment dates according to an entity-individual statistical model must also be designatable as hedged items. The EAPB therefore demands a permission of fair value hedge accounting for portfolios of "core deposits" as well.

Finally, we have noted the willingness of the IASB to limit the comments only to the issues raised by the Exposure Draft. However, some additional issues have to be seen in direct connection with the suggested hedge accounting on a portfolio basis. We would therefore point out several important issues which were already addressed in the past. This concerns particularly the „short cut"-method which should be permitted under the conditions referred to in IAS 39.147 and IAS 39.148. Furthermore, hedging the interest rate risk should also be allowed for „Held to Maturity"-financial instruments, thus requiring to delete the last two clauses in IAS 39.127. We would also suggest to avoid a broadening of the scope of application of IAS 39 to include financial guarantees with regard to their initial recognition and measurement.

IAS 39 could be substantially improved if these comments were given due consideration. In case you would like to discuss any of the above mentioned points in further detail, please do not hesitate to contact us.

Yours faithfully,

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