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Secrétariat
Général

Fédération
des Experts
Comptables
Européens

Rue de la Loi 83
1040 Bruxelles
Tél. 32 (0) 2 285 40 85
Fax: 32 (0) 2 231 11 12
E-mail: secretariat@fee.be

CL 122

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street, 1st floor
GB-LONDON EC4M 6XH

Email: commentletters@iasb.org.uk

Dear Sir David,

Re: Exposure Draft on Proposed Amendments to IAS 39 Financial Instruments – Fair value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) is pleased to submit its views on the Exposure Draft of Proposed Amendments to IAS 39, Financial Instruments: Recognition and Measurement. FEE as a founding organisation of EFRAG has contributed to the EFRAG commenting process by submitting our views to EFRAG on their preliminary comments. Where we are in agreement with the EFRAG comments we refer to these comments, where we are in (partial) disagreement our own views are put forward.

General

We welcome the decision of the IASB to address the issue of hedge accounting since this has been the single most commented subject in the reactions – in writing and during the round table discussions - given to the proposed amendments issued in June 2002, even though no significant changes were proposed in that Exposure Draft to the guidance on hedge accounting. The proposed changes in the current exposure draft are a welcome step in the direction of bringing hedge accounting requirements more in line with effective risk management applied by banks in particular.

The entirety of IAS 39 has been the subject of extensive political debate in Europe and, in view of the anticipated amendments the European Union has not yet endorsed the application of IAS 32 and IAS 39 under the IAS Regulation applicable from 2005. Yet, a comprehensive set of standards that can be applied in Europe is essential to European capital markets and, therefore, a standard on financial instruments is needed. In view of the European timetable it is of utmost importance that agreement can be reached with stakeholders on a standard for financial instruments that is both technically sufficiently robust and at the same time acceptable to entities as a sound base of financial reporting. Time is not on our side. For that reason a pragmatic approach is needed to complete the standard in good time and to facilitate the acceptance and proper application of the standard.

Although we have comments of a technical nature, that are to a large extent similar to those raised by EFRAG, we generally agree with the proposal to apply a fair value hedge accounting model to what is generally referred to as macro hedging.

Our major comments are the following:

- We support the introduction of fair value macro hedge accounting for interest within the IAS 39 framework. As we have indicated above, we favour an approach as simple, clear and practicable as possible, in line with the Cash Flow Hedge accounting methodology outlined in Q&A 121-1 and 2. Since Asset and Liability Management (ALM) methods differ between entities there is a need for a relatively simple and practicable approach that can be aligned with effective ALM practice and that minimises the need for major changes in information systems.

- For testing of effectiveness we favour a layer approach under which ineffectiveness would only arise and need to be measured in situations of an “over-hedged” position. (Within the layer approaches for top shelf positions we consider that approach B and C have in fact an identical basis and are thus further described as B/C.) For that reason we prefer the approach B/C as suggested by EFRAG. Given our preference for a principles based, rather than rules based approach, for the standard, we recommend that the approach to measuring ineffectiveness is to a maximum extent possible left to the discretion of individual entities, allowing them where this is in fact effective, to align the measurement of ineffectiveness to their ALM practice. We do not agree with the suggestion made by EFRAG for further research on how method D could be applied. This is not so much based on the arguments, but more on the feasibility to have this research completed whilst the timeframe for the introduction and proper implementation of IAS 39 on the revised bases is already very short.

- We understand the arguments raised by the IASB in relation to core deposits, like EFRAG, are of the opinion that, in view of the major agreement reached between IASB and stakeholders in financial reporting, it would be advisable to include a further exception in the standard and allow that core deposits (also in cases where a net credit position arises in a time bucket that can only be attributed to these core deposits) are eligible for hedge accounting in the fair value portfolio hedge accounting model as a pragmatic approach.

- We agree with the IASB to adhere to the major principles underlying IAS 39 as stated in the Appendix to the ED. Without being aware of the details of the changes proposed by the Board to IAS 39 following the discussion of the comment letters to the initial Exposure Draft of IAS 39 in the area of hedge accounting, we would like to repeat one comment made in our earlier comment letters on the amendments to IAS 39. We ask the IASB to ensure that in the finalisation of the redrafting of the hedge accounting paragraphs of IAS 39, the principles of the standards are emphasised and clarified, while at the same time providing sufficient guidance and interpretation rather than further rules to support the principles. We recommend that the guidance provided in IAS 39 on when to apply hedge accounting and when this is not allowed is more clearly linked to the criteria for hedge accounting: designation, measurability and effectiveness as stated in the Appendix to the ED and also to the principle that hedge accounting should be aligned with the risk management policy and strategy of an entity where this is in fact effective. Consideration needs to be given as to which unnecessary rules and exceptions to rules can be deleted. The appendix to this ED forms an excellent basis for such an exercise.

- In addition to the proposed fair value hedge model for portfolios, the implementation guidance includes a cash flow hedge model for portfolios with interest rate risk (Q&A 121) and an interpretation for foreign currency hedges of portfolios (Q&A 134-1). In our view, these approaches require a similar status in the standard and the interpretation guidance as this ED’s proposal. When these two approaches are given a similar status in the standard it would also be appropriate to clarify to what extent the two different models for hedge accounting of interest rate risk can be used at the same time next to each other. (see also Other observations)

Answers to the individual questions

Q1. Hedge designation and the resulting effect on measuring ineffectiveness

Draft paragraph 128A proposes that in a fair value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount. For example, it may hedge the change in the fair value of the designated amount attributable to changes in interest rates on the basis of expected, rather than contractual, repricing dates (the repricing date is the date on which the item will be repaid or repriced to market rates). 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 set out alternative methods of designation that the Board considered, their effect on measuring ineffectiveness and the basis for the Board's decisions including why it rejected these alternative methods.
Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness? If not,

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

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

(c) *under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet?*

We agree with EFRAG's response to this question. It remains our belief that for measuring ineffectiveness a layer approach is preferable, rather than the proposed percentage approach, were it only on the basis of the availability of the method at this moment. Within the layer approaches for top shelf positions we consider that approaches B and C have in fact an identical basis and are thus further described as B/C. In applying the layer approach we consider approach B/C (measurement of ineffectiveness in situations of "over-hedging") the preferred method within the three proposals for measuring ineffectiveness outlined in the exposure draft.
We would, however, not object to approach A for practical reasons and because the approach is similar to the cash flow portfolio hedging approach (Q&A 121-1 and 2).

We propose an amendment to method B/C of the layer approach that, in our view, would lead to the approach being more aligned with good ALM practice.
Our proposal is that in the layer approach, ineffectiveness results when the net amount of assets and liabilities - rather than gross assets or liabilities - is lower than the notional amount of the derivative designated as the hedge (a net "over-hedged" situation). The reason is that, unlike the implicit assumption in your comments, changes in expectations will influence both the amounts of assets and of liabilities. In proposing this approach, we are not suggesting that for measurement purposes a net amount be used; this could still be done on the basis of gross assets or liabilities. Our proposal is that for the determination of the amount of ineffectiveness, the net of assets and liabilities and the changes therein are considered.

Given our preference for a principles based, rather than rules based approach, we recommend that the approach to measuring ineffectiveness is not prescribed in detail in the standard, so that entities have the possibility to align the measurement of ineffectiveness to their ALM practice. For

example in practice, banks do not distinguish new business from revisions of repricing expectations as required under the ED and they would wish to base the assessment of ineffectiveness on the total change in a repricing bucket, irrespective of what caused the change.
It would be helpful it IASB could clarify that the layer approach of bucketing assets and liabilities for the purpose of determining a net gap for hedging purposes is based on the assumption of portfolios of assets and liabilities with similar yield curves and not only those with a similar repricing date. This is based on our understanding that similar repricing dates but different original interest periods could be sensitive to different risks.

Q2. The treatment of core deposits

Draft paragraph A30(b) proposes that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair value hedge accounting if they had been designated individually. It follows that a financial liability that the 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.b
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, thus potentially giving rise to a gain on initial recognition? If not, why not?

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

We agree with the practical recommendation made by EFRAG to accept a net position of core deposits for portfolio hedging by way of exception.
The August 2003 ED was issued by the Board in the light of the concentration by respondents to the earlier ED on the issue of hedge accounting. The revised proposals seek to be "...workable in practice…" and to reflect how banks actually manage interest rates within well defined and disclosed risk management procedures. This approach of ensuring, to the extent possible, that financial statements reflect the economic reality of the reporting entity's business, is central to our proposals in relation to core deposits set out hereunder. We are well aware that core deposits are considered in good ALM practice when determining the risk positions. At the same time we understand and agree with the IASB's proposal that only those assets and liabilities would be eligible for portfolio hedging that could on an individual basis also be part of a hedge relationship. One of the conditions for the hedged item is that a portion of the risk could be hedged, however the derivatives' interest rate should not exceed the interest rate hedged, which may often happen with core deposits.
In our opinion the fair value of the core deposits respond to changes in the market interest rates, but in a different way to the response of the fair values of other assets and liabilities.

Notwithstanding the above, we agree with the conclusion contained in the last paragraph of the EFRAG letter and request the IASB to allow core deposits to be included in the application of fair value portfolio hedge accounting "as a pragmatic approach by way of exception on the grounds of needing a consistent accounting solution to a consistent business activity". Important reasons for allowing this are:

- the ED accepts that core deposits are included in ALM in the repricing buckets for different terms other than only the shortest, and
- banks manage the interest rate margin and including core deposits in both risk management and hedge accounting would align hedge accounting more with the purpose of risk management.

Other observations

In relation to the transitional provisions we do not understand what is intended in the last sentence of IAS 39.172. We agree that the results of transactions entered into before the date of amendment relating to these prior periods should not be restated. We fail to see why hedging transactions entered into before the date of amendment cannot be designated as hedges going forward, only now under a different model – the fair value portfolio hedge accounting model. In our view the intention of the transitional provisions from former IAS 39 to the revised IAS 39 need to be clarified. Furthermore, we assume that provisions for first time adoption of this model will be included in IFRS 1.

It should be clarified whether for interest rate risk portfolio hedge accounting, the cash flow hedge accounting model as outlined in the implementation guidance and the fair value hedge accounting model proposed in the ED can be applied simultaneously and therefore whether the analysis of repricing positions into time buckets can be done for a selection of the positions of an entity. We would like to point out that were this permitted, entities could engineer a portfolio in such a way that achieving zero ineffectiveness would be feasible and the difference between the approaches A and B/C would in practice disappear.

We would be pleased to discuss any aspect of this letter you may wish to raise with us.

Yours sincerely,

David Devlin
President