Dexia Group

Management Board
Chief Financial Officer

Paris , the 14th November 2003

Dear Sir,

Dexia is pleased to answer your invitation to comment the International Accounting Standard Board's (IASB) exposure draft of proposed amendments to IAS 39: fair value hedge accounting for a portfolio hedge interest risk (the "ED)"). Dexia is a prominent player in the banking business, especially as the world leader in financial services to local authorities. As such, Dexia is in full agreement with the objectives set by the Board of establishing internationally acknowledged financial reporting standards enabling the users of the financial statements to have a true, fair and comparable view of the activity of companies all over the world.

As far as the ED is concerned, Dexia also first wants to express its agreement with the aim as set in the Background § 3 (b). We believe that finding a way to ensure a fair representation of global hedging strategies conducted by the banking industry in general and Dexia in particular is of utmost importance, and we want to acknowledge the effort conducted by the IASB to find a solution to the issues raised in various comments of IAS 39.

Nevertheless, we do not believe that the ED succeeds in meeting these aims. This can be illustrated in two ways.

Firstly, the designation of the hedged item either as an amount of assets or an amount of liabilities entails that ineffectiveness could arise even if the interest rate exposure of the portfolio doesn't change.
As an example of that, let us consider a portfolio comprising CU 100 of assets and CU 80 of liabilities, i.e. a net exposure to interest rate of CU 20 which is fully hedged by the entity. If during the period, the entity has unexpected repayment of CU 30 of assets and it decides to maintain its interest rate exposure by repaying CU 30 of liabilities, the interest rate exposure remains at CU 20 throughout the period, even if the final exposure is due to the difference between CU 70 of assets and CU 50 of liabilities. In a such a situation, the hedging strategy implemented by the entity is fully effective, whereas the designation of an amount of assets as the hedged item would entail an ineffectiveness of 30% of the variation of the fair value of the hedged CU 20 (cf. §A36).

Secondly, the ED seems to narrow the gap between fair value hedge accounting requirements and management practices by authorizing the hedged item to be designated in terms of an amount of currency rather than individual assets (§128A).
However, both the requirements for calculating ineffectiveness as set in paragraph A36, and the computations necessary to determine what part of amounts included in valuation of the interest risk of the hedged item as set in A26(f) will have to be removed from the balance sheet, lead to a close monitoring of individual transactions included the hedged item.

The follow-up of the variations of a hedged item designated as an amount of asset or liability rather than as a net amount would de facto entail major system changes and not be actually workable.

As a consequence, our answers to your questions will be as follows:

Question 1:

We do not agree with the proposed designation and the resulting effect on measuring ineffectiveness, as we do not believe that designating the hedged item as an amount of assets or liabilities is the appropriate way to designate the hedged item in the portfolio hedge of interest rate risk as it is implemented by Dexia or other banks.

The most prominent fact in that is that we often hedge only a part of the net risk-bearing amount of a portfolio. As a consequence, we consider that each and every variation in the amounts of assets or liabilities not leading to a net amount inferior to the amount hedged is a variation of the un-hedged elements of the portfolio.

The proposal of the ED does not occur to us as correctly reflecting this situation. This can be seen through two examples of effects the designation as described in the ED has on hedging effectiveness measurement that lead to a misrepresentation of a hedge we do consider to be economically sound and effective.

The first is what we have described above pertaining to ineffectiveness measurement in case of variation of the assets and liabilities without variation of the net exposure to interest rate.

The second can be described in an example where the portfolio consists of CU 100 of assets and CU 80 of liabilities, leading to a net amount of CU 20, of which only CU 10 are hedged through derivatives. At the end of the period, the assets remaining have fallen to CU 95. The methodology as described in the ED would lead to recognition of an ineffectiveness, whereas we would not consider this hedge to be inefficient as the net position at the end of the period (CU 15) remains above the hedged amount (CU 10) and would not necessarily entail a modification of our hedging derivatives.

To circumvent such difficulties, we can propose a different approach that we have fully described in our conclusion below.

Question 2:

We believe that core deposits can be included in a hedged portfolio. However, as stated before, we think the appropriate way to account for interest rate hedge accounting of a portfolio is different from what is proposed in the ED. Therefore, the question whether core deposits can qualify for fair value hedge accounting as defined in IAS 39 does not seem relevant to us.

In our opinion, it is the paradigm in which the core deposits occur that creates a confusion. The ED obviously implies that the individual characteristics of a deposit still apply at the level of a portfolio. We do not agree with this opinion: on the one hand, a deposit at individual level has a value that is equal to the amount that is payable on demand of the client.

On the other hand, a portfolio of core deposits that is historically stable over a longer period than a few days enables the bank to invest in fixed-rate interest bearing assets, thus creating value that exceeds the nominal value of the portfolio. This can also be seen in the fact that such value would be included in the price of the transaction if the portfolio were to be sold as a whole to another entity.

In fact, the value of the portfolio is not equal to the sum of the value of its components. Though we understand the reasons given by the IASB in BC 13-15, we believe that they only apply at individual level and that they should not preclude core deposits considered as a portfolio to be included in the net amount that could be designated as the hedged item.

For the same reasons, we concur with the IASB's opinion that no profit or loss should be recognized at initial recognition: in this case, the fair value would have to be computed at individual level, resulting in this fair value being equal to the amount received from the depositor.

In conclusion, we can propose a hedge accounting that we think would appropriately describe the portfolio hedge of interest risk as we or other similar financial institutions conduct it. It should include the following characteristics:

- So as to avoid any confusion with other rules set for fair value hedge, we think it would be useful to set this as a new hedge accounting possibility, separate from fair value hedge or cash flow hedge.
- The entity should define the portfolio it wishes to hedge and calculate its net amount exposed to risk. As proposed in §A26(b) of the ED, the portfolio would be analysed into maturity time periods based on expected repricing dates.
- The portfolio could include assets and liabilities qualifying for fair value hedge of an interest rate risk and core deposits.
- A portion of the net amount of the portfolio would be designated by the entity as the hedged item.
- The hedging derivatives would be evaluated at fair value in the balance sheet (thus fully complying with the fair value measurement of all derivatives which is an underlying principle of IAS 39).
- Ineffectiveness in the hedging relationship should occur if the net amount of the portfolio at the end of the period became inferior to the amount of the hedged item:
    - In case of an effective hedging relationship, the valuation of the hedged item would be equal to the portion of the fair value of the hedging derivatives that pertains to the interest rate hedged.
    - In case of an ineffective hedging relationship, the valuation of the hedged item as described above would be corrected by a ratio equal to the net amount of the portfolio at the end of the period divided by the hedged item.

To illustrate this ineffectiveness calculation, let us take a portfolio of CU 100 of assets and CU 80 of liabilities, thus having a net position of CU 20. The hedged item designated by the entity is a net position of CU 10. At the end of the period, the change of fair value of the hedged item due to changes in interest rates is of CU 2.

If at the end of the period the assets have fallen to CU 80 and the liabilities to CU 65, no ineffectiveness occurs as the new net position of CU 15 remains superior to the hedged item of CU 10. The change of fair value of the hedged item recognized in the balance sheet is then of CU 2.
If at the end of the period the assets have fallen to CU 70 and the liabilities to CU *65*, the ratio is then of CU 5 (the remaining net position) divided by CU 10 (the hedged item), i.e. 50%. The change of fair value of the hedged item due to the risk hedged recognized in the balance sheet would then be of CU 2 multiplied by 50%, i.e. CU 1.

We believe that this proposal would meet both the objectives of a workable representation of the hedges made by entities that manage interest rate risk on a portfolio basis and of meeting the principles that underlie IAS 39, as set in paragraph 3 of the background section of the ED.

If a representative of the International Accounting Standards Board wishes to discuss the contents of this comment letter or other matters that may arise during the re-deliberations of this proposed financial reporting guidance, please contact Mr. Thierry Nederlandt, head of accounting and consolidation, phone +32.2.213.58.9 1 - email : thierry.nederlandt@dexia.com

Your sincerely,

Rembert von LOWIS

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK