CRÉDIT AGRICOLE S.A.

LE DIRECTEUR GENERAL ADJOINT

Paris, le

November 14th 2003

DCC/NP 2003 .083

01.30.44.79.55
Exposure Draft of Proposed
Amendments to IAS 39:
Financial Instruments

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

Dear Sir,

You recently submitted a series of proposed amendments to IAS 39 (Financial Instruments: Recognition and Measurement) for public comment, with specific reference to fair value hedge accounting for a portfolio hedge of interest rate risk. The Credit Agricole Group welcomes this initiative.

Please find enclosed our answers to the questions raised in the Exposure Draft, along with detailed comments.

In addition, this comment letter draws your attention to the following issues:

We are pleased that, among other things, the amended section of IAS 39 recognises the general principle of macro-hedging, a technique used by banks on a daily basis for many years.

We do, however, regret that the practical measures adopted by the IASB will actually cancel out the benefits of this general recognition. This is because the IASB has not seen fit to reconsider what it considers to be the underlying principles of IAS 39, namely:

a) derivatives should be measured at fair value;

b) all material hedge ineffectiveness should be identified and recognised in profit and loss;

c) only items that are assets and liabilities should be presented as such in the balance sheet. Deferred losses are not assets, and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be presented in the balance sheet.

As we already mentioned in our response to the last Exposure Draft, and also at the March 2003 roundtable discussions, the principle of fair-valuing all derivatives, with an entry in the balance sheet and / or income statement, is ill-suited to bank intermediation. We believe that the method used to measure hedging derivatives should minor that employed to value the instruments they hedge. In other words, if a hedged instrument is not fair-valued - which is usually the case for instruments used for bank intermediation purposes - then neither should the associated hedging derivatives be fair-valued; they should be measured in the same way as the hedged instruments. This naturally concerns the valuation of macro-hedging derivatives, which hedge intermediation activity as a whole. Most of the financial instruments used in this activity are recognised on the balance sheet at cost or amortised cost. More precisely, since the aim of asset-liability managers is to hedge away a risk to the interest margin between assets and liabilities recorded at cost or amortised cost, we fail to understand how the IASB can require that hedging derivatives be measured at fair value. This would mean that different valuation and accounting methods will be used for financial assets and liabilities that are used to determine the net position they are intended to hedge.

In our considered opinion, the reason behind the IASB's principle, namely that, without fair value measurement, financial-statement users have no information about derivatives, does not apply in blanket fashion. Most European accounting standards provide that these derivatives be recorded off-balance sheet and that all necessary information be provided in the notes to the accounts. Accordingly, financial-statement users already have all the information they need.

The IASB’s incomplete vision has resulted in a standard which, if applied automatically, would misrepresent banks’ core businesses and impose constraints that are inconsistent with their activities.

Further, while the principle of macro-hedging has been accepted, there has been no concomitant revision of the hedging methods currently recognised by the IASB, i.e.

- fair value hedging
- cash flow hedging

In the context of macro-hedging, and on the basis of the principles currently set out in IAS 39, a bank would have to recognise either a fair value hedge or a cash flow hedge for the same hedging transaction. If these principles were to be enforced, banks could choose the option they wish. This runs counter to the aim of accounting standardisation. Further, it shows that the general treatment currently being promoted is inadequate and does not address the specific characteristics of bank intermediation.

Similarly, while the proposal rightly permits provisional future cash flows to be recorded in a general manner on a schedule, it disallows this method for demand deposits, pretexting that the fair value of such core deposits cannot change. This doctrinal stance means that the treatment of assets and liabilities is inconsistent.

For these reasons, we consider that the new practical proposals put forward by the IASB do not respond sufficiently to the concerns of our bank.

We are available to discuss these matters with you in greater detail, or to sit on a working group, in order to produce a standard that gives greater recognition to the activities of credit institutions.

Yours truly.

Group Chief Financial Officer

Gilles de Margerie

Question 1: 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?

Designation of the hedged item

We appreciate the IASB's aim of coming closer to the risk management methods used by banks, namely overall management of financial exposures on a portfolio of assets and liabilities.

However, although it is recognised that specialists in asset-liability management (ALM) work with a net position per maturity rather than with a gross position, and that demand deposits are counted when calculating a net position, draft paragraph l28A ultimately proposes that hedged items should be designated precisely in terms of an amount of financial assets or liabilities for a given maturity time period. Further, the level of hedging is assessed proportionally. This clearly contradicts the goal sought by banks when using a macro-hedge, and it reflects a lack of awareness of the real financial world. Macro-hedging seeks to cushion the impact of interest rate risk on the total interest margin between assets and liabilities recorded at cost. Broadly, however, interest rate risk in a maturity period occurs when the amount of fixed-rate assets differs from the amount of fixed-rate liabilities. Accordingly, identifying a specific balance-sheet item to justify the hedging relationship does not square with ALM practice. In fact, it defeats the purpose of offsetting assets and liabilities, by comparison with a micro-hedging approach. Only net positions can be designated and recognised in connection with the macro-hedging relationship.

Basically, the reason for designating an amount of assets or liabilities for a given maturity time period, as the IASB advocates in the Exposure Draft, is that such an approach stresses the legal characteristics of each component of the macro-hedging portfolio. The Credit Agricole Group regretfully notes that, in adopting this approach, the Board has overlooked the contribution of the statistical techniques on which the methods for modelling the hedgeable net position are partly based.

Effect on measuring ineffectiveness

The consequences for ineffectiveness testing vary greatly depending on whether one is reasoning truly on a net basis or on a gross basis. This is important insofar as an ineffectiveness test must reflect a bank's management intentions. Since the aim of macro-hedging is to reduce a net position (total hedging is not an end per se), regardless of movements on assets and liabilities, ineffectiveness testing should consist solely in checking that hedging items do not reverse or increase the net position. Accordingly, increases or decreases in the level of hedging that result from adjustments to underlying assumptions and amounts at risk — the overall net position is always reduced after hedging — cannot be considered to cause ineffectiveness.

This aim cannot be achieved if an amount of assets (or liabilities) alone is identified as a hedged item. If this is the case, then neither the fungibility of assets and liabilities nor the effects of offsetting between them will be taken into account. By way of illustration, it is totally feasible for a bank to scale back its forecasts for loan prepayments (and thus increase the provisional amount of assets) while at the same time recording fewer withdrawals from deposit accounts (which spurs it to increase provisional liabilities). In this illustrative example, the net position remains stable even though the asset and liability items change. Under the IASB's proposal, the bank would have to recognise ineffectiveness, even though the risk it is trying to hedge has not altered. In sum, reasoning on a net-position basis makes it possible to strike a balance between the economic approach and accounting treatment.

Determining the net position

To reach the goal of reducing the interest rate risk to the interest margin between asset and liability rates, all assets and liabilities that contribute to risk formation must be taken into account, without exception.

Similarly, when calculating the schedule for each item carried on the balance sheet and used to determine the net position by maturity time period, it is vital to take account of customer behaviour - not just in terms of loans (a fact accepted by the Board for recognising provisional loan repayment rates) but also in terms of demand deposits. Only the combined effect of both behaviours is meaningful.

The Credit Agricole Group believes that the IASB should develop accounting principles that permit banks to continue with their macro-hedging activities in the same way as at present. This approach, which has been in place for many years, is not confined to a purely legalistic view of individual financial instruments; it also incorporates economic, financial and statistical factors. Banking regulators have given their approval to the asset-liability management techniques currently in use in Europe because these technics have proven their reliability and efficiency over the years

If not,

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

The Credit Agricole Group acknowledges that the IASB has taken a commendable step by recognising the possibility that a hedged item can be designated in terms of an amount of assets or liabilities in a given maturity time period rather than as individual assets and liabilities. However, macro-hedging consists in protecting against the interest rate risk engendered by the <u>net position</u> resulting from the bank's entire balance sheet. To avoid introducing a distortion between interest rate risk management and accounting treatment, the hedged item must correspond to the amount of the net position, by maturity period, and not to a particular balance sheet item. Designating an asset or liability makes no sense economically and produces inconsistent results in ineffectiveness tests.

(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 Credit Agricole Group agrees with the principle laid down in IAS 39 whereby all material hedge ineffectiveness must be recognised in profit or loss for the period; and we endorse that principle <u>on condition that the ineffectiveness recorded in the accounts accurately reflects the real economic and financial situation arising from the decisions taken by ALM specialists</u>. For this reason, our Group cannot understand or accept the Board's argument that ineffectiveness results as much from over-hedging as from under-hedging. The principle of symmetrical ineffectiveness has no justifiable basis in the light of banks' financial management techniques.

The principle recommended by the Credit Agricole Group is that ineffectiveness should be materialised if the actual objective of the macro-hedge is frustrated. Because the management intention behind macro-hedging is primarily to reduce the bank's net position, ineffectiveness will be recognised if the hedging item either reverses (in the case of over-hedging) or increases (inappropriate hedging) the net position. No ineffectiveness arises in the case of a position that was initially partially hedged and then subsequently amended upon rescheduling while maintaining a partial hedge.

Further, where ineffectiveness is recognised, it is because a portion of the hedging derivatives are considered to have formed a trading position since they were assigned to a hedge (when net positions were last measured). The ineffectiveness measure to be used in the balance sheet and the income statement must be equivalent, in the case of over-hedging, to the value difference between designated derivatives and a hypothetical derivative that is a perfect hedge, and, in the case of inappropriate hedging, to the total value of the derivatives.

In the case of a partial hedge, the balance sheet value corresponds to the value of the "hedged net position", i.e. the converse of the value of the hedging derivatives. This approach is similar in some respects to approach C. However, it differs fundamentally insofar as it can be applied only to the "overall net position" (and not to a chosen portion of the balance sheet). The overall net position must incorporate all asset and liability items (including demand deposits and their equivalents).

This solution is therefore entirely consistent with the underlying principles of IAS 39.

(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?

In the method we propose, the balance sheet line item (accrued assets or liabilities) referred to in paragraph *154* will be symmetrical to the value of the derivatives used to hedge the net position if the hedge is totally effective.

Since the value of a swap starts at 0 and finishes at 0, regardless of changes in interest rates, the amounts presented in this line item will automatically be removed from the balance sheet as derivative transactions are progressively extinguished.

In the event of ineffectiveness arising from over-hedging, the value used for calculation purposes will be the value of a hypothetical derivative that hedges the entire net open position. In the case of ineffectiveness arising from inappropriate hedging, no value will be recorded for the net position.

<u>Question 2: The treatment of core deposits</u>

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 (Le. 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?

As mentioned in our answer to Question 1, the aim of macro-hedging is not to hedge value changes but to protect against margin risk measured on the basis of the overall net position. This implies firstly that demand deposits must be considered as hedgeable, like all assets and liabilities without exception, and secondly that managers do not seek to hedge away the effects of changes in the value of prepayment options but simply their effects on the margin.

Consequently, the Credit Agricole Group cannot accept the IASB's proposal whereby a financial liability that a 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. The method put forward by the Board does not address the problem raised by banks, whose core business involves transforming liabilities into assets. For retail banks in particular, this includes demand deposits.

Admittedly, the possibility of modelling assets and liabilities on the basis of expected rather than contractual maturity (with no impact on entry values) is an unquestionable advance because it means that accounting documentation will remain consistent with management practice. However, disallowing demand deposits as hedgeable items imposes a major and unwarranted constraint. In this respect, the procedures used to model demand deposits are accepted by regulators because they reflect an inescapable financial reality.

The mismatch between the IASB's proposals and those put forward by the banking industry is attributable to the fact that when a bank's ALM specialists manage an overall interest rate position, they do not try to hedge away the risk of changes in the fair value of financial assets and liabilities; they are merely protecting the net interest margin. However, the Board has made no provisions for the hedging of interest margins.

Accordingly, the reasons for including demand deposits in the schedule is certainly not to hedge value changes, but simply to identify the outstanding amounts that are exposed to margin risk for a given period of time. That the IASB should exclude demand deposits demonstrates once again that a legalistic approach - demand deposits are legally refundable at any time — has taken precedence over an approach rooted in economic reality. From a statistical perspective, the research carried out so far has resulted in the modelling of flow equations on demand deposits, thus making the implementation of a macro-hedging strategy possible.

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?

Yes, we agree with the Board's decision that demand deposits should be recognised at face value. This does not mean, however, that these deposits cannot be included in the macro-hedging portfolio - a point we have already argued in detail.

(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?

No, we do not consider that including demand deposits in the overall interest rate risk management schedule would be equivalent to recording a gain when a demand deposit is initially recognised. The fair value of a demand deposit is nothing more or less than the amount payable on demand.

In the same way that a loan is recognised on a nominal basis - something that the ISAB has explicitly accepted - regardless of how it is incorporated into the bank's schedule, the same applies to demand deposits.

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 specified in the answer to Question 1, all items in the asset/liability portfolio forming the overall net position that can be macro-hedged, either partially or totally, are fungible. In the approach that we propose, therefore, no specific treatment is adopted for value changes in demand deposits relative to value changes in the other items in the macro-hedged portfolio. Thus a change in value of this hedged item, which includes demand deposits in particular, is recorded in an accrual account (see Question 1 c)) and cannot be allocated to a specific balance-sheet item.

In other words, neither the fair value hedging documentation referred to in this Exposure Draft, nor the cash flow hedging documentation referred to in IGC 12 1-2, takes into account the real aim of ALM.

As mentioned before, the Credit Agricole Group stresses that the methodology proposed by the IASB for overall hedging of portfolios of financial assets and liabilities deviates significantly from current practices, which have been implemented successfully by the banking industry for many years. This mismatch is certainly attributable to an approach that emphasies the legal substance of transactions rather than their economic reality. This seems to run counter to the aims of International Financial Reporting Standards.