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30 Cannon Street, London EC4M 6XH, United Kingdom

Fortis Group Position Regarding Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

Following to your invitation to comment on the above Exposure Draft, Fortis has carefully examined the proposed amendments to IAS 39.

Our conclusion is that, whilst the Board's intention was to develop an approach that can be more readily be used for portfolio hedging, proposed amendments fail to consider the risk management strategies used by banks and the main objective of the Exposure Draft, which was to come up with a workable approach that would not require entities to make major system changes. In our opinion, the proposed approach does not reflect economic reality and does not allow data captured for risk management to be used in preparing financial statements and still requires major systems changes for banks.

Question 1

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. However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (eg 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

We believe the proposed designation approach does not consider the reality of banks' hedging strategies, which consist in hedging an overall net position. The immediate consequence is a complete and undesirable disconnection between the risk management strategies and the accounting.

Banks can use various risk measurement and management techniques with respect to interest rate risk, depending on the complexity of their interest rate risk exposures. The most widely used approach consists in:

(i) distributing interest-rate sensitive assets, liabilities and interest rate sensitive derivative positions into a certain number of predefined time bands according to their *expected* maturity or next repricing date. Interest-rate sensitive assets and liabilities comprise all variable and fixed rate instruments, with fixed maturity and also with no stated maturity (demand deposits). The fixed leg and the variable leg of interest rate swaps are considered separately for inclusion in the repricing brackets;

(ii) identifying the repricing brackets for which asset positions exceed liabilities positions (or liabilities positions exceed assets positions);

(iii) entering into derivatives (eg interest rate swaps) to reduce the gaps for both the maturity bracket in which the floating leg of the swap will be included and the maturity gap in which the fixed leg of the swap will be included.

We believe it is not appropriate to designate the hedged item as a portion of assets or liabilities for accounting purposes because this is contrary to the reality of the risk management strategy described above. The aim of such risk management strategy is to measure and manage the interest rate sensitivity of both earnings and economic value of the net worth with respect to interest rates variations.

From the economic perspective, this strategy aims at decreasing the sensitivity of the fair value of the bank to fluctuations in interest rates. In economic terms, the hedged item is the fair value of the bank, and not any asset or any liability position.

The Board's proposed macro-hedging approach would introduce the complete disconnection between risk management and accounting. Furthermore the proposal does not allow data captured in risk management systems to be used in preparing financial statements and still requires major systems changes for banks.

Ineffectiveness measurement

While we agree with the rule of recording the derivative in the balance sheet at fair value with changes through P&L, we do not agree with the proposed method of measuring ineffectiveness, because it does not reflect the risk management practices in banks. In the Board's proposed effectiveness measurement, any change in the risk of prepayment from initial expectations creates ineffectiveness. Whilst we agree that prepayment risk and interest rate risk should be considered together, we believe ineffectiveness only arises when the change in prepayment risk creates over-hedging situations.

In our opinion, the adjustment of the hedged position should mirror the change in the fair value of the derivative as long as the hedging derivative reduces the gap in both maturity brackets impacted by it. In case of over-hedging, banks must be able to choose a method of measuring ineffectiveness that is in line with risk management strategies.

Fortis proposed approach

We propose the following model:

- **ALL** interest-sensitive assets and liabilities (fixed rate, floating rate, with or without maturity) are grouped into time bands based on their expected maturity or repricing date. If the bank uses a replicating portfolio methodology to calculate the risk of demand deposits, the cash flows of this replicating portfolio should be put into the corresponding time buckets.
- To the extent that the derivative (eg interest rate swap) reduces the bank's exposure to changes in interest rates, it is considered an effective hedge. Changes in the fair value of the derivative are taken to income, and a mirror adjustment is recorded to neutralize the income statement impact (fair value hedge model).
- Ineffectiveness arises when entering into a derivative transaction leads to changing the position on a time band from long to short or vice-versa.
- Ineffectiveness is measured as the portion of the change in fair value of the derivative that corresponds to the portion of the notional in excess of the maturity gap being hedged.

Illustration

To illustrate the above approach, we assume the following: all interest rate sensitive assets and liabilities of the bank are allocated to predetermined maturity brackets based on their expected maturities. The banks determines that:

- in the 3 - 6 months maturity bracket, there are CU 150 of assets (composed of CU 100 of variable rate loans and 50 of fixed rate bonds) and CU - 200 of liabilities (deposits, including deposits available on demand). The gap for this bracket is CU - 50

- in the 5 - 6 years maturity bracket, there are CU 200 of assets (e.g. fixed rate bonds and fixed rate mortgages with expected maturity within the 5 to 6 years bracket) and CU 130 of liabilities (deposits). The assets/liabilities gap is CU +70.

To reduce the interest rate risk resulting from these maturity gaps, we assume that the bank enters into a payer swap on a notional of CU 40. The fixed payer leg of the swap is included in the 5 - 6 years maturity bracket and the variable receiver leg of the swap is included in the 3 - 6 months maturity bracket. The gap in the 3 - 6 months maturity bracket is CU - 10 after the hedging transaction (compared to CU - 50 prior the hedge), while the gap in the 5 - 6 years maturity bracket amounts to CU +30 (compared CU +70 prior the hedge). Thus, the interest rate risk of the bank was reduced in both maturity brackets.

As long as the bank is under-hedged in the maturity brackets impacted by the swap (i.e. as long as the notional of swap is lower in absolute terms than the gap or, in our words, as long as the position is not reversed as a result of the derivative), there is no ineffectiveness, because the impact of the derivative is to decrease the overall risk of the bank. In this case, the hedge is fully effective from an economic point of view and therefore we propose to offset the change in the fair value of the swap recorded in profit or loss by a minor adjustment of the hedged net position.

In ease of over-hedging in one of the maturity brackets (i.e. if the notional of swap is higher in absolute terms than the gap), we agree ineffectiveness will arise and should be recognized in P&L. The amount of ineffectiveness recognized in profit or loss would be the portion of the change in fair value of the derivative that corresponds to the portion of the notional in excess of the maturity gap being hedged.

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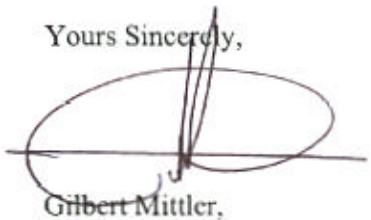
As a conclusion, our main comments are that the final proposal should reflect the risk management strategies of banks and should not require significant system changes. In particular, it should allow banks to designate the hedged item as a net position and to choose the most appropriate technique of measuring ineffectiveness.

Yours Sincerely,



Gilbert Mittler,
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