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ING GROUP

EXECUTIVE BOARD

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Chief Financial Officer

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International Accounting Standards Board
30 Cannon Street
London
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Date
1 November 2002

Subject
Exposure Draft of Proposed Amendments to
"IAS 32: Financial instruments: Disclosure and Presentation" and "IAS 39: Financial Instruments: Recognition and Measurement".

Dear Sir David,

We appreciate the opportunity to provide comments on the Exposure Draft of Proposed Amendments to "IAS 32: Financial instruments: Disclosure and Presentation" and "IAS 39: Financial Instruments: Recognition and Measurement". We agree with the necessity to develop an amended standard for the important area of financial instruments. However, we believe that several important issues for banks and insurance companies are not adequately addressed in the current exposure draft. We have included our comments below. These are related to the following subjects:

1. general comments
2. hedge accounting
3. insurance contracts
4. valuation of financial assets
5. impairment of financial assets

Our response to the questions in the "Invitation to Comment" paragraphs in the exposure draft is included in the appendix.

1. General comments on exposure draft of proposed amendments to IAS 32 and IAS 39

Need for a principles-based approach
IAS 32 and IAS 39, together with the extensive implementation guidance, constitute very detailed, rule-based accounting standards. We welcome the initiative of the IASB to improve

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the current requirements for financial instruments, but we are concerned that the current amendments do not resolve the complexity and rule-based approach of the standards. In our opinion, the purpose of any accounting standard is to present in substance a true and fair view of the economic performance and financial position. An accounting standard should not change the way a company is managed.

The requirements of IAS 39 (especially the requirements on hedge accounting) will either produce economically insensible financial information or will result in changes to business management that are economically not wanted. In our opinion, IAS 32 and IAS 39 should be replaced by a more principles-based approach rather than a rule-based approach, making them consistent with other IAS standards and the IASB Framework.

Status of the exposure draft
Many of the issues in the existing IAS 39 standard, which have been addressed by the Implementation Guidance Committee ("Q&A's") have neither been addressed in the new exposure draft nor has it been confirmed whether these will remain valid as implementation guidance. The exposure draft of amendments to IAS 39 indicates that the status of individual Q&A's will be reassessed when the amendments are finalised. We are of the opinion that it is unacceptable to decide on the status of certain important Q&A's only upon the finalisation of a new standard without incorporating these changes in the exposure drafts.

2. Hedge Accounting

General
In our opinion, IAS 39 fails to recognise well-established practise of portfolio risk management and asset-liability management and is therefore not suitable for financial institutions with large volumes of transactions in financial instruments. We believe that the current requirements on hedge accounting are unnecessary complex and may result in economically insensible results. This mainly results from the basic approach of recognising all derivatives at fair value, irrespective whether these derivatives are held for the purpose of hedging other instruments that are valued at (amortised) cost. This approach results in detailed and complex requirements, asymmetry in accounting and economically irrelevant volatility in equity and net income. In our opinion, hedge accounting requirements should be principles-based and should be aligned with economically sensible risk management procedures. Hedge accounting requirements should enable the currently existing approaches to company-wide risk management and should not force companies to change their current sophisticated risk management practices for accounting purposes only.

Accounting for hedged item following the hedged instrument
in our opinion, the basic approach of the hedged item following the hedging instrument should be reversed and the hedging instrument should follow the hedged item. This would mean that derivatives that hedge other instruments that are recorded at amortised cost, are measured at accrual basis. This method ensures that gains and losses on the hedge are recorded at the same time as the gains and losses on the hedged item. However, it prevents that hedged items that

are normally valued at amortised cost are being valued partly at fair value only because these are being hedged (as required by IAS 39).
The very complex requirements on fair value hedges and cash flow hedges in the exposure draft would then be unnecessary and the artificial distinction in accounting treatment of fair value hedges and cash flow hedges would be unnecessary. The fair value of the hedging derivative would then be disclosed in the notes, which effectively provides better information to the users of the financial statements.

Restrictions on hedge accounting
IAS 39 includes several restrictions on hedge accounting of which we fail to see the rationale. These restrictions include:

- *Prohibiting the hedge of interest rate risk on held-to-maturity assets.*
  As the held-to-maturity portfolio also forms part of the overall risk exposure analysis, hedging the related interest risk may economically be sensible. In our opinion this hedge should not be prohibited for accounting purposes only.
- *Prohibiting the use of non-derivative financial instruments as a hedging instrument*
  In current practice, the balance sheet of banks and insurance companies is actively managed with various types of financial assets and liabilities (including non-derivative financial instruments). Where effective hedging may be obtained with non-derivative financial instruments, we do not see any reason to specifically exclude these from hedge accounting.
- *Prohibiting the use of internal transactions as hedge.*
  Internal hedges are currently used under well-established procedures between portfolios under operationally segregated responsibilities. These internal transactions between separately managed trading and banking books are in substance similar to external transactions. IAS 39 forces banks to engage in expensive external transactions where they could also utilise positions within the group with the same effect. In our opinion internal hedges should be allowed, under the same criteria as external hedges.
- *Prohibiting the use of portfolio-based macrohedging*
  Banks currently hedge overall positions on the basis of generated cash flows, rather than individual balance sheet items. IAS 39 would introduce accounting models and requirements that are completely different from those used in operational management. Banks have developed sophisticated hedging/risks models that support the current risk management approach to hedging. The workaround given in Q&A 121 does - to a certain extent - make possible the hedge of portfolios but in doing so, the accounting does not necessarily reflect anymore the result of the risk management activities of the bank.

In our opinion, the criteria for hedge accounting should focus on adequate designation and effectiveness testing. The specific restrictions result in complex, rule-based requirements that prohibit hedge accounting for economically effective hedge transactions. Hedge accounting should be allowed when general criteria of designation and effectiveness are met; specific exemptions on certain types of hedges, hedging instruments and hedged items do not serve any economic purpose.

3. Insurance contracts

There is considerable debate on the definition of insurance contracts and the question whether certain insurance contracts should be accounted for as financial instruments under IAS 32 and IAS 39. The definition of insurance contracts in the exposure draft of amendments to IAS 32 is different from that in the draft statement of principles for insurance contracts ("DSOP"). Although under the definition in IAS 32 certain insurance contracts will be in the scope of IAS 39, IAS 39 does not provide any specific guidance on accounting for insurance contracts. As a financial instrument under IAS 39, the liability arising from insurance contracts would have to be accounted for at amortised cost or at fair value. This treatment is inconsistent with many current locally accepted accounting practices and with the DSOP. In our opinion complete and consistent accounting requirements for insurance contracts should be defined in a final standard for insurance contracts. This would prevent that insurance companies need to implement a new definition of insurance contracts both in 2005 and upon implementation of a new insurance standard. In the meantime, we strongly object to including in IAS 39 any insurance contract that currently falls under the definition of insurance contracts under local legal/regulatory definitions. We also refer to the letter of the European Insurance Group of 18 September 2002, which includes a proposed "interim solution" for the period between 2005 and the effective date of a new standard on insurance contracts.

4. Valuation of financial assets

Held-to-maturity investments
Investment portfolios of debt securities held by banks and insurance companies are strategic investment portfolios held for continuing use in the business as part of a long-term investment strategy. These investments are held against long term insurance liabilities and funds entrusted to the banking operations. As these investments are held in a long-term strategy against liabilities measured on a cost basis, we are of the opinion that these investment portfolios of debt securities should be measured at amortised cost. Under IAS 39, this is only allowed for held-to-maturity investments. However, the current requirements for held-to-maturity investments in IAS 39 conflict entirely with the way in which these portfolios are managed in practice. Meeting these criteria would impose limitations on investment management practices that are not economically sensible. On the other hand, classifying these investment portfolios as available-for-sale would result in a mismatch between assets and liabilities and create market value fluctuations in shareholders' equity that have no economic substance. We are of the opinion that IAS 39 should allow accounting at amortised cost for investment portfolios of debt securities held to match long term liabilities of banks and insurance companies. This could be effected either by amending the held-to-maturity criteria or introducing an additional category of investments specifically for assets matching liabilities of financial institutions.

Fair value option
We appreciate the introduction of the option to measure any asset or liability at fair value. We disagree however with the one-time irrevocable designation at initial recognition. In our opinion, transfer between categories should be allowed when a change in circumstances substantiates such redesignation. This is especially relevant for investments held to match long term liabilities of insurance companies. The introduction of a new standard for insurance liabilities may fundamentally change the measurement of insurance liabilities and may also impact the decision whether or not to use the fair value option for the matching investments. Redesignation after initial recognition should therefore be allowed.

Purchased loan portfolios
Under IAS 39, loans originated by the entity are classified as “originated loans”, valued at amortised cost. Purchased loans, originally issued by another entity, may not be classified as originated loans. Therefore, purchased loan portfolios are either classified as available-for-sale (at fair value) or held-to-maturity (for which very strict criteria apply). As a result, originated loans and purchased loans, which are held for the same business purpose, are accounted for differently. We consider this inconsistency inappropriate, hi our opinion, purchased loan portfolios that are held for the same purpose as originated loans should have a similar accounting treatment.

5. Impairment of financial assets

Provisioning for loan losses
The proposed requirements for impairment on financial assets carried at amortised cost introduces a radical change from the basis on which loan loss provisioning is determined under current practice. Determining loans loss provisions on a fair value-based approach (discounting of expected future cash flows) is incompatible with measuring originated loans at amortised cost. Furthermore, in our opinion the practical consequences for operational systems have not been adequately considered. The proposed impairment rules differ substantially from international practice (including US GAAP) and the direction in which provisioning is taken by the Basle Committee. We do not believe that such inconsistencies should be introduced.

Impairment of available-for-sale financial assets
The proposed amendments to IAS 39 introduce one new indicator of impairment: “a *significant and prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment* ". This additional paragraph may suggest that impairments on equity investments may be required solely based on the fact that the fair value has been below cost for a longer period of time. This would result in a “mathematical” determination of impairment that ignores the investment strategy and financial position of the issuer. The requirements should be amended such that impairment is only required if in substance, after considering all impairment criteria mentioned in paragraph 110, the investment is considered impaired.
Furthermore, the proposed amendments to IAS 39 introduce a new requirement that impairment on available-for-sale financial assets may not be reversed. In our opinion, changes in circumstances

that reflect new information on the fair value of any previously impaired assets should be reflected in the financial statement and therefore impairment should be reversed if and when changes in circumstances support such reversal. We also note that the current prohibition of reversal is inconsistent with the reversal of impairment on financial assets carried at amortised cost (IAS 39) and the reversal of impairment on other assets (IAS 36).

6. **Internal deals**

The exposure draft of amendments to IAS 39 prohibits transfers between the trading and banking books. In practice however, such transfers are used as part of the well-established risk management procedures in banks. As a result, banks will be forced into external transactions with third parties instead of using internal transfers to react on changes in risk profiles. This unnecessarily crates transaction costs and credit exposure. Given the strictly separated management of trading and banking portfolios, transfers (at fair value) between banking books and trading books should be allowed.

We strongly feel that the comments mentioned above should be reflected in the amendments to IAS 32 and IAS 39 before the revised standards become effective. We are available for any further discussion of our comments.

Yours sincerely,

APPENDIX: ANSWERS TO QUESTIONS RAISED IN THE EXPOSURE DRAFT

a. IAS 32

Question 1: Probabilities of different manners of settlement
Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non- occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).
In our opinion, the classification of a financial instrument as a liability or as equity should indeed be based on the substance of the contract. The requirements in IAS 32 should reflect this basic principle. The additional guidance and examples are unnecessarily complicating and distract the focus from the general requirement of economic substance.

Question 2: Separation of liability and equity elements
Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair- value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?
In our opinion, the option to use the relative fair value method should be retained.

Question 3: Classification of derivatives that relate to an entity's own shares
Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?
Yes, we agree.

Question 4: Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard
Do you believe it would be useful to integrate the text in IAS 32and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)
We would welcome one comprehensive standard for financial instruments.

b. IAS 39

Question 1: Scope: loan commitments
Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IA S 39?
Yes, we agree.

Question 2: Derecognition: continuing involvement approach
Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?
No, we do not agree with this change. “Continuing involvement” is a conceptually incorrect criterion for derecognition and will lead to the (continued) recognition of assets and liabilities that do not meet the criteria of the IASB Framework. In our opinion, the derecognition of assets and liabilities for which there is continuing involvement should be based on the fact whether significant risks and rewards have been transferred. If this is the case, derocognition should be applied irrespectiv e of the continuing involvement.

Question 3: Derecognition: pass- through arrangements
Do you agree that assets transferred underpass- through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?
Yes, we agree.

Question 4: Measurement: fair value designation
Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?
Yes, we agree. However, for the reasons set out above we are of the opinion that the one-time designation at initial recognition should be removed. Redesignation after initial recognition should be allowed.

Question 5: Fair value measurement considerations
Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95-100D of the Exposure Draft? Additional guidance is included in paragraphs A32-A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?
In general we agree. However, paragraph 99 assumes that for actively traded instruments the fair value is always equal to the quoted market price. In our opinion there are however exemptions where the quoted market price is not the best estimate of fair value (e.g. in

holdings that are large in relation to trading volumes). We believe that in such situations it should be allowed to use an alternative method for estimating fair value.

Question 6: Collective evaluation of impairment
Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A- 113D?
We agree with the proposal to allow measuring impairment on a portfolio basis. However, we do not agree with the requirement to do so. If adequate specific provisions have been set on an individual basis, it should be allowed but not be required to measure impairment on a portfolio basis.

Question 7: Impairment of investments in available-for-sale financial assets
Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?
No, we do not agree. In our opinion impairments should be reversed if the circumstances have changed. The amendment that impairments on available for sale investments may not be reversed is inconsistent with the reversal of impairment on originated loans and instruments held to maturity. Furthermore, it is inconsistent with the reversal of impairment on other assets covered by IAS 36 "Impairment of assets".

Question 8: Hedges of firm commitments
Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present? As set out above, we do not agree with the proposed method for hedge accounting. Therefore, we do not consider it useful to comment on this specific element of hedge accounting.

Question 9: 'Basis adjustments'
Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?
As set out above, we do not agree with the proposed method for hedge accounting. Therefore, we do not consider it useful to comment on this specific element of hedge accounting.

Question 10: Prior derecognition transactions
Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if *the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)?*

Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?
No, we do not agree. In our opinion, previously derecognised financial assets should be grandfathered and should not be recognised upon transition to IAS.