European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

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COMMENTS AND PROPOSALS ON THE

IASB'S
EXPOSURE DRAFT ON PROPOSED AMENDMENTS TO
IAS 32/ IAS 39

The European Association of Co-operative Banks (EACB) is one of the main associations of the European credit industry. Its core objective lies in defending the professional interests of its members. The EACB represents one of the leading banking groups in Europe. Its membership base of more than 30 organisations comprises co-operative banking groups from the 15 European Union Member States, but also from Central and Eastern European countries. These represent 38 million Members, 104 million customers, 527,000 employees in more than 50,000 business points and deposits of about EUR 1,317,000 million.

The association welcomes the fact that the IASB has published a draft exposure document and thus given the banking-community the opportunity to raise a public debate on this issue.

I. Preliminary Remarks

The European Co-operative Banks support the move towards the use of a common set of international accounting standards by quoted companies, in order to allow meaningful comparisons across borders and to promote confidence in financial reporting and in financial markets. However, the members of the association are of the opinion that the approach of the International Financial Reporting Standards to some issues, as it becomes evident regarding "fair-value accounting" should be thought over and incorporate some additional principles:

- In the opinion of most of the members of the EACB, the notion of Accounting Prudence, should be re-introduced into the IASB concepts. In relation to non trading activities, this would mean not recognising unrealised profits but making appropriate reserves for unrealised losses. This is essential for ensuring the stability of reporting results and the solidity of balance sheets and would reduce the effects of financial bubbles and periods of crisis which arise as a part of the functioning of modern capital markets ;

- According to most of our members, standards should incorporate the principle that "fair value" is not necessarily the value at the date of a given financial closing but is calculated differently according to the underlying activity : while trading activities should indeed be valued at the date of the closing, longer term activities, such as those

Rue de la Science 23-25, Box 9 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • e-mail : secretariat@gebc.org

included in the “banking book”, other long term investments, and medium term activities (including assets held as “available for sale”) should be valued at either their historical cost, the value at the date of maturity of the asset or an average calculated using longer or shorter periods as appropriate.

II. General Comments on the IAS 39 Exposure draft

The members of the EACB have studied the draft exposure text in detail and appreciate that some progress is made in comparison to the existing IAS 39. For many members is a step forward that the asymmetric treatment prescribed/allowed in the old IAS 39 proposal has now been overcome, since full fair value treatment is allowed We very much support this modification.

Today, IAS 39 represents a standard of high complexity and extensive implementation difficulties. It has attracted considerable criticism not only within the European banking community, but also from other sides, as evidenced by the reservations expressed by EFRAG. The members of the EACB therefore believe that IAS 39 is standard requiring further changes, in addition to the currently proposed amendments.

III. Hedge Accounting

a.) Macro-Hedging

The major issue of concern about IAS 39 is hedge accounting. The effect of the current provisions goes beyond accounting to unduly influence the Risk Management activities of the treasury departments of conglomerates, insurance companies and banks, resulting in artificial transactions in those departments. In fact, the overall present way of doing business (based on risk analysis, cost effectiveness and effective control) is not supported by the accounting regulations. Therefore a change in the risk management attitude and systems, including limit setting, management oversight and daily control, will be required, caused by the accounting treatment. This will create a serious amount of awkwardness. We do not deem that the reasons given by the IASB for this attitude (reliability, transparence) are justified. We think that the principle must be the other way round: Accounting should follow the business and the business should not be guided by accounting rules. We therefore suggest to amend Nr. 127 of the draft exposure as follows:

« a hedged item can be

a) a single asset , liability, firm commitment or forecasted transaction or

b) a group of assets , liabilities firm commitments or forecasted transactions with similar risk characteristics

or a net exposure »

b.) Internal Transactions

We also think that internal contracts, under certain conditions, can be qualified as hedged item or hedging instrument. We therefore suggest to amend Nr. 126 B of the draft exposure as follows:

For hedge accounting purposes, ~~only~~ derivatives that involve a party external to the entity ~~or~~ and internal contracts between two separate entities within a consolidated group or two divisions within an entity can qualify for hedge accounting by those entities in their separate financial statements or by those divisions and can be designated as hedging instruments or hedged items. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any gains or losses on such transactions are eliminated on consolidation. Nevertheless, ~~Therefore,~~ such intragroup or intra-entity hedging transactions ~~do not qualify for hedge accounting in consolidation.~~ allow groups to meet segmental information reporting requirements by business, with the calculation of results specific to each segment

c) Diverging accounting of economically identical transactions

Another point of most serious criticism of the current hedge accounting provisions is that, taken together, they lead to the reporting of very different numbers for what are basically identical economic situations. For fair value hedges, changes in the fair value of both the hedging instrument and the hedged item are recognised, whereas for cash flow hedges the hedged item is unchanged but the gain or loss on the hedging instrument is taken to equity and released only as the hedge ceases to be effective. The result is that even when the same risk is being hedged (interest rate risk) and the same hedged items are involved, using the same hedging instrument, very different accounting consequences arise depending on which side of the balance sheet the risk manager chooses to hedge, because in the one case the hedge would be a cash flow hedge while in the other it would be a fair value hedge. The use of fair value hedges in large portfolios becomes impractical. Where cash flow hedges may work in the area of interest rate risk management, fair value hedges require basis adjustment of the hedged item, which can in practice only work for small portfolios and single transactions. However, the bulk of the business of ALM risk management involves such large portfolios that the systems cannot provide the link between the calculated (generated) cash flows and the single hedged items in the balance sheet.

In addition, it has to be underlined that IAS 39 will in some cases allow that hedges are accounted for differently, i.e. certain hedges may lead to different results, depending on how they were accounted for. Certain hedges, for instance, may be accounted either as a future-flow micro-hedge or as a fair-value micro-hedge. By consequence, identical transactions may, depending on how they were accounted for, lead to seriously diverging results.

The EACB and its experts will be ready at any time to make suggestions in this respect.

d) Reducing Complexity and providing for a homogenous Approach

We propose reducing the overall complexity by focusing the hedge accounting provisions on the following three principles that should be adhered to in all hedging relationships: hedges should from the outset be seen to be: (i) clearly defined, (ii) measurable and (iii) effective. These three criteria alone should be adhered to in all hedging relationships. They represent the benchmark against which to measure the need for and the content of more detailed rules.

Furthermore, we believe that the accounting for the hedging relationship should be such that the accounting rules for the hedging instrument follow the accounting rules for the hedged, during the life of the hedge. There should be a homogenous approach for both, hedging instrument and hedged item, namely an amortised cost recognition plus disclosures, and only disclosures, about the variations of value of the global portfolio. It should thereby be avoided to transfer the volatility induced by the changes in fair value of the hedge from income to equity, which is no more relevant given the hedging objective and financial impact. This should apply in particular, if both the hedged item as well as the hedging instrument, in particular when the principal terms of the hedging instrument and of the hedged asset or liability or hedged forecasted transaction are the same (see paragraph 147).
In our opinion the objective of reducing complexity of hedge accounting will be achieved best when the IASB will also allow macro hedging.

e) extended scope of hedging instruments
Furthermore, we see no good reasons why hedging instruments for other than currencies are restricted to derivatives. There is no reason to consider that an open position can only be covered by a derivative and not by another financial instrument. We do not see any reason why “non derivatives instruments” cannot be designated as hedges; the largest part of hedging is made with “non derivative financial instruments” and accounting rules should reflect that fact. In particular, we think that non-interest bearing at sight deposits may also qualify for hedging purposes. We therefore suggest to amend the last sentence of IGC 121-2 as follows:

"Note that some banks consider some portion of their non interest bearing demand deposits to be economically equivalent to long-term debt. ~~However these deposits do not create a cash flow exposure to interest rates and therefore, would be excluded from this analyses for accounting purposes."~~

We also do not understand why the interest rate risk in the held-to-maturity category may not be hedged. This restriction should be abandoned.

SFAS 133 paragraph 68 explicitly states that an interest swap that exactly matches the terms (maturity, size, currency, underlying) of a hedged interest-bearing instrument is assumed to represent a perfect hedge which means that no further effectiveness testing is needed (so called “short-cut method”). Since paragraph 147 of IAS 39 currently says that such as hedge is likely to result in effectiveness without stating that perfect hedge effectiveness can be assumed, we propose conforming paragraph 147 to the wording of SFAS 133.

IV. At Cost Measurement of Derivatives

Another important issue for this association is the treatment of derivatives, which do not satisfy the criteria for hedge accounting. They are definitely assigned to “held for trading”. Nevertheless, in practice derivatives not only held for hedging or trading but also for investment purposes. As a consequence of this treatment, transactions in the investment book with on-balance-sheet items or off-balance-sheet items (such as interest rate swaps) lead to identical economic results but will lead due to IAS 39 to diverging figures in the income statement.. Therefore, the consequent assignment of derivatives to the “held-for-trading” category does not make sense. By contrast, consideration should be given to treating and measuring derivatives as on-balance deals, depending on whether they are kept as “held-to-maturity”, “available-for-sale” or “held-for-trading”. This would result in measuring them at cost rather than at fair value. We therefore suggest to delete in Nr. 10 ,“Definitions of Four Categories of Financial Instruments”, within the first paragraph the letter *c) is a derivative”*.

V. Other Issues

As regards the technical aspects, which are tackled in the questions Q1-Q10 (pp. 124-126 of the draft exposure document), we support the views expressed by the European Financial Advisory Group (EFRAG) to the extent that they do not contradict our comments as expressed above.