Enclosure to Letter N° 0011

European Banking Federation

RK
D0045A
10.01.2008

IASB EXPOSURE DRAFT ON EXPOSURES QUALIFYING FOR HEDGE ACCOUNTING

BACKGROUND

Before International Accounting Standard (IAS) became legally binding in the EU (through Regulation) for listed companies, they had to be endorsed by the Commission, after consulting Member States in the ARC, the European Parliament and the European Financial Reporting Advisory Group (EFRAG). Prior to the 1st of January 2005, the Commission endorsed 33 standards. As to IAS 39 on Financial Instruments - Recognition and Measurement, the Commission endorsed about 95% of the text and carved out certain provisions because it considered they required further revision. The Regulation endorsing IAS 39 provided for two carve-outs: one on the use of the full fair value option and one on hedge accounting.

Regarding the latter, it is stated in the **preamble to Regulation N° 2086/2004**:

§ 7. On hedge accounting, there is discussion whether IAS 39 sufficiently takes into account the way in which many European banks operate their asset/liability management particularly in a fixed rate environment. The controversy is about the limitation of hedge accounting to either cash flow hedges or fair value hedges and the strict requirements concerning the effectiveness of those hedges.

§ 8. Many European banks argue that IAS 39 does not allow them to apply hedge accounting to their core deposits on a portfolio basis and would force them to carry out disproportionate and costly changes both to their asset/liability management and to their accounting systems. As a portfolio hedge, due to internal interactions and the law of large numbers, is different from the hedge of a single asset or a single liability, it is also argued that enabling portfolio hedge accounting of core deposits on a fair value measurement basis is consistent with the principle in IAS 39 that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand.

§ 10. Therefore, the provisions of IAS 39 that are directly related to the accounting treatment of portfolio hedging were not adopted for mandatory use in 2005. The relevant provisions that are excluded from mandatory application are clearly distinct and separable from the rest of the standard. They concern those provisions that do not reflect a portfolio approach and therefore prevent the application of hedge accounting to a portfolio of core deposits and those provisions that assimilate a prepayment risk to an interest rate risk and therefore prevent the continuation of risk management techniques recognised as acceptable by banking supervisors. However, companies do have the option to apply these provisions and can therefore apply all hedge accounting provisions in IAS 39.

a.i.s.b.l.

10 rue Montoyer B- 1000 Brussels
+32 (0)2 508 37 11 phone
+32 (0)2 511 23 28 fax
http://www.ebf-fbe.eu

As a result hedge accounting in IAS 39 as adopted in the EU contains **carve-outs in the following paragraphs** (see http://ec.europa.eu/internal_market/accounting/docs/ias/ias-adoption-process_en.pdf):

- **Standard: § 81A**;

- **Application Guidance: §§ 99A, 99B, 99C, 107A, 114 (c) and (g), 118 (b), 119 (d), (e) and (f), 121, 122, 124 (a) and (d), 126, 127, 129 and 130**.

CURRENT STATUS OF THE DISCUSSIONS BETWEEN THE IASB AND THE EBF

Since the adoption of the European hedge carve-out, the EBF has been engaged in a dialogue with the IASB in order to define a framework that could support the hedging of a retail banking book under IAS 39, so that removing the carve-out could be envisaged. As currently set out, hedging relationships in IAS 39 do not accommodate edge mismatches in fixed rate positions in the balance sheet (i.e. between fixed rate assets and fixed rate liabilities), although such practice is widespread amongst banks ALM departments and supported by international supervisors as being adapted to interest risk management, especially in a fixed-rate environment.

It is in this context that the EBF has developed the proposed Interest Margin Hedge (IMH) methodology. The IMH proposal is based on the ALM practices used in many European countries and is supported by international supervisors. In particular it enables banks to account for macro-hedges in the context of the fixed rate environment and liability gaps that prevail in many EU countries.

At an educational session held during the IASB Board meeting of 13 December 2006, the IASB made clear that a third hedging methodology on top of the Fair Value Hedge (FVH) and the Cash Flow Hedge (CFH) could not be envisaged. Rather, the concerns addressed in the framework of the IMH proposals should be dealt with in the framework of the CFH method, i.e. IMH should be documented as CFH, though the contexts in which these methodologies have been designed are obviously far different.

At the end of the above mentioned meeting, the EBF was asked to identify the paragraphs in the Standard (IAS 39) and related implementation/application guidance that in their view would need to be clarified or amended to allow European banks to apply hedge accounting.

Between January and May 2007, the EBF task force consulted EBF members on their concerns about the CFH and their reasons for using the carve-out. The task force used this information to submit a list of issues for the IASB to address, a copy of which has been forwarded to the technical staff of the European Commission.

This list identified the main stumbling block to be AG 99C, which prevents some European banks from designating a liability with a commercial margin (liability yielding below the benchmark interest rate/LIBOR) as a hedged item. Under the CFH method of IAS 39, the hedged portion of the cash flows of a financial instrument cannot be greater than the commercial rate of such instrument. However the European retail banking business model is based on the fact that interest rates for liabilities (deposits and borrowings) are below the market rate as interest rates for assets (credits) are above the financial market rates.

The difference is due to the commercial margin that increases the rate for an asset (adding revenue) and decreases the rate for a liability (adding also revenues).

In contradiction with the treatment of a positive commercial margin for an asset (that is fully eligible as hedged item whatever the level of commercial margin is) and in contradiction with current FAS 138 (that symmetrically recognizes hedges based on benchmark rates on both asset and liabilities), the CFH method prevents the designation of any commercial liability of a retail bank as hedged item.

As a consequence, a bank with an excess of fixed rate assets on its balance sheet would be unable to hedge its position under CFH method of IAS 39 if it gets resources from its retail network.

The EBF task force met the IASB on June 21st 2007 to explain the commercial margin issue (already mentioned in the presentation of December 2006). It would seem from this that we have a difference of view over AG 99C.

Nevertheless, the staff that recognizes that this issue may require reconsideration has been given the instruction by the October Board to develop further studies and present some proposals.

PROPOSALS IN THE IASB EXPOSURE DRAFT OF SEPTEMBER 2007

IAS 39 Paragraph 81 (designation of financial items as hedged items) is deleted.

If the hedged item is a financial asset or a financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).

IAS 39 Paragraph 80 Y is added by ED:

Subject to the restrictions in paragraph 79, a financial instrument may be designated as a hedged item with respect to all of its risks. Subject to the restrictions in paragraph 79, a financial instrument may also be designated as hedged item for one or more of the following risks:

(…)

(e) The risks associated with the contractually specified cash flows of a recognized financial instrument. For example, an entity may hold a financial asset that pays interest at inflation plus 3 per cent. Assuming that the entity is not required to account for the inflation embedded derivative separately, the entity is permitted to designate as a hedged item changes in the cash flows of the financial asset attributable to changes in inflation. This is because inflation is a contractually specified cash flow of the financial asset. However, an entity holding a fixed rate financial asset is not permitted to designate as a hedged item changes in its fair value attributable to changes in inflation. This is because either the inflation component is not a contractually specified cash flow or, if inflation is a contractually specified cash flow, the remaining component would be residual.

IAS 39 Paragraph 80 Z is <u>added</u> by ED:

An entity may designate as a hedged item one or more of the following portions of the cash flows of a financial instrument:

(…)

(e) The portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a risk-free rate

(f) The portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a quoted fixed or variable inter-bank rate (for example, LIBOR)

Application Guidance AG99BA is <u>added</u> by the ED

A financial instrument may be designated as a hedged item with respect to all of its risks. However, an entity may be managing only a single risk, for example, interest rate risk. To avoid recognising ineffectiveness for the risks not being hedged, an entity is permitted to hedge the financial instrument with respect to one or more of the risks specified in paragraph 80Y. The risks designated as hedged risks must not in aggregate exceed the total risk of the financial instrument.

Application Guidance AG99BB is <u>added</u> by the ED

Hedge effectiveness may be improved if only a portion of the cash flows of a financial instrument is designated as the hedged item. For example, an entity may wish to hedge its exposure to changes in fair value attributable to LIBOR of a CU1,000 fixed rate asset that pays interest at 10 per cent. In order to achieve this, the entity enters into an interest rate swap at market rates under which the entity pays 7 per cent fixed interest and receives LIBOR. If the entity designates as the hedged item all of the cash flows of the entire fixed rate asset (i.e. CU1,000 + 10 per cent interest) ineffectiveness will arise. However, ineffectiveness might be reduced if the entity designates as the hedged item a portion of the cash flows of the fixed rate asset. For example, the entity could designate a portion of the fixed rate asset that is equal to the cash flows of a CU1,000 fixed rate asset that pays interest at 7 per cent (i.e. the inter-bank swap rate on the date the swap is entered into). Designating a portion of a financial instrument is permitted only in the situations described in paragraph 80Z. If an entity designates as a hedged item a portion of the cash flows of a financial instrument in accordance with paragraph 80Z, the risks eligible for designation are also restricted to those risks described in paragraph 80Y.

Application Guidance AG99C is <u>amended</u> by the ED

If, in accordance with paragraph 80Z, a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate

(a) a portion of the liability equal to the principal amount plus interest at LIBOR; and
(b) a negative residual portion.

EBF COMMENTS ON THE IASB EXPOSURE DRAFT OF SEPTEMBER 2007

The designation of liabilities yielding below LIBOR (IAS 39 AG 99 C) is not addressed in the Exposure Draft. This is a key issue for European banks and we are disappointed that it is not addressed in the Exposure Draft. In this context, the proposed amendments confirm the blocking rule of paragraph AG 99C that prohibits the hedging of commercial liabilities (i.e. liabilities paying interests at LIBOR minus a margin).

However, there are at least three objective arguments in favour of removing this restriction:

- It would allow assets and liabilities to be treated symmetrically in respect of the commercial margin;

- It would be in line with the provisions in SFAS 138, which defines the risk of changes in the benchmark interest rate as the hedged risk, and therefore recognises market practice by excluding the transaction-specific commercial margin from the hedged risk definition; and

- A generic risk (the benchmark interest risk) is the only risk that can be hedged as it is the one that is transferable to the market – as opposed to the margin, which is specific to a particular transaction and cannot be sold to a third party.

By publishing an exposure draft in which the IASB does not address the issue which led to the carve-out, the Board contradicts its October decisions to reconsider the substance of the wording of AG 99C for addressing the commercial liabilities issue.

In this exposure draft the IASB does not appear to take into account either the EBF position or the actual situation for the banking business in Europe where banks are protecting their customers from financial market moves by offering risk management solutions through fixed rate products.

Furthermore, the Exposure Draft contradicts in our view the IASB Staff Working Papers presented at the Board meeting on 17 October 2007.

In this context, the recently published Exposure Draft “IAS 39 – Exposures Qualifying for Hedge Accounting” raises several concerns that we believe need to be highlighted:

- The ED reaffirms in writing the set of rules adopted to ring-fence hedging under IAS 39, which continues to prohibit the hedging of commercially priced liabilities;

- It does not take into account the discussions that are underway between European banks and the IASB; and

- It is incompatible with the carve-out as it introduces new paragraphs in contradiction with the objectives of the carve-out and plans to amend paragraph AG 99C, which is only partially adopted in the EU.

To put it into a broader perspective, the proposed amendments confirm that IAS 39 comes to impose a specific accounting model, which is at odds with a principles-based approach. In particular, this model is not appropriate to a fixed-rate environment – such as the European one –, where banks play an institutional role by managing the risk instead of transferring it to the final customer: under AG 99C, banks with an excess of fixed rate assets cannot achieve cash flow hedging.

EBF CONCLUSIONS / RECOMMENDATIONS

The Exposure Draft does not solve the issue which led in 2005 to the adoption of the European carve-out. Under such circumstances, as AG99C (at least the first sentence) should be carved out. Given the relation between AG99C and IAS 39 Paragraph 80 Z, the latter (in particular indents (e) and (f)) should also be carved out. As a consequence, the EBF recommends the European Commission to ignore the proposals in the ED or, at least, to withdraw the paragraphs contradicting the purposes of the carve-out.

A least it is essential that the adoption of ED 22 does not change the way IAS 39 is applied in the European Union. Banks using the carve-out should continue to be allowed to apply those parts of IAS 39 that are covered by the carve-out. Conversely, banks that do not use the carve-out should be able to apply the revised version of IAS 39 in its entirety.