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The Deputy Director General

11 January 2008

FBF Comments on the Exposure Draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement Exposures Qualifying for Hedge Accounting

Dear Sir / Madam,

The French Banking Federation is pleased to have the opportunity to comment on the "Exposure Draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement Exposures Qualifying for Hedge Accounting".

We understand that the proposed changes to IAS 39 are driven by the Board's intention to address several issues relating to hedging provisions that were previously submitted to the IFRIC. While we generally support the Board's objective to clarify IAS 39 on what risks are eligible for hedge accounting and what portions can be designated as a hedged item, we have strong reservations on this objective being reached by the proposals set forth in this exposure draft, for the following reasons:

First, we question the approach adopted, which is rules-based, and will prevent reporting entities from simultaneously adapting their accounting and risk management practices so as to follow market evolutions on a timely basis: new risks emerging from the development of economic activity or new businesses will not be eligible to hedge accounting as they will not be included in the list provided in proposed paragraph 80Y. This means that new amendments to the Standard will be necessary to fill any gap arising between risk management practices and accounting rules.

Instead, we would have favoured the IASB developing an accounting principle that could have applied to every present or future market situation. We see no theoretical reason to limit the range of risks that can be hedged under IAS 39.

Second, we consider that the timing of the publication of the exposure-draft is not appropriate, since the discussions undertaken in December, 2006 between European banks and the IASB are still underway, in order to find an acceptable solution to the existing "carve out" for IAS 39 in the European Union.

We have no doubt that the Board is aware of the reasons why some hedging requirements in IAS 39 have not been adopted in the EU. This is because they are neither in line with the fixed-rate market environment that exists in a number of European countries nor with the portfolio-based asset and liability management of the banking industry that reflects such environment and is supported by international supervisors as sound interest risk management practices.

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As a consequence, the proposed amendments came as an unpleasant surprise, especially as they raise several concerns that we believe need to be pointed out:

- **The ED reaffirms the prohibition to hedge commercial liabilities** that are a core component of banks' liabilities.
  We do not conceptually understand why the accounting treatment of a positive margin for an asset (credits in the retail banking industry) and that of a negative margin for a liability (deposits and borrowings) should not be symmetrical: it is not consistent with the economic rationale of both types of financial instruments, which consists, for assets, in adding a commercial margin to the market rate and, for liabilities, in subtracting a margin, in order to recognise revenue in both cases.
  We consider that the approach adopted under US GAAP (SFAS 138), which symmetrically recognises hedges based on benchmark rates on both asset and liabilities, is more relevant;

- **It is therefore incompatible with the European carve-out on macro-hedging** as it, notably, proposes to amend paragraph AG 99C, which is not adopted in the EU.

- Additionally, the new **AG 99E would not allow entities anymore to use the terminal value of the purchased option** designated as the hedging instrument to document the effectiveness of their hedging relationship. We outright oppose this restrictive approach which is not supported by convincing arguments in the ED and which goes against a long established practice based on the economic substance of the hedge (the changes in the value of the hedging option are, by construction, perfectly matching those of the hedged item that is one-sided risk). There is sound theoretical basis to measure one-sided risks using a probability-weighted outcome approach, time value is therefore not artificial and does exist in the hedged item. We would like, in that respect, to underline that such conclusions are in line with those developed in US GAAP (SFAS 133 interpretation DIG G20, which allows a terminal value approach).

We would like to draw your attention on the fact that this guidance would have a significant operational impact and induce artificial volatility in the P&L.

Finally, some parts of the ED are drafted in a way that not only prevents the IASB from meeting its clarification objective but also is bound, in our opinion, to add complexity and further need for guidance or interpretation on several levels:

- Some paragraphs, such as 80Y (eligible risks), are not internally consistent, incomplete (definitions, common risks are missing) or confusing either when read on a stand-alone basis or when articulated with the Application Guidance;

- There seems to be a confusion between cash flows and risks in several of the proposed paragraphs, notably in paragraph 80Z (e) and (f);

- The wording may, in some instances, lead to unattended consequences: for example, paragraph AG 99E as currently drafted could be read as prohibiting partial term hedging and then would appear to conflict with IG F.2.17.

All in all, the FBF shares the view that the benefit of adding the proposed guidance in IAS 39 would not be sufficient to outweigh the costs and practical issues surrounding such a significant change to current practice. We would therefore advocate the Board not to adopt the proposed amendment and to wait until further work has been completed on the outstanding issues relating to hedge accounting in IAS 39.

Please find enclosed in the appendix our detailed responses to the questions raised in the Exposure Draft.

Yours sincerely,

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Appendix: responses to the questions raised in the Exposure Draft

Question 1 – Specifying the qualifying risks
The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y.

Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why? Are there any other risks that should be included in the list and why?

We disagree with the proposal which consists of rules and therefore leads to a prescriptive list of risks. This list shows the following drawbacks:

- Some, yet not all, of the risks listed in paragraph 80Y are defined and we are puzzled with the scope of the risks referred to in 80Y (e), - "the risks associated with the contractually specified cash flows of a recognised financial instrument". We believe it awkwardly articulates with the other hedgeable risks and appears to develop a completely different approach, which we find questionable and complicated to implement;

- It appears, as currently drafted, not to be exhaustive (for example equity risk is missing) and we consider that it will be difficult to update the list in order to reflect the evolution of risks. Paragraph 80Y will have to be amended each time a new risk is created by the development of businesses or markets: that means several months of due process that could have been avoided by adopting a principles-based approach.

Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item
The proposed amendments specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item.

Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why?

Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item?
If so, which situations and why?

We disagree with the proposal as currently drafted, in particular because the same restrictive and rules-based approach has been used to specify the hedgeable portions in paragraph 80Z (and related AG) as to define the eligible risks in paragraph 80Y.

In the area of portions, it seems to us that there is some confusion throughout the ED between cash flows and risks. We would like to remind the Board that entities actually hedge risks and not portions of cash flows.

Hence, the current drafting of paragraph 80Z and its related Application Guidance does not contribute to clarify some issues related to portions of financial instruments that are of crucial importance for the banking industry.

1- Hedge of commercial liabilities:

We do not understand why IAS 39 still does not take on board market reality by requiring an asymmetric treatment for commercial assets and liabilities.

Banks take a commercial margin on both financial assets and liabilities: both are revenues, have the same economic purpose and the difference lies in the sign of the margin, due to the accounting mechanism. The commercial margin for assets is a positive one, it results from the credit rate being superior to market rates; the commercial margin for liabilities is a negative one, because banks' deposits and borrowings bear interest rates that are generally below market rates.

European banks play an institutional role by managing the risk instead of transferring it to the final customer and therefore need to hedge the value of both financial assets and liabilities against the various risks that can make this value change to an extent that is not acceptable.

Paragraph 80Z(f) would seem to indicate that IAS 39 allows hedge accounting of both positive and negative portions. However, when read in conjunction with (already existing and carved out in the EU) paragraph AG 99C, which prevents from designating/documenting as the hedged item a liability yielding below the benchmark interest rate/LIBOR, it is no longer the case.

Nevertheless, the commercial margin, which is specific to a particular transaction, cannot be sold to a third party (transferred to the market). This results in only a generic risk (the benchmark risk) being able to be hedged as it is the only one that is transferable to the market. This situation applies to both assets and liabilities. US GAAP (SFAS 138) recognises market practice by excluding the transaction-specific commercial margin from the hedged risk definition (the hedged risk is defined as the risk of changes in the benchmark interest rate). We believe that IAS 39 should be amended accordingly, instead of being made more restrictive on that issue.

2- Use of the terminal value of a purchased option to document the effectiveness of the hedging relationship

As an opening comment, we would like to underline that we consider option-based hedging as not specifically related to the hedge of portions. We therefore question the appropriateness of this issue being addressed in the part of the Standard that deals with portions.

That said we wish to express our strong opposition to the provisions set forth in paragraph 80Z(c) and its related guidance AG 99E.

When applied to optional hedges, the application of both paragraphs will have the following consequences, which we consider inappropriate:

- only the option's intrinsic value changes will be considered, in IFRS accounting, as effectively offsetting the hedged cash flows changes
- the changes in the time value of the option will be recorded in P& L until the exercise or the expiration date.

<u>Optional cash flow hedges:</u>
IAS 39 § 36 b defines a cash flow hedge as a hedge of the exposure to a variability of expected future cash flows attributable to a particular risk.

Options are used to hedge a directional risk (broadly put: the risk that the underlying's price goes beyond or below a given price – the strike price).

Whether they are "vanilla" or more complex instruments, they are designed to replicate the cash flows of the underlying and are therefore always related to the distribution of the possible underlying price's distribution on the expiration date (or over a period for American options).

Measurement of the effectiveness
To measure the effectiveness of cash flow hedge, IAS 39.96 (a) requires that the cumulative changes in fair value of the expected future cash flows be considered during the hedging period and compared with the changes in fair value of the hedging instrument.

The valuation models used to price options include the time value and the intrinsic value, in order to encompass all future events and uncertainties.

We see no theoretical reason to apply, in order to measure the effectiveness of the hedge, a method that is different from that used to measure the changes in the fair value of the option on an ongoing basis by market participants.
On the contrary, we believe that the Board is wrong when they consider limiting the measurement of effectiveness to the changes in the option's intrinsic value. We urge the Board to converge towards the US GAAP interpretation DIG G20 *Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge*, which allows the effectiveness test to be performed on the whole changes of the option, because these conclusions were drawn from a reasoning based on the economic and financial substance of optional cash flow hedges.

Question 3 – Effect of the proposed amendments on existing practice
The aim of the proposed amendments is to clarify the Board's original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in practice from arising.

Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

The FBF believes that proposed amendments will result in a significant change to existing practice for those entities that applied DIG G20 (and therefore did not apply the treatment proposed in AG 99E): for optional hedges, the time value would have to be separated from the intrinsic value of the option in the IT systems.
We understand that the Board was already aware of this potential consequence of the ED as they acknowledge in BC 14 that "Comment letters received in response to the IFRIC's agenda decision suggest that there is diversity in practice in this area. Consequently, the guidance in paragraph AG99E may result in a change to existing practice for some entities".
Nevertheless, we would like to draw the attention of the Board on the undue cost incurred by this change in practice that is, as we already said, not supported by compelling arguments.

Additionally, we would like to remind the Board that if AG 99C were to be applied European banks, it would prevent them from hedging their commercial liabilities. It would preclude banks from reflecting the economic substance of the risk management strategies in their accounts and create unsustainable volatility in the P&L.

Question 4 – Transition
The proposed changes would be required to be applied retrospectively.

Is the requirement to apply the proposed changes retrospectively appropriate?
If not, what do you propose and why?

We are not supportive of a retrospective application of the proposed changes, as this would be extremely detrimental to those entities that applied DIG G20 (and therefore would have to change accounting practices in order to apply AG 99E) to determine the efficiency of their option-based cash flow hedges.

We believe that the approach that was adopted in paragraph 29 of IFRS 1 *First Time Application* for hedges of net positions, which allowed firms to keep their previously designated hedging relationships, is still relevant.