European Banking Federation

Secretary General

RK/MT
EBF ref. N° 0011

Email

Mr Stig Enevoldsen
Chairman & CEO
European Financial Reporting Advisory Group (EFRAG)
Avenue des Arts 13-14
B-1210 Brussels
E-mail: stig@efrag.org

Copy to: Mr Pierre Delsaux, DG Markt, European Commission

Brussels, 11 January 2008

Subject*:** ***IASB Proposed Amendments to IAS 39 – Exposures Qualifying for Hedge Accounting

Dear Mr Enevoldsen, dear Stig,

I am writing to you on behalf of the European Baking Federation (EBF)[1] to inform you of the EBF position on the above-mentioned IASB Exposure Draft.

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 hedge 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.

[1] Set up in 1960, the European Banking Federation (EBF) is the voice of the European banking sector. It represents the interests of over 5000 European banks, large and small, from 29 national Banking Associations, with assets of more than EUR 20 000 billion and over 2.3 million employees.

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

European Banking Federation
Secretary General

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.

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.

You will find attached to this letter an analysis of the ED and the reasons why if it were adopted by the EU, it should also be carved-out.

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.

European Banking Federation

Secretary General

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.

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.

Yours sincerely,

Guido Ravoet

Enclosure: 1