

Dr. Alexander Schaub
Director General
European Commission
Directorate General for the Internal Market

1049 Brussels

8 July 2004

Dear Dr. Schaub,

Re: Adoption of the amended IAS 39 *Financial Instruments: Recognition and Measurement*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to respond to your request to give our opinion on the adoption of the amended IAS 39 *Financial Instruments: Recognition and Measurement* as published by the IASB on 17 December 2003 and further amended on 31 March 2004.

EFRAG has evaluated the amendments to IAS 39, including the Basis for Conclusions and the consequential amendments to other IFRSs. Our evaluation is based on input in accordance with EFRAG's due process which includes issuing a draft comment letter for public comment with a one month comment period. EFRAG considers the comments received and thereafter meets to issue a final endorsement advice letter. EFRAGs meetings are open to the public, when discussing technical agenda items.

We have decided only to issue a positive endorsement advice if there is a majority supporting endorsement, whereas EFRAG can only issue a negative endorsement advice if there is more than 2/3 of the members not supporting endorsement.

EFRAG has received more than 40 letters commenting on the endorsement of IAS 39 from a diverse group of our European constituents. Letters have been received from:

- supervisors and regulators;
- financial institutions including banks, banking organisations, insurance companies and insurance organisations;
- the accounting profession;
- manufacturing companies and organisations; and
- standard setters.

The comments in favour of endorsement generally came from regulators and supervisors including CESR, the accounting profession, individual manufacturing companies, national standard setters of Denmark, Germany, The Netherlands and the UK, two banks, insurance companies, one user organisation and one insurance organisation.

The comments opposing endorsement came mainly from banks, banking organisations including FBE, some insurance companies, two organisations of manufacturers and the national standard setters of France, Italy and Spain.

EFRAG met yesterday on 7th July and debated the final advice letter. The meeting was attended by more than ten observers in the public gallery.

Voting on IAS 39, 5 members voted to support endorsement and 6 members voted to oppose endorsement.

The arguments to support and oppose endorsement of IAS 39 are reflected in Appendix 1 to this letter. The members are united in supporting very significant parts of IAS 39, but some members oppose certain important elements of the standard.

The opposing views are drafted by the opponents themselves.

EFRAG Conclusion

As indicated above, five members support endorsement of IAS 39 in its present form but six members oppose endorsement. EFRAG cannot recommend non-endorsement of a standard unless there is a two third's majority vote against the standard and EFRAG does not support endorsement unless there is majority in favour.

Therefore, EFRAG does not issue any advice whether to endorse IAS 39 or not.

On behalf of the members of EFRAG, I should be happy to discuss our letter with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Stig Enevoldsen
EFRAG Chairman

Arguments supporting and opposing endorsement of IAS 39

Introduction to the standard

The IASB undertook an initiative to improve the IAS 32/39 financial instruments standards, in time for them to be used by companies adopting International Financial Reporting Standards for the first time in 2005. The then current versions of IAS 32/39 were covered by EFRAG's positive "en-bloc" endorsement advice that was submitted to the Commission in June 2002. At that time, we indicated that the IASB was reviewing a number of its existing standards and that we would consider all changes to the existing IFRS when promulgated. As regards IAS 39, we commented that this standard was complex and controversial, particularly in the area of hedge accounting.

In contributing to the IASB's due process, EFRAG issued on 18 October 2002 a comment letter to the IASB on its exposure draft of proposed amendments to IAS 32 and 39. Following its European roundtable discussions on IAS 32/39 in March 2003 and subsequent discussions with European banking representatives, the IASB published in August 2003 an exposure draft entitled *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, on which we also commented. These proposals resulted in the publication by the IASB on 31 March 2004 of amendments to the IAS 39 hedge accounting requirements.

The intention of the IASB's improvements project was not to reconsider the fundamental approaches contained in IAS 32/39 because to do so would have resulted in a significant delay in the production of a new standard on financial instruments. Rather, it was the IASB's objective (i) to improve the existing requirements based on issues raised by preparers, professional accountants, standard setters, regulators and others and (ii) to reduce some of the complexity by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the standards key elements of existing interpretations and implementation guidance.

More specifically, the IASB's main objectives with regard to improving IAS 39 were a limited revision to amend requirements or provide additional guidance on selected matters, including derecognition, the provision of an option to measure any financial asset or financial liability at fair value, the recognition and measurement of impairment, the determination of fair value, and certain aspects of hedge accounting.

The introduction to the revised standard (paragraphs IN4-25) summarises the main changes from the previous version of IAS 39. The revisions retain the main thrust of the proposed amendments and incorporate further improvements at a number of points, some of which were proposed by EFRAG.

The amended IAS 39 becomes effective for annual periods beginning on or after 1 January 2005, with earlier application permitted. An entity applying IFRSs for the first time in 2005 is not required to prepare the comparative information in accordance with IAS 39. This facilitates transition to IFRSs in 2005 while allowing for further improvement of the standard.

Introduction to EFRAG's evaluation

EFRAG has evaluated the amendments to IAS 39, including the Basis for Conclusions and the consequential amendments to other IFRSs. Our evaluation is based on input from standard setters and market participants in accordance with EFRAG's due process.

The subject matter of IAS 39 is particularly complex and contentious because it has to bridge the gap between traditional accounting techniques based on historical cost and the fair value measurements that underlie market transactions.

EFRAG is united in supporting all significant aspects of IAS 39 relating to recognition and derecognition of financial instruments, fair value measurement and impairment, the implementation of which is likely to lead to improved financial reporting in Europe.

In particular, all members of EFRAG support the requirement of fair value measurement of financial derivatives. However, some members believe that, as a consequence from this requirement, the current hedge accounting provisions lead to an incorrect reflection of the impact of hedging derivatives in some cases.

On the other hand, as regards certain aspects of hedge accounting, the treatment of liabilities repayable on demand, certain aspects of investment products marketed for example by insurance companies and some other measurement issues, EFRAG members are divided:

- Those supporting endorsement of IAS 39*, while hoping that further improvement will be possible in the medium term to meet the concerns raised below, believe that IAS 39 now meets the requirements of the IAS Regulation. Accordingly, they favour endorsement of IAS 39.
- Those opposing endorsement* disagree with the requirements related to these issues, for reasons set out below in detail, and believe that IAS 39 in its present form does not meet the criteria of the IAS Regulation and therefore should not be endorsed.

Set out below are:

- The detail underlying the supporters' views;
- The detail underlying opposers' views;
- EFRAG's conclusion

As an introduction to the following sections, the current state of accounting concerns can be summarised as follows:

- Liabilities with a demand feature, which experience shows remain outstanding over a long period (e.g. core deposits), represent a major business component for certain

* See page 7 for the names of supporting and opposing members.

entities in Europe. EFRAG believes that such liabilities have an economic value that is not currently reflected in the financial statements. Since that economic value provides the basis for a significant number of market transactions, all members of EFRAG think it is important to find an acceptable method under the Framework to capture the effects of hedging strategies that rely on that value.

Particularly over the past 18 months, the IASB Board and staff have devoted an immense amount of time to debate and consultation on the issues covered in the standard. The IASB has indicated, however, that the question of how to fair value a liability with a demand feature is closely related to issues being debated by the Board in other projects, including Phase II of accounting for insurance contracts. Since the Board's discussions in these other projects are continuing, the Board considered it premature to reach a conclusion in the context of portfolio hedging without considering the implications for the other projects.

- Many members believe that more should be done to address the mismatch issue for investment products marketed by insurance companies and the deposit floor measurement requirement for those entities.
- With regard to the definition of hedge effectiveness the standard recognises ineffectiveness in respect of prepayments, which are in many respects impossible to hedge. As explained in detail in our comment letter to the IASB dated 14 November 2003, the EFRAG preference would have been to exclude prepayment risk from the designated risks for which hedge accounting is sought.

Supporters' views

The supporters, having considered carefully the technical arguments set out in the basis for conclusions, believe that IAS 39 is technically robust. In particular, they support a standard that:

- requires recognition of all derivatives at fair value;
- does not allow recognition of gains as liabilities and losses as assets; and
- provides an adequate mechanism for testing the effectiveness of a hedge.

Furthermore, they believe that the introduction of the amendments to IAS 39 provide a very considerable and necessary improvement to the original standard. In reviewing the standard and in the light of concerns expressed by European constituents, the IASB has pursued what it considers to be simpler and superior solutions where possible to ease the implementation of IAS 39 and to make it more compatible with existing bank risk-management systems. For example:

- i. The IASB has developed, with the assistance of the Federation of European Banks, an approach to the portfolio hedging of interest rate risk. While the IASB did not accept approaches to designation and effectiveness advocated by some, EFRAG and a number of European constituents have encouraged the IASB to proceed.
- ii. The IASB has introduced a notion of hedging "portions" that is both broader and more principles-based than that found in US GAAP. By allowing designation of a portion, IAS 39 allows application of hedge accounting for a broader range of hedging strategies than possible in the past or under US GAAP.

- iii. The IASB has introduced the fair value option, which allows many entities to achieve results similar to those produced by hedge accounting without the complexities of hedge accounting. It also allows entities to produce more relevant financial information in economies without well-developed derivatives markets.

The supporting members favour fair value measurement of financial derivatives in all circumstances including hedge accounting since they regard it as the only basis that provides sufficient transparency in the financial statements because most derivatives have little or no initial cost.

The supporters believe that progress towards a more satisfactory outcome on hedge accounting for liabilities with a demand feature cannot be made in the very short term. because it would involve discounting liabilities below the amount at which they could be called, recognising an intangible asset in respect of liabilities bearing a below market rate of interest. These matters require an in depth study of certain recognition and measurement principles. These and related issues are being studied by the IASB in a broader context and a high priority is attached to this work.

The supporters believe that the IASB has complied with its conceptual framework when developing the standard. Recommendations for making IAS 39 more acceptable to various groups in the short-term rely to a greater or lesser extent either on derogations from the concepts or on extensions of the recognition and measurement concepts that may have significant implications for other areas of accounting and that cannot therefore be undertaken without substantial further research and debate.

The supporting members believe there is an urgent need for a standard on the recognition and measurement of financial instruments to be in place for use by EU listed companies from 2005. Without such a standard, the accounting regime for Europe would have major omissions. There would be no requirements dealing with: the impairment of financial assets, including provisions for bad and doubtful debts; no regulation of the off-balance-sheet financing issues surrounding the derecognition of financial assets and liabilities; nor any proper recognition and measurement of financial derivatives, all of which are matters of the utmost importance.

The supporting members believe that it is critical that European listed companies should receive at the earliest possible date a clear and unequivocal message in relation to the adoption of IAS 39. They expect that the adoption of IAS 39 in Europe will improve the overall accounting practice for financial instruments and that a single European standard on the recognition and measurement of financial instruments will substantially enhance the transparency and comparability of European financial statements.

They further share the view that in the absence of a standard on the recognition and measurement of financial instruments, those dependent on a high quality of financial reporting – the investors in the international capital markets, and their investment analysts – would regard information provided by EU listed companies as second-rate, potentially inconsistent and lacking in transparency. That would have very damaging consequences and would seriously undermine the integrity of financial reporting within the EU.

In summary, although recognising that certain concerns remain, the supporters' view is that none is of sufficient significance to outweigh the benefits that would result from adoption of IAS 39 in time for application as from 1 January 2005.

The supporters therefore conclude that on balance the revised IAS 39 meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, and in particular that it is not contrary to the true and fair principle and meets the criteria of transparency, understandability, relevance and reliability.

Those supporting this view are: MM. Enevoldsen (chairman), Cook, Giner, Pohle and Spandl.

Opposers' views

MM. Bezold, Flores, Guttman, Leeuwerik, Marinelli and Thouvenin disagree with the above views for reasons explained hereafter.

1. MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin share the concerns of the supporters that there is an urgent need for a standard on the recognition and measurement of financial instruments in Europe. As is explained in the introduction to EFRAG's evaluation, IAS 39 provides suitable recognition, derecognition, fair value measurement and impairment requirements, the implementation of which is likely to bring improved financial reporting throughout Europe. However, they believe that the present requirements in IAS 39 related to hedge accounting and the accounting for liabilities with a demand feature in the context of a portfolio are flawed. EFRAG's comment letters have throughout the last two years detailed and explained the conceptual weakness at stake. MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin observe that, although some improvements have been achieved, significant issues are not solved. Therefore they disagree with the conclusion that - on balance - IAS 39 (Financial Instruments: Recognition and Measurement) meets the requirements of the Regulation of the European Parliament and the Council on the application of international accounting standards.

In their view, implementation of IAS 39 would result in many financial institutions and other companies heavily involved in hedging to suffering significant distortions in their financial reporting. This, in the view of MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin, conflicts with the conclusion that the standard meets the criteria of understandability, relevance and comparability or that it satisfies the "true and fair view principle". MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin strongly believe that these significant distortions induced by artificial equity volatility, cannot be coped with through explanations inserted as disclosures. MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin reject the assertion that disclosures can be considered, in the case of a flawed standard, a suitable substitute for sound accounting. They fully support IAS 1 paragraph 16 "Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material". Furthermore, conversion to IFRS will generate a tremendous communication challenge [as well as information flow process]. This challenge will not be successfully met if companies have to communicate not only the impact of the conversion itself but also the impacts of erroneous representation of the effects of their hedging strategies.

Hedging is, in MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin's views, an activity to be closely monitored by management to safeguard shareholders' interest. Hedge accounting should be designed to reflect faithfully the extent and the effectiveness of hedging activities. Hedge accounting requirements set out in IAS 39 fail to fulfil this basic objective of the IAS framework. IAS 39 therefore remains flawed. Hedge accounting requirements should be reviewed in order to remove the unnecessary limitations that are imposed on hedging and hedged items and on their economic interdependency, and that are contrary to properly internally controlled risk management policies. The inadequacy of hedge accounting requirements may create substantial distortions in the financial statement of a number of listed entities in Europe and they create for all entities artificial limitations in hedge accounting. In some European countries the application of IFRS is also being extended to entities other than just listed ones. The significance depends on the degree to which entities are impacted by IAS 39, i.e. the more they are involved with financial instruments and hedging, the more this impact will be significant. IAS 39's hedge accounting requirements most often conflict with the centralised treasury management that entities other than financial institutions have developed over time in order to increase efficiency in risk management and to tighten internal control. Some, such as the prohibition against non-derivatives qualifying for hedging, lack the necessary conceptual basis. The current limited definitions for hedging lead to arbitrary and counterintuitive accounting consequences. The proposal for a portfolio hedge of interest rate risk does not achieve its initial objective to simplify significantly the implementation of the Standard.

In addition to the revision of hedging requirements, the IASB should develop an approach that better reflects the portfolio approach that is characteristic of financial instruments as managed by financial institutions. Such an approach should help solve the critical issue of valuation of liabilities with a demand feature, as highlighted in the introduction to EFRAG's evaluation.

2. MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin also reject the view developed in detail in the supporters' views that EFRAG should recommend IAS 39 on the grounds that Europe would be better off with than without the existing IAS 39. IAS 39 assessment should, they believe, be made solely on the basis of the existing standard, i.e. the requirements that European listed companies have to comply with when implementing IFRS. The potential positive outcome of continued discussions between the IASB and other stakeholders, if any, might form, in the future, a sound basis for recommending the adoption of IAS 39. They are not relevant to the present assessment. Furthermore, if these discussions were to fail, the problem of how to achieve the desired Standard on financial instruments as soon as possible cannot override technically the failure to comply with the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards.

3. MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin believe that Europe deserves high-quality accounting standards, and that no requirement that prevents IAS 39 from meeting the IAS Regulation criteria should be made mandatory. They further believe that some agreement on interim measures could be reached with the IASB in time to meet the 2005 European deadline as the IASB has indicated to be willing to straighten out, in a reasonably close future, hedge accounting requirements and other pending issues related to IAS 39. Those interim measures should include well identified optional treatments, in particular in the areas of hedge accounting and accounting for liabilities with a demand feature, with possible temporary exemption of the compliance with the IAS framework. Such a temporary exemption might indeed

be desirable, to match the need for accounting derivatives at fair value. All other basic principles for hedge accounting set out by the IASB at the outset of the discussions would be satisfied.

As soon as the IASB has completed the necessary amendments to IAS 39, the optional treatments and/ or exemption would be withdrawn. In the meanwhile, IAS 39, including temporary optional treatments could be endorsed and comparability among entities be achieved on recognition, derecognition, fair value measurement and impairment requirements for financial instruments. Furthermore, no entity would be prevented to be fully compliant with IAS 39 as it stands today.

Views of Mrs. Guttman:

1. Mrs Guttman shares the comments expressed by MM. Bezold, Flores, Leeuwerik, Marinelli and Thouvenin in the first point of their comment.

The matter of significant distortions raised in their view, is in her opinion linked to three conceptual issues, combination of which leads to the fact that IAS 39 will not provide relevant and reliable information for many financial institutions (banks and insurance groups).

Those businesses act as an intermediary: they collect a large volume of resources of a limited amount each (financial liabilities) that are repayable on demand from individuals and replace those amounts in various forms ranging from investments in bonds (and so providing finance to companies and States), or loans to companies or individuals (providing finance to companies and individuals). These companies use interest rate swaps and/or non derivative interest rate financial assets to hedge their exposure to the interest rate risk arising from the financial liabilities having immediate demand features.

Under IAS 39, those entities cannot apply hedge accounting principles in an efficient way. As a result, changes in fair value of hedging derivatives and other fixed rate financial assets (*other than loans*) used economically as hedging instruments have a direct effect on those entities' equity, or profit or loss, without any possible mitigation of the effect with the interest rate risk component of the economically hedged financial liabilities.

The three conceptual issues are the following:

1.1 IAS 39.49 requires that “the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid”.

This accounting requirement does not recognize the effects of the behaviour of a portfolio of financial liabilities having an immediate demand feature, such as demand deposit or other financial contracts issued by insurance companies with an immediate demand feature. Historical evidence indicates that a part of the overall average balance is stable over several months and decreases gradually over several years as some deposit-makers close their account. However, IAS 39 indicates that the life of the financial liability is deemed to be limited to the date of the demand feature of each of the items in the portfolio.

This example illustrates a major conceptual weakness of the Standard: one of IAS 39's principles is that the measurement of financial instruments shall be performed instrument by instrument. IAS 39 rejects the fact that the behaviour of a portfolio of assets or liabilities

having similar characteristics is not equal to the sum of the behaviours of the individual items in those portfolios. As a result, IAS 39 does not allow to take into consideration the interest risk component included in those portfolios.

In reality, the fair value of a homogeneous group of items is often different from the sum of the fair values of each item of that group taken individually. The reason is that the 'law of large numbers' applies and that this theory is always considered in the valuation of transactions. Although IAS 39 rejects this, we note that it does require the use of models that take into account statistical and probabilistic behaviours in measuring the fair value of optional derivatives.

Furthermore, IASB Standards make use of *probabilistic* models and so acknowledge their relevance such as:

- (a) IAS 37, *Provisions, contingent assets and contingent liabilities*, with the measurement of provisions involving a large population of items using an "expected value" approach;
- (b) IAS 19, *Employee benefits*, with the consideration in the measurement of an employee benefit obligation of turn-over, mortality and other assumptions;
- (c) IFRS 2, *Share-based payment*, with the measurement of the expense to be recognised for employee stock options including turn-over assumptions; or even
- (d) IAS 39, which requires consideration of probabilities for the measurement of groups of assets including prepayment clauses or options to extend the remaining term to maturity of a debt instrument (an entity must use an "expected life" approach for the determination of the effective interest rate) or the measurement of impairments for portfolios of groups of assets that do not include financial assets already impaired.

1.2 The basis for conclusion of IAS 39 (BC 188) states that the fair value of financial liabilities consisting of debt instruments having an immediate demand feature is not affected by interest rates if the fixed interest rate is nil.

This statement, in connection with the point 1 referred above, is the reason presented by the IASB to justify that non interest bearing financial liabilities do not qualify for hedge accounting.

If it is acknowledged that a portfolio of financial liabilities at zero interest rate has some stability (refer to first conceptual issue), the fair value of the portfolio cannot be equal to the sum of the nominal value of its items. It is a fact that the fair value of a portfolio of resources having a fixed rate below the rate to refinance this resource on the market is not its nominal value, and that its fair value is linked to the changes in market interest rates. In addition, it makes no economic sense to state that this type of resource does not have a interest rate risk component where it is known that the stability of those portfolios of liabilities is directly linked to the economical environment and its related currency, which currency also fluctuates according to the level of inflation and interest rates on the market.

Even if the IASB acknowledges in IAS 39.BC 188(b) the reality of the two conceptual weaknesses addressed in 1.1 and 1.2 above, the IASB considers that there is no sufficient knowledge of all the elements making up the fair value of a *portfolio* of financial liabilities

having immediate demand features to ensure their reliable measurement. Therefore, their conclusion is reached that nominal value was the only possible measurement method.

Even if additional research would be needed to determine the fair value of such portfolios, the interest rate risk component is directly identifiable and measurable. Therefore, there is no obstacle to identify this component in a hedging relationship, as long as the other hedging requirements are met.

IAS 39 will introduce a fictitious accounting volatility, for those preparers that have implemented a policy where, interest rate risk component is economically hedged.

1.3 IAS 39 prohibits the ability for a non-derivative financial instrument to qualify as a hedging instrument of another debt instrument and hence prohibits the ability to hedge the interest rate risk component of a non derivative financial liability with the interest rate component of a non derivative financial asset. No justification of those prohibitions is based on technical or financial grounds.

Debt instruments recognised as financial assets and financial liabilities are representative of series of cash flows for principal and interests, in the same way as derivatives (e.g. interest rate swaps). An interest rate swap is nothing more than the combination of a loan (financial asset) and a borrowing (financial liability) with the same counterpart. Therefore, it would not be complex to allocate the expected future cash flows to maturity bands arising from either non derivative financial instruments (either financial assets or financial liabilities) or interest rate swaps so as to determine the net interest rate gap exposure and to measure the inefficiency of a hedge relationship.

The impossibility to consider non derivative financial instruments for the purpose of interest rate risk hedge accounting is a third conceptual weakness.

2. Mrs. Guttmann further expresses the following view :

By analogy to the hedging of future transactions, the Standard considers that hedge accounting can be applied to a variable debt instrument (e.g. future cash flows having a fixed maturity but a value that varies according to an index), but only within a cash flow hedge relationship. In this case, the standard requires changes in value of the derivative instrument are recognised in equity.

Therefore, according to IAS 39 a fixed interest rate financial asset is accounted for at fair value with changes in fair value recognised in equity or profit and loss (or are accounted for at amortised cost) depending on the accounting classification of this asset. On the contrary, changes in fair value of a variable rate financial asset that is swapped to fixed rate with an interest rate swap are accounted for in equity only.

The argument used, to justify the recognition in equity for hedges of future transactions, is that those future transactions are not recorded as an asset or a liability.

This argument is not relevant for hedges of variable rate instruments:

- The cash flows of variable rate instruments are contractually determined;

- The values of those variable instruments is recorded in the balance sheet; it is only the variation of their fair value which is nil (provided the fixing date and the closing date are the same).

So, there is no justification in accounting hedge to a variable instrument in equity.

3. Mrs. Guttman expresses the view that accounting for hedged portfolios of financial instruments at fair value could not be a solution on a short term basis.

Indeed as long as fixed (or variable) interest rate financial assets are backed by fixed (or variable) interest rate financial liabilities, including derivatives, changes in fair value of the cash flows relating to financial instruments that exactly match the hedged position would be offset in profit and loss (thus evidencing there is no interest rate mismatch).

Irrespective of one's opinion on what is the right concept for fair value measurement, since IAS 39 states that the fair value of financial liabilities with a demand feature cannot be less than their redemption value, this solution is however not applicable to the particular case of financial liabilities that are repayable on demand.

Additionally, fair value measurement principles are not sufficiently finalised to provide a reliable and relevant answer: fair value measurement of portfolios of financial instruments with similar risks or fair value measurement of financial instruments having servicing components embedded are not finalised yet in IAS / IFRS.

The current Exposure Draft on the fair value option published in April 2004 allows the use of the fair value option in only limited circumstances and would prohibit in particular its use in the case of portfolios where the risk exposures are only partially offset (refer to the EFRAG's letter on this ED).

As a result, this possible solution can be envisaged only when the IASB projects on measurement and revenue recognition will be completed. It cannot be a short-term solution.

4. Possible way forward on a short term basis:

To address the identified weaknesses, a short-term workable solution could be to permit:

- (a) the use of time buckets for the net interest gap between financial assets and financial liabilities (including interest rate derivatives). Those financial liabilities would be allocated to the maturity bands according to their expected maturity based on the expected behaviour of the portfolio (in the same way as this is permitted by IAS 39 for financial assets including prepayment clauses or options to extend the remaining term to maturity of a debt instrument); and
- (b) the recognition of changes in fair value of hedging instruments (derivatives or financial assets depending on the hedging strategy) and of the hedged component of the liability as follows:
 - (i) the changes in fair value of the portion of the hedging instrument that is entirely backed according to the interest rate gap built as described above would be recognised as an asset or a liability against profit or loss. The change in fair value of the interest component of the hedged risk of the liability would also be recognised as an asset or a

liability against profit or loss, resulting in an accounting solution that is similar to IAS 39's accounting of a fair value hedge. If the position is perfectly matched, the impact on the profit or loss would be zero; and

- (ii) the changes in fair value of the portion of the hedging instrument that is not backed (and that is therefore in excess over the hedged position) would also be recognised in profit or loss.

This solution would remain valid until the IASB projects on measurement and revenue recognition are completed.

This solution is also compliant with the requirements of IAS 39.BC177¹, if it is accepted that there is an interest rate risk component where financial assets and financial liabilities are considered to form a hedge relationship. This is particularly true in the light of IAS 39.BC 181².

It addresses the concerns expressed in IAS 39.184³. The solution will not result in inappropriate fair value measurements of a net position. Using techniques of interest rate gap already recognised to be adequate by the Standard, it relies on the fact that (fixed / variable) interest rate assets that are properly matched by (fixed / variable) interest rate liabilities positions should not give rise to an impact in profit and loss or equity.

It is consistent with the IAS 39 principle that requests to recognise at fair value derivatives, available for sale financial assets, etc.

It would require the recognition in profit or loss of any change in fair value of cash flows relating to hedging financial instruments.

It would avoid the "false" volatility of equity or profit and loss, created solely by the proposed accounting rules.

Mrs. Guttman has provided in appendix 1.1 to this letter two illustrations which amplify her views.

¹ « ... the three principles that are most relevant to a portfolio hedge of interest rate risk are : (a) derivatives should be measured at fair value ; (b) hedge ineffectiveness should be identified and recognised in profit and loss ; (c) only items that are assets and liabilities should be recognised as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be recognised in the balance sheet."

² "The Board also noted that if the items in the hedged portfolio are subject to different amounts of prepayment risk, they may fail the test in paragraph 78 of being similar and the related requirement in paragraph 83 that the change on fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. The Board decided that, in the context of a portfolio hedge of interest rate risk, these requirements could be inconsistent with the Board's decision, set out in the previous paragraph, on how to incorporate the effects of prepayment risk. Accordingly, the Board decided that they should not apply. Instead, the financial assets of financial liabilities included in a portfolio hedge of interest rate risk need only share the risk being hedged."

³ « In considering questions of designation, the Board was also concerned about questions of measurement. In particular, the Board observed that fair value hedge accounting requires measurement of the change in fair value of the hedged item attributable to the risk being hedged. Designation on the net position would require the assets and the liabilities in a portfolio each to be measured at fair value (for the risk being hedged) in order to compute the fair value of the net position. Although statistical and other techniques can be used to estimate these fair values, the Board concluded that it is not appropriate to assume that the change on fair value of the hedging instrument is equal to the change in fair value of the net position."

Illustrations of Mrs. Guttman's views

Let us consider successively two different simplified scenarios. For simplification, credit risk is assumed to be nil.

First case: interest rate gap is managed using hedging interest rate swaps

1/ Let us consider an entity which has a portfolio of demand deposits bearing variable interest rate and which extends loans at variable rate. We assume that interest rate indices are similar.

According to IAS 39 these financial assets and liabilities would normally be accounted for at amortised cost, which would not cause any particular distortion on equity or profit and loss.

2/ Let us consider that an entity which has a portfolio of demand deposits bearing variable interest rate and which extends fixed rate loans to customers. In order to hedge its interest rate exposure, it enters into interest rate swaps (paying fixed rate and receiving variable rate).

According to IAS 39, paying fixed rate – receiving variable rate swaps can be documented either as a fair value hedge of fixed rate assets or as a cash flow hedge of variable rate liabilities. However, accounting consequences will vary depending on the choice made by the entity:

- Interest rate swaps are documented as a fair value hedge of the fixed rate assets. The following points are worth consideration:
 - As mentioned above, IAS 39 allows taking into account portfolio effects and statistical behaviour of prepayable financial assets. For the purpose of the interest rate gap's elaboration prepayable assets can be allocated into different time bands according to their expected maturity. Interest rate swaps will then be gauged compared to the resulting net exposure.
 - According to IAS 39, changes in fair value of the hedging swaps in a fair value hedge relationship are accounted for in profit and loss. However, as long as the hedge relationship is efficient this impact is entirely offset due to the re-evaluation of the interest rate component of the hedged fixed rate assets.
- Interest rate swaps would be documented as a hedge of the variable rate liabilities. The following points need to be emphasised:
 - In this case, because the deposits are repayable on demand and have thus a contractual maturity of one day, the entity needs to make roll-over assumptions of these deposits in order to document the interest rate swaps in a cash flow hedge relationship.

- According to IAS 39, variable rate instruments are only eligible to cash flow hedge accounting. As a result, changes in fair value of the interest rate swaps are recognised in equity (for the efficient part).

3/ Let us consider an entity which has a portfolio of demand deposits bearing fixed rate and which extends variable rate loans.

As shown above, using the same swap, the entity could either choose to document a cash flow hedge relationship of the variable rate assets or a fair value hedge relationship of the fixed rate liabilities.

- In the first case, as the variable rate assets are swapped from variable to fixed rate (i.e. cash flow hedge relationship), changes in fair value of the interest rate swaps are accounted for in equity
- In the second case, according to IAS 39, hedge accounting is not permitted at all as the fixed rate liabilities have a demand feature. Portfolio effects are disregarded by IAS 39 and as a result the expected life of demand deposits cannot exceed their contractual life (i.e. one day). Consistently, IAS 39 considers that the fair value of demand deposits cannot be different from the redemption value. As a consequence:
 - Changes in fair value of the interest swaps are entirely recognised in profit and loss;
 - Practically, the entity has no other choice than to document the hedge relationship as a cash flow hedge relationship of the variable rate assets (refer to first case above).

Conclusion: Based on these very simplified examples, it is clear that IAS 39 introduces accounting distortions that cannot be justified from an economical point of view.

Second case: managing interest rate risk using non derivatives interest rate assets

Let us consider an entity which has issued zero coupon liabilities with long maturities. These liabilities are repayable on demand. Redemption value is nominal value plus any accrued interests.

In order to be able to pay the interests on these liabilities to the holders of these contracts, the entity acquires fixed rate instruments, excluding interest rate swaps.

According to IAS 39, hedge accounting is not available.

As a result, the entity has fixed rate financial assets and fixed rate liabilities.

Applying IAS 39 would result in the following accounting treatment:

- Changes in fair value of the fixed rate assets classified as available for sale assets are recognised in equity (these assets cannot be classified as held until maturity or as loans and receivables and thus cannot be accounted for at amortised cost)
- On the contrary, financial liabilities are accounted for at amortised cost and changes in fair value (including changes in the fair value of the interest rate component) are not recognised either in equity or in profit and loss.

Although the interest rate gap can be nil provided the cash flows of the fixed rate assets perfectly match the cash flows on the fixed rate liabilities, artificial volatility will be recorded in equity as shown in the previous examples.

This distortion is the result of the following:

- Except for forex exposure, non derivative financial instruments cannot be hedging instruments according to IAS 39, although certain non derivative financial instruments are accounted for at fair value and are comprised of similar cash flows;
- According to IAS 39, it is prohibited to hedge the interest rate risk of a non derivative financial liability with a non derivative financial asset, although the two legs of an interest rate swap (e.g. fixed rate paying leg and variable rate receiving leg) can be assimilated to the sum of a fixed rate borrowing and of a variable rate loan, same nominal, same maturity.

Based on this example, it is clear that ignoring combinations of non derivative financial instruments and of combinations of interest rate exposures for hedging purposes leads to accounting anomalies.