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ITEM X OF THE AGENDA: IAS 39 – FINANCIAL INSTRUMENTS

Background

The European Banking Federation industry has been critical of IAS 39 from inception. Its concerns about IAS 39 and, in particular, the inappropriateness of its hedging rules can be traced back to 1999 when the International Accounting Standards Committee (IASC) adopted IAS 39. Since that time the FBE and others have been tireless in seeking to draw to the attention of the IASB the need to undertake a fundamental review of IAS 39.

During the subsequent years, the International Accounting Standards Board (IASB) – which is the successor of the IASC – has taken several initiatives aiming at improving IAS 39. However, no significant amendments were made to areas which were key to the European banking industry. The IASB even refused to discuss the concerns which the FBE had expressed on a bilateral basis. It was only prepared to meet with an FBE delegation after it had been put under pressure by the European Commission to do so.

Since that time, the FBE engaged in a series of almost monthly meetings with the IASB with the objective of making sufficient progress on hedging that would have enabled the banking industry to support IAS 39 being endorsed by the European Union. This dialogue culminated in the publication by the IASB of a standard on fair value hedge accounting for a portfolio of Interest Rate Risk. The outcome was, however, disappointing mainly because:

- the hedge accounting rules did not enable banks to hedge the exposure to changes in interest rates that arise from the behavioural maturity of “core deposits” (i.e. sight and savings deposits);
- the standard put many restrictions on the use of such hedges which made the standard cumbersome to apply in practice and resulted in accounting rules which were not in line with banks’ risk management practices.

As a result, the FBE is currently seeking support from the IASB for its “Interest Margin Hedge” proposal, i.e. a hedging model that focuses on interest margin and in doing so

provides a basis more compatible with the way in which banks seek to manage risk. It would, moreover, allow core deposits to be included in the hedged portfolio.

In the meantime, the European Central Bank had severely criticised IAS 39 because it allowed entities to designate any financial asset or financial liability as one to be measured at fair value ("fair value option").

Partial Adoption of IAS 39 by the European Commission

The fierce opposition from the European Central bank as well as from the European banking industry against IAS 39 led the European Commission to endorse IAS 39 only partially in November 2004. It refused, more particularly, to support its provisions:

- on the use of the fair value option and
- on hedge accounting.

The two 'carve outs' are purely temporary because the Commission expects the IASB to bring forward the necessary amendments to the current full fair value option by December 2004 and to the provisions on hedge accounting by September 2005.

Work on the Fair Value Option

The carve-out of the fair value option is based on concerns which have been expressed by the European Central bank. The ECB is opposed to the option mainly because:

- the option implies supporting a "full fair value" model on the basis of which all assets and liabilities would be measured at fair value (as opposed to the current mixed model according to which some items are measured at historic cost whilst others are measured at fair value);
- applying the option would not be in conformity with the principle of prudence, particularly in those instances where there is no reliable market value available;

Therefore, it convinced the IASB to prepare a draft amendment aiming at restricting the use of the fair value option as much as possible.

It must be said that the FBE had much sympathy with the position taken by the regulators. However, the possibility to make use of the option revealed essential for European institutions which had planned to make use the fair value option. The option allowed them to deal with sophisticated financial instruments without much difficulty and provided, moreover, a pragmatic means to overcome the many restrictions which IAS 39 contained in the area of hedge accounting. Without the option it would be considerably more onerous for banks to apply IAS 39. The European Central Bank appeared, however, intransigent.

To limit the damage, the FBE approached the Basel Committee and suggested that both institutions would undertake joint efforts to try and develop a compromise solution which would be acceptable to all stakeholders involved, including the European Central Bank.

Interest Margin Hedging (IMH) Proposal

The IMH Proposal seeks to introduce an accounting model that takes as its starting point the retail banking process: banks collect deposits with a view to transforming them to provide lending over a longer timeframe. Hence the need for an accounting model that focuses on the interest margin and, in doing so, provides a basis which is more compatible with the way banks seek to manage interest rate risk. In doing so, the model which the

FBE proposed would particularly see to it that exposures arising from core deposits are being accommodated on a more straightforward basis.

Initially, the IASB appeared to be extremely critical on the proposal. The criticism which it raised appeared, however, to be based to a large extent on many misgivings about the FBE proposal. As these misgivings were lifted following clarifications provided by the FBE experts, the IASB started realizing that it was not the intention to strive for an overly flexible approach and that, on the contrary, the proposed methodology imposes constraints on banks. As a result, they seem to have become more constructive.

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