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Mr. Patrick Mommens
Project Manager EFRAG
Avenue des Arts 41
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5 July 2004

Re : Adoption of IAS 39: "*Financial Instruments: Recognition and Measurement*".

Dear Mr. Mommens,

We are pleased to provide our comments on the Adoption of IAS 39 "*Financial Instruments: Recognition and Measurement*".

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)

Adoption of IAS 39 “Financial Instruments: recognition and measurement”

1. Introduction

As pointed out in the OIC comments referring to the exposure draft on “Fair value hedge accounting for a portfolio hedge of interest rate risk”, we particularly appreciated the fact that the IASB decided to introduce the possibility of designating as a hedged item an “amount” that represents a portion of assets or liabilities, with no need to identify the single assets or liabilities.
However, in the same comments, we also highlighted some critical issues, mainly relating to some types of banking activities concerning hedging effectiveness and the hedging of core deposits, which remained unresolved in the final version of the document.
As explained in full in the conclusions, these critical issues (summarised below) induce us not to consider possible the adoption of IAS 39 by the European Commission, at least as far as these issues are concerned.

2. Risk management in banks and financial institutions

Banks activate interest rate exposure hedging with the intention of maintaining the variability/volatility of the interest margin generated by financial assets and liabilities within the limits defined by risk management policies.

The interest margin is variable when the components, interest costs and interest revenues, are determined on the basis of two different rate categories, one fixed and one variable.
This kind of situation arises in every period in which there is a mismatch between fixed rate assets and liabilities.
A mismatch generates an interest rate exposure risk, meaning that adverse rate variations could erode the net interest income of financial and credit institutions.

Interest rate exposure hedging aims to protect the variability of the interest margin for a future period. In order to gain such protection, an entity enters derivative contracts in order to balance its exposure to such a variability.
In other words, in these cases, hedging does not aim to protect against fair value variations of the fair value components of the banking book (which is the aim of fair value hedging) or against cash flow variations as defined in the cash flow hedging.
A fair value hedge is designated to protect asset (or liability) value when the asset (or liability) is sold (or bought). However, in normal banking transactions, banking book components are not sold.
A cash flow hedge does not cover the variation in the difference between future fixed and variable cash flows of opposing signs; it only aims to cover the exposure of one specific cash flow.

Interest rate exposure hedging in financial and credit institutions is managed in the following manner.

1. Identification of a portfolio of financial instruments for which the hedging of the interest margin is desired. The portfolio includes assets and liabilities with both fixed and variable rates.

2. Analysis of the portfolio in terms of maturity periods based on the expected re-pricing dates or contract re-pricing dates. This means that the portfolio exposure to interest margin variation must be analysed identifying a net open position on interest.

3. Based on such analysis, the entity shall decide the amount of hedging it intends to achieve and designs as a hedged instrument a notional amount of the identified net position on interests.

All fixed rate financial assets, including those held to maturity, can be part of a portfolio hedged for interest risk exposure. Where a fixed rate asset is financed by a variable rate liability, the interest margin on such a position is obviously subject to the risk of interest rate variations.

Core deposits can be part of a portfolio based on their expected maturity (or re-pricing dates where they generate interest).
Any component of a core deposit that does not generate interest creates a net position on interest in combination with the investment portion of those funds; the interest margin deriving from nil costs and variable revenues is exposed to fluctuations or variations.

3. Unresolved issues

IAS 39 does not consider this kind of risk management logic nor does it consider the indications expressed by national or supranational regulatory committees. Interest rate risk management (and the relative standardization, in time, of the interest margin) in financial and credit institutions is the result of a study conducted by a working group created by the Basel Committee, which established the rules and methods for economic measurement and disclosure. A number of entities belonging to the industry have, over time, organized themselves (in terms of company structure, business activities and strategic planning) and have made decisions related to IT investments and risk management policies, following the aforementioned indications and suggestions.

As the accounting methods of hedging operations currently indicated by IAS 39 do not reflect the risk management philosophy of banks or other financial institutions, the European Banking Federation proposed to the IASB an accounting method for hedging operations that is more coherent with risk management procedures (the “interest rate margin hedge”).

The disclosure methods of portfolio hedging operations indicated in the “Fair value hedge accounting for a portfolio hedge of interest rate risk” document, which supplements IAS 39, only partially satisfy the needs indicated above.
If, on the one hand, the document has correctly considered the possibility of designating as a hedged item an “amount” representing a portion of assets or liabilities without the need to identify the single assets or liabilities, on the other hand, the method proposed for determining hedging effectiveness (and the accounting consequences) is not acceptable.
Such a method, which foresees the identification of ineffectiveness in the presence of both “over hedge” and “under hedge” situations, instead of measuring the effectiveness of the hedging, tends to measure the correctness of the forecasts made by an entity relative to the cash flows produced by the hedged assets and liabilities. In those situations where, as an effect of non-forecast cash flow variations, the hedged values become higher than originally foreseen, with the result that the hedging

instrument is able to only partially cover the risks connected to the hedged values, it is not correct to talk about hedge ineffectiveness because the aims of risk reduction are still valid.
It is, instead, correct to talk about hedge ineffectiveness in the opposite situation, for the portion of hedged instrument no longer correlated to the asset or liability present in the financial statement.
This means that only in "over hedge" situations would it be correct to declare that the hedging presents a total or partial ineffectiveness. However, in the case of an "under hedge", only the forecast made by the entity and relative to the cash flows is not correct, while the hedging maintains its effectiveness as it still answers the entity's need to reduce financial risks.

Another issue concerns the possibility of considering core deposits among the hedged values.
Core deposits represent a relevant and structural component of the onerous liabilities of Italian banks. They will always be an integrated part of ALM strategies for risk management and hedging operations.
The core deposits portfolio is mainly structural. In other words, if it is true that every single deposit does not present fixed or determinable maturity, it is also true that a significant portion of the compound portfolio represents a form of funding, and therefore a liability that is quite stable over time.
A sudden and consistent withdrawal of deposits on behalf of the clients would have a severe impact not so much on the hedge accounting as on the continuity of the banking activity.
At the same time, there is no doubt that such liabilities present an economic value that is different form the nominal value represented in the financial statements.
With this view in mind, such a stable liability component must be treated as all the other banking book assets and liabilities not only for the identification of assets and liabilities subject to portfolio hedging but also for the designation of liabilities hedged in the case of a "liability net position".

Concerning insurance, the current version of IAS 39 leaves some issues unresolved:
- There is still a mismatch between macro-hedging investments of insurance contracts measured at fair value, and insurance liabilities measured on a different basis (local GAAP);
- The mismatch issue and the non–applicability of HTM category without a temporary exemption of the "tainting rules";
- The introduction of a correction to the fair value measurement basis (deposit floor) of liabilities, showing a demand-deposit feature;
- For insurers, those contracts issued are not sold as demand deposit contracts, but rather as long-term savings contracts.

4. <u>Potential consequences of applying the current version of IAS 39</u>

The difficulties indicated above in applying IAS 39 may create accounting effects that do not enable the real company situation to be expressed or that may induce arbitrary actions.
In the first case, the indication of an ineffective situation, in terms of hedge accounting, that is not considered as such in terms of risk management ("under hedge" situations) means representing an unreal income variability in the income statement. In the same terms, the use of cash flow hedging determines an unreal equity volatility as it derives from a fair value variation of financial assets and liabilities that is not evidenced in the financial statement data.
In the second case, the possibility of choosing between fair value hedging and cash flow hedging may create different representations of hedging operations even though the risk management modality is identical (for example, the hedging of a portfolio of fixed-rate loans with a variable-rate liability can

be represented as a fair value hedge if the decision is to transform fixed-rate loans into variable-rate ones, or as a cash flow hedge if the decision is to transform the variable-rate liability into a fixed-rate one).

5. Conclusions

The OIC is of the same opinion as the EFRAG concerning the need to have a high-quality accounting principle for the measurement and disclosure of financial instruments.
However, the application of the current provisions of IAS 39 relating to hedge accounting and in particular to portfolio hedge accounting does not allow such operations to be disclosed in a way that is in conformity with their substance and aims, which are mainly risk reduction and the stabilization of economic results.

On the contrary, the limits introduced by IAS 39 in terms of determining hedge effectiveness and treating core deposits create numerous circumstances in which the volatility of economic results and/or equity tends to rise, which is the exact opposite of desired aim.

These potential distortions cannot be eliminated through explanations inserted as disclosures as indicated in IAS 1 article 16.

Furthermore, the current version of IAS 39 leaves some important insurance-related issues unresolved.

For these reasons, the OIC thinks that, in the absence of a satisfactory solution to such issues, IAS 39 does not meet the criteria of understandability, reliability and comparability indicated as necessary by article 3 of European Commission Ruling 1606/2002 for the endorsement of accounting principles.

Should the European Commission, taking into account the systematic connections between IAS 39 and the other IAS/IFRS principles, deem it necessary to adopt IAS 39 in order to satisfy the need for a sufficiently complete and defined regulatory framework, we suggest that the endorsement of IAS 39 at least exclude those parts relating to the issues highlighted in the present letter.
This would, of course, require a temporary discipline for a series of problems arising from such a decision.

Concerning the fair value option, we intend to address this issue in a separate comment.