Swedish Bankers´ Association

Svenska Bankföreningen

POSITION PAPER

14 November 2003

IASB
30 Cannon Street, London EC4M 6XH
United Kingdom

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT - FAIR VALUE HEDGE ACCOUNTING FOR A PORTFOLIO HEDGE OF INTEREST RATE RISK

Swedish Bankers´ Association welcomes the opportunity to comment on the Board's exposure draft of fair value hedge accounting for a portfolio hedge of interest rate risk.

Introduction

Interest rate risk emerging from banks lending activities is usually managed on a portfolio basis. Often the purpose is to substantially reduce the risk position incurred by fixed interest rate lending and to manage it within given limits. Banks use both cash instruments and interest rate derivatives including cross currency interest rate (CC/IR) derivatives in order to efficiently achieve that goal within a portfolio framework. Huge artificial volatility in reported earnings is expected when portfolios include both instruments measured at cost and at fair value. This will occur when off setting value changes in the portfolio, caused by interest rate movements, will be recognised in reported earnings in different time periods due to the different measurement method. High volatility in reported earnings normally sends clear signals to the market of a high risk level in the business. This will be the case even if the volatility is artificial. When an entity is regarded as risky its cost of funding and of doing business in general will increase. Hence huge artificial volatility in earnings could be very costly. As a consequence the focus of risk management may have to change from avoiding economic

Postadress	Gatuadress	Telefon	Telefax	Bankgiro	Postgiro
Box 7603 SE-103 94 STOCKHOLM www.bankforeningen.se	Regeringsgatan 38	08-453 44 00	08-796 93 95	700-1779	505-8

losses to avoid artificial volatility in reported earnings, which of course is completely against prudent risk management practices.

We have earlier informed the IASB about these concerns and proposed an application of the proposed fair value option included in the exposure draft of IAS 39 as a measure to resolve the problems.

We have concluded that hedge accounting will not provide the full solution to the problem with artificial volatility in earnings as long as cash instruments are prohibited as hedging instruments.

Since the Board now explicitly is requesting comments on matters set out in the exposure draft we will limit our focus in this position paper to the proposed framework. In our reply, we accept the restriction imposed by the Board that hedge accounting is not applicable when only cash instruments are used as hedge instruments.

Swedish Bankers' Association welcomes the Board's decision to explore the possibility of amendments to IAS 39 for portfolio hedge of interest rate risk within the underlying requirements. We share the Board's aim to create a practical and workable approach for entities to manage interest rate risk on portfolio basis, which also allows data collected for risk management to be used in preparing financial statements. We share the aim to avoid major and costly system changes.

Summary of Swedish Bankers' Associations views on the proposal

1. We agree with the suggestion to designate amounts instead of individual assets.
2. We agree with the suggestion to present the effects in the balance sheet lines referred to in paragraph 154.
3. We do not agree with the suggested approach to measure ineffectiveness as we believe it to reflect a special market practice and therefore is not generally applicable.
4. We are of the opinion that it has to be allowed to designate the gross amount of assets *and* liabilities as the hedged item.
5. We are of the opinion that the time-buckets must be in separate currencies to take into consideration that there are markets which depend on funding in foreign currencies.

6. We are of the opinion that it is crucial, in the application of hedge accounting, to allow separation of CC/IR-derivatives into their different currencies and fair value them using two different reference interest rates.
7. We find the proposal to be static not recognising that transactions take place continuously. We suggest a dynamic approach.
8. We suggest minor changes in paragraph 128A needed to create a general model for measurement of ineffectiveness and for the creation of hedging relationships. Otherwise, the macro hedge proposal will not be useful on the Swedish as well as many other markets.

– – – – – – – – – – – – – – – –

Below we discuss the reasoning behind our suggestions. We believe that our suggestions will create a more general solution that is not tied to specific market characteristics. We also must add that as the proposal now is stated it will very much distort results and thus will not be useful.

General comments

Swedish Bankers' Association unfortunately concludes that the exposure draft seems to be limited to the special cases when fixed interest rate assets and liabilities either can be prepaid without any obligation to pay a prepayment fee - or can not be prepaid at all - and where only single currency interest rate derivatives are used to hedge interest rate risk.

Generally, in Sweden prepayment of a fixed interest loans triggers a full yield maintenance prepayment fee. We have found that full yield maintenance prepayment fees are allowed in most European countries.

Another special feature for Swedish banks, which we share with other banks working outside the USD and EUR zones, is that funding to a large degree is raised in other currencies than the lending currency. As a consequence interest rate risk in several currencies exists in the portfolio. Cash flows in different currencies in a CC/IR-derivative are often used to hedge interest rate risk in both of the currencies the derivative is denominated in. These features make the scope of application of the proposed framework limited for Swedish banks.

However, we believe that the scope of application will be substantially enlarged with a few changes in the proposed framework.

Expectations about prepayment have no impact on interest rate risk ex ante when prepayment of fixed interest lending triggers a (full yield maintenance) prepayment fee. In such cases calculated value changes and hedge effectiveness should be based on contractual, rather than expected, repricing dates even if prepayment is expected. Swedish Bankers' Association therefore proposes that approach C should be used when designating the hedged item and when measuring ineffectiveness. In a prepayment fee environment there is no need for estimating expected prepayments but in a different environment expected prepayments could be handled by designating relevant parts of the hedged item. This is an approach which could be accepted by the four Board members that voted against the publication of the Exposure Draft.

In paragraph 128A it is stated that "the amount designated, as a hedged item, is an amount of assets *or* an amount of liabilities". This leads us to the conclusion that the proposed framework is not applicable when interest rate risk in several currencies is managed in the same portfolio. Swedish Bankers' Association is of the opinion that if an entity effectively should be able to use portfolio hedge accounting – regarding interest rate risk when the portfolio consists of hedged items denominated in different currencies – it has to be allowed to designate the gross amount of assets *and* liabilities as hedged items.

Swedish Bankers' Association believes it is crucial that the Board changes the rules regarding the application of hedge accounting to a portion of a derivative contract so that hedge accounting also could be applicable when the interest rate risk in one currency is hedged with counter balancing interest risk in the same currency in a CC/IR-derivative contract. Such decomposition is fully consistent with the methods used to calculate the market value of such instruments.

In Appendix 1 we describe current Swedish bank practices with regards to "macro hedge accounting". In Appendix 2 we deepen our rational behind our statements in response to the questions in the exposure draft. We also give examples describing the effects on the accounts when prepayment occurs. Furthermore, an example is presented on the effects on the accounts when both assets and liabilities are defined as hedged items.

Answers to the questions raised in the Exposure Draft

Question 1

Draft paragraph 128A proposes that in a fair value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount. For example, it may hedge the change in the fair value of the designated amount attributable to changes in interest rates on the basis of expected, rather than contractual, repricing dates (the repricing date is the date on which the item will be repaid or repriced to market rates). However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (e.g. in the light of recent prepayment experience), or actual repricing dates differ from those expected. Draft paragraph A36 describes how the amount of such ineffectiveness is calculated. Paragraphs BC16-BC27 of the Basis for Conclusions set out alternative methods of designation that the Board considered, their effect on measuring ineffectiveness and the basis for the Board's decisions including why it rejected these alternative methods.

Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness? If not,

(a) in your view how should the hedged item be designated and why?

(b) would your approach meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit or loss?

(c) under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet?

Response

Q1:a in your view how should the hedged item be designated and why?

We believe that the proposal has focused on interest risk management strategies used when prepayment risk is an issue and where the funding is in the same currency as the assets. In an environment where prepayment is not allowed without the banks paying a prepayment fee the proposal is not in line with interest rate risk management practices used. Therefore, Swedish Bankers' Association is of the opinion that the proposal needs to recognise markets using prepayment fees as well.

In an environment with prepayment fees the contractual repricing date should be in focus. Furthermore, the IASB proposal will not give a true view of the actual realised effects on the market value of the portfolio being hedged. We believe that the most accurate methodology – fully in line with the prohibitions in IAS 39 regarding hedging a net position – would be to:

1. Identify the hedge portfolio (assets and liabilities being hedged).
2. Identify the interest rate risks being hedged.

3. Identify the derivative portfolio used as a hedging instrument.
4. Fair value the derivative portfolio.
5. Discount the gross amount of assets and liabilities being hedged using the relevant interbank interest rate.
6. Recognise the change in fair value of hedged item and hedging instrument in earnings with contra entries in the balance sheet.

The proposed method would align the IASB proposal in full with risk management practices used by financial institutions working in an environment highly affected by the following factors influencing day-to-day business:
- A large proportion of the funding is in currencies other than the assets.
- A large number of derivative contracts are used, fair valued using two different zero coupon interbank interest rates when valuing each contract. The reason is that they are denominated in two separate currencies.
- Prepayment fees are received when the customers choose to prepay their loans.
In the Appendixes we try to elaborate on the different issues raised and present simple examples to highlight our concerns.

Q1:b would your approach meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit or loss?
Yes. In our approach, ineffectiveness is immediately identified and recognised in earnings since the total portfolio being hedged is measured at fair value using the relevant interbank interest rate. Any ineffectiveness immediately occurs in the fair valuing process without any extensive documentation needs. It is enough to be able to keep track of which transactions are part of the hedge portfolio and the related cash flows.

Q1:c under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet?
In our approach, the items referred to in paragraph 154 are automatically removed when the remaining cash flows are fair valued (which normally should be done on a daily basis).

Proposed changes in IAS 39

128A. In a fair value hedge of the interest rate exposure of a portfolio of financial assets and/or financial liabilities, the portion hedged may be designated in terms of an amount of currency (e.g. dollars, euro, pounds) rather than as individual assets (or liabilities). Although the portfolio may include, for risk-management purposes, assets and liabilities, the amount designated is an amount of assets and/or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate based on expected, rather than contractual, repricing dates. An example of a portfolio where a hedge might be designated as assets and liabilities is a portfolio of amounts in several different currencies hedged with a portfolio of derivative contracts where each derivative contracts might be denominated in two different currencies (e.g. cross currency interest rate swaps). Where the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness will arise if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Question 2

We do not have any comments on this question.

SWEDISH BANKERS' ASSOCIATION

Bengt G. Löwenthal

Mikael Holmberg

Appendix 1

Macro hedging in our environment today

When we work with portfolio hedges today, we designate certain portfolios as hedge portfolios and all deals entered into the portfolio are hedged items or hedging instruments. The assets and liabilities within these hedge portfolios are hedged by one or several derivative contracts hedging both the assets and the liabilities at the same time.

It shall be noted that we firstly feed assets and liabilities that are individually possible to hedge regarding fair value risks into the portfolio. The reason for not being able to apply the hedging rules individually is the significant number of transactions and that the portfolios are changing continuously with new transactions entered into the portfolios.

Then, regularly (monthly or daily depending on importance and complexity) the portfolio is fair valued (using one zero coupon curve for each currency within each portfolio) – with changes in fair value entered into the income statement. The interest rate risk is managed continuously making sure that no intra-day limits are breached. A separate exercise regularly verifies that hedged items (assets and liabilities) have derivative contracts eliminating the interest rate risk for each hedge within the portfolio. The method used will also consider that transactions occur more often than at month ends and therefore adds a dynamic dimension.

Appendix 2

Concerns

To be able to use the macro hedge technique proposed we believe that the portfolio defined for the purpose of hedge accounting needs to take all hedgeable financial assets and liabilities within the consolidated entity into consideration. These financial instruments have to be separated into different currency units as well as in time buckets. Cross currency interest rate swaps are used frequently. To be able to use the macro hedge proposal, these need to be separated into different currencies and time buckets and used for hedging the open positions in each separate currency and time bucket.

The reason that the macro hedge proposal forces an entity to aggregate all financial assets and liabilities to group level is that internal transactions are not accepted as hedging instruments, even though they are used for the management of interest and foreign exchange risks at sublevel. Therefore it is not possible to define macro hedge portfolios on a sublevel.
Furthermore the macro portfolio is never constant since new transactions are entered into the portfolio 24 hours a day. At the same time, interest rates and foreign exchange prices are never constant. This means that an entity would need to have a real time updated portfolio on the consolidated level. Since the prices and the positions are changing constantly the macro hedge proposal force the entity to constantly define macro hedge positions if it aims at presenting its earnings in a true and fair view. The reason being that only fair value changes of the hedged items are recognised in earnings.

We believe that this is almost as complicated as trying to document single market value hedges, and in certain respects even more complicated. The reason that we will need to do this is that we otherwise would not be able to match changes in fair value of the hedging instruments with fair value changes of the hedged instruments

Suggestion

Instead, if IAS 39 allowed the entity to decide that all "amounts" entered into certain hedge portfolios could be fair valued using the reference rate from the inception of the transaction, our documentation problems in previous paragraphs would be much easier to handle. Since it is only transactions in predefined portfolios that are managed in this way, the risk for abuse should be small. Of course only instruments whose fair value is affected by the reference rate should be allowed to be included in these hedge portfolios and hedging instruments used are derivative contracts only.

In the following we will try to explain in detail our concerns with the proposal.

Funding in another currency than the asset

The amendments in IAS 39 regarding portfolio hedging indirectly do not allow cross currency derivative contracts as hedging instruments for interest rate risk in portfolio hedging. The rational behind our statement is that no change is proposed regarding the possibilities to decompose derivative contracts into different risk components. The lack of change in this area combined with the wording in 128A where "the amount designated is an amount of assets *or* an amount of liabilities" do not seem to permit portfolio hedging of interest rate risks where there are several currencies involved.

To be able to effectively use portfolio hedge accounting – regarding interest rate risk when the portfolio consists of hedged items denominated in different currencies – it has to be allowed to designate the gross amount of assets *and* liabilities as the hedged item.

The above paragraphs are not an attempt to include portfolio hedging of foreign currency risks. Instead it is an attempt to align the amendments in IAS 39 to the risk management practices used when an entity is dependent on foreign markets for its funding.

Decomposing of cross currency swaps

An example of a derivative contract commonly used when hedging the interest rate risk in a portfolio is cross currency interest rate swaps. This instrument has the form of a derivative contract but is in essence a combination of:

(a) A Time Deposit contract in one currency (the amount is exchanged between the two counterparts),
(b) A Time Deposit contract in another currency (the amount is exchanged between the two counterparts),
(c) And a netting agreement reducing the credit risk to a minimum.

Since the credit risk is zero at the inception of the derivative contract the instrument is a very effective method of:

(a) Raising funding to the asset
(b) Investing the money borrowed
(c) Eliminating/reducing the liquidity risk
(d) Eliminating/reducing the interest rate risk,
(e) Managing the foreign exchange risk (possibility to match all cash-flows from the borrowing in the foreign currency)

All the risk-reducing effects are accomplished without creating any extra credit risk. Both legs in the swap as well as the assets and liabilities may be in fixed interest rates. Furthermore all are separately affected by changes in interbank interest rates. Therefore it is very hard to understand why they should not qualify for fair value hedge accounting, especially why not portfolio hedge accounting should be allowed. To not allow this creates huge extra costs for banks concerned if they do not accept the artificial volatility created by this unnecessary restriction. The reason behind our statement is that cross currency derivatives need to be separated into their different currencies if they should be effectively used for fair value hedge accounting of interest rate risk. This separation is not allowed today.

Prepayment fees are received when the customers choose to prepay their loans

As discussed above we do not consider that the amendments proposed in IAS 39 have recognised the existence of prepayment fees. The existence of those fees changes the focus of the risk management of interest rate risk from the expected to the contractual repricing date. We will try to visualise our concerns in a simple example.

At the first of January 2005 ten lending transactions are started with ten different banks rated as the average bank. The amount lent is SEK 10 000. Borrowing USD 1 000 funds the transaction. The SEK/USD price is 10. To handle the cash flows and to hedge the interest rate risk the entity enters into a cross currency interest rate swap:

Receive SEK 100 000 initially
Pay USD 10 000 initially
Receive USD 10 000 31 December 2005
Pay SEK 100 000 31 December 2005.

All the transactions give rise to the following cash flows:

SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending	-100 000		103 000
Liabilities			
Net amount	**-100 000**	**0**	**103 000**
Derivative	100 000		-103 000
Net cash flow	**0**	**0**	**0**

USD, recalculated to SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending			
Liabilities	100 000		-102 000
Net amount	**100 000**	**0**	**-102 000**
Derivative	-100 000		102 000
Net cash flow	**0**	**0**	**0**

The example shows that the derivative contract has been split per currency and is used to manage the interest rate risk in each currency.

If no prepayment would occur the market values at 30 June 2005 would be as follows:

	1 Jan 2005	30 Jun 2005	31 Dec 2005
SEK-interest	3%	2%	3%
USD-interest	2%	2%	2%
SEK/USD	10	10	10

SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending	100 000	101 985	103 000
- of which interest		1 500	
- of which change in fair value		485	
Liabilities			
Net fair value	**100 000**	**101 985**	**103 000**
Derivative	-100 000	-101 985	-103 000
Net fair value	**0**	**0**	**0**

USD, recalculated to SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending			
Liabilities	100 000	-100 995	-102 000
Net fair value	**100 000**	**-100 995**	**-102 000**
Derivative	-100 000	100 995	102 000
Net fair value	**0**	**0**	**0**

If, instead a nominal amount of lending of SEK 10 000 was prepaid, the following cash flows would occur:

(a) Repayment of loan, SEK 10 000
(b) Payment of accrued interest, SEK 150 (3% interest during 6 months)
(c) Prepayment fee, SEK 50 (10 000 * (3%-2%)*(6/12)).

Since the entity still is obligated to deliver the same SEK amount, the SEK amount received has to be reinvested. To visualise the separate effect of the reinvestment, the cash received from the repayment is classified as interest bearing cash. Note that the total revenue increase in the example is due to a higher effective interest rate since the interest received and the prepayment fee is reinvested. The market values at 30 June 2005 after reinvestment and the final cash flows 30 December 2005 are shown in the following table.

	1 Jan 2005	30 Jun 2005	31 Dec 2005
SEK-interest	3%	2%	3%
USD-interest	2%	2%	2%
SEK/USD	10	10	10

SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Cash		10 200	10 302
Lending	100 000	91 787	92 700
- of which interest		1 350	2 700
- of which change in fair value		437	0
Liabilities			
Net fair value	**100 000**	**101 987**	**103 002**
Derivative	-100 000	-101 985	-103 000
Net fair value	**0**	**1**	**2**

USD, recalculated to SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending			
Liabilities	100 000	100 995	102 000
Net fair value	**100 000**	**100 995**	**102 000**
Derivative	-100 000	-100 995	-102 000
Net fair value	**0**	**0**	**0**

As you have been shown a fair value model using the interbank interest rate is able to accurately describe the economic effects of changes in the composition of an economically hedged portfolio where prepayment is made by paying the fair value of the amount prepaid. Prepayments do not give rise to any volatility in earnings. This is a true description of reality, which has been shown in the two previous tables. The transactions described in the example do not qualify for fair value hedge accounting since the derivative contract can not be separated into the two basic risk components and since the proposal regarding macro hedging does not allow a hedged item to be the gross assets and liabilities. We would like to describe the effects on the income statement that will occur when following IAS 39.

According to IAS 39 the prepayment fee must be taken to earnings. In combination with the reinvestment made, the following effects will occur in earnings.

Aggregated numbers each period

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Interest income		1 500	2 952
Interest expense		-995	-2 000
Other income		50	50
Net result of financial transactions		-990	-1 000
Net income		**-435**	**2**

The table above shows that even though an economically hedged portfolio exists, consisting of instruments that individually qualify for hedge accounting, IAS 39 prevents the entity from describing the true and fair view of the transactions made. An artificial volatility occurs in earnings. In this case the volatility is between two interim periods. It is easy to create examples where the income statement could be distorted in years due to the prescriptive nature of IAS 39.

The artificial effects on earnings will also occur when using the macro hedge proposal. Consider the following example. At the first of January 2005 ten lending transactions are started with ten different banks rated as the average bank. The amount lent is SEK 10 000.
The lending is financed by:

Borrowing SEK 80 000 for 1 year
Borrowing SEK 20 000 for 6 months
Entering into the following interest rate swap:
Pay 3% interest 30 December 2005
Receive 6 months STIBOR
Nominal amount is SEK 20 000.
To simplify, the yield curve is flat at each reporting date.

The transactions give rise to the following expected cash flows:

	1 Jan 2005	30 Jun 2005	31 Dec 2005
SEK-interest	3%	2%	3%
SEK			
	1 Jan 2005	**30 Jun 2005**	**31 Dec 2005**
Lending	-100 000		103 000
Liability 1	80 000		-82 400
Liability 2	20 000	-20 300	
Liability 3		20 000	-20 200
Net amount	**0**	**-300**	**400**
Derivative - floating		300	200
Derivative - fixed			-600
Net cash flow	**0**	**0**	**0**

The entity uses the macro hedge proposal and designates 20% of the amount on the assets give rise to as a hedged item. If everything follows the expected, the balance sheet and the income statement at 30 June 2005 will look like this:

Balance sheet

	1 Jan 2005	30 Jun 2005	31 Dec 2005
SEK-interest	3%	2%	3%
SEK			
	1 Jan 2005	**30 Jun 2005**	**31 Dec 2005**
Lending	100 000	101 489	103 000
Value adjustment		99	0
Total lending	**100 000**	**101 588**	**103 000**
Liability 1	80 000	81 191	82 400
Liability 2	20 000	20 300	
Liability 3			20 200
Total liabilities	**100 000**	**101 491**	**102 600**
Accrued interest derivative contracts		-2	400
Strip market value derivative contracts		99	0
Net assets and liabilities	**0**	**0**	**0**

Income Statement

	Q1--Q2 2005	Q3--Q4 2005	Ack Dec 2005
Interest Income Lendning	1 489	1 511	3 000
Interest expense liabilities	-1 491	-1 409	-2 900
Realised result financial transactions	2	-102	-100
Value adjustment hedge accounting	99	-99	0
Unrealised result financial transations	-99	99	0
Net result before taxes	**0**	**0**	**0**

30 June a nominal amount of lending of SEK 10 000 is prepaid creating the following cash flows:

Repayment of loan, SEK 10 000
Payment of accrued interest, SEK 150 (3% interest during 6 months)
Prepayment fee, SEK 50 (10 000 * (3%-2%)*(6/12)).
Since the entity still is obligated to deliver the same SEK amount, the SEK amount received has to be reinvested. Note that the total revenue increase in the example is due to a higher effective interest rate since the interest received and the prepayment fees are reinvested. The final cash flows 30 December 2005, the market values at 30 June 2005 after reinvestment and the effects on the income statement are shown in the following tables.

Cash-flows

	1 Jan 2005	30 Jun 2005	31 Dec 2005
SEK-interest	3%	2%	3%

SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending	-100 000		92 700
Prepayment:			
- notional amount		10 000	
- accrued interest		150	
- prepayment penalty		50	
Time deposit		-10 200	10 302
Liability 1	80 000		-82 400
Liability 2	20 000	-20 300	
Liability 3		20 000	-20 200
Net amount	**0**	**-300**	**402**
Derivative - floating		300	200
Derivative - fixed			-600
Net cash flow	**0**	**0**	**2**

Market values

	1 Jan 2005	30 Jun 2005	31 Dec 2005
SEK-interest	3%	2%	3%

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending	100 000	91 787	92 700
Prepayment:			
- notional amount			
- accrued interest			
- prepayment penalty			
Time deposit		10 200	10 302
Liability 1	-80 000	-81 588	-82 400
Liability 2	-20 000		
Liability 3		-20 000	-20 200
Net amount	**0**	**399**	**402**
Derivative - floating		198	200
Derivative - fixed		-594	-600
Net market value	**0**	**3**	**2**

If the prepayment occurs ineffectiveness has to be calculated.
Initial percentage hedged: 20 600/103 000 = 20%
20% * 92 700 = 18 540
Fair value change per currency unit: 99/20 600 = 0,00048
Fair value of revised hedged amount: 18 540 * 0,00048 = 89

The macro hedge accounting will affect the balance sheet and the income statement as follows:

Balance sheet

	1 Jan 2005	30 Jun 2005	31 Dec 2005
SEK-interest	3%	2%	3%

SEK

	1 Jan 2005	30 Jun 2005	31 Dec 2005
Lending	100 000	91 340	92 700
Time Deposit		10 200	10 302
Value adjustment		89	0
Total lending	**100 000**	**101 629**	**103 002**
Liability 1	80 000	81 191	82 400
Liability 2	20 000	20 300	
Liability 3			20 200
Total liabilities	**100 000**	**101 491**	**102 600**
Accrued interest derivative contracts		-2	202
Strip market value derivative contracts		99	0
Net assets and liabilities	**0**	**41**	**200**

Income Statement

	Q1--Q2 2005	Q3--Q4 2005	Ack Dec 2005
Interest Income Lendning	1 340	1 360	2 700
Interest Income prepayment	200	-98	102
Interest expense liabilities	-1 491	-1 409	-2 900
Realised result financial transactions	2	96	98
Value adjustment hedge accounting	89	-89	0
Unrealised result financial transations	-99	99	0
Net result before taxes	**41**	**-41**	**0**

If you compare the previous statements with the table showing the actual fair values, you will notice that the macro hedge proposal does not present the actual changes in fair value in a correct manner if prepayment options are involved. For these kinds of transactions it is necessary to designate 100% of the hedged amount as a hedged item. All other methods will not present a true and fair view of the actual value changes.