AB Svensk Exportkredit

To: IASB

From: AB Svensk Exportkredit (SEK), see appendix 1.

Comments to Exposure Draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement; The Fair Value Option (April 2004)

Question 1

Question:
A) Do you agree with the proposal in this Exposure Draft? B) If not, why not? C) What changes do you propose and why?

Answer:
A) No

B) SEK believes that the Fair Value Option, as it was approved in December 2004, was the best effort so far by IASB to allow a more theoretical correct approach to fair value accounting. It allowed companies to mark-to-market all financial instruments and at the same time stated that the effects of such valuation should always affect the income statement.

Such approach would allow companies to reflect their risk management strategy in their financial reporting, without detailed regulations about every single strategy or every single class of assets and liabilities, and at the same time force the companies to show the ineffectiveness of such strategy in the income statement. Since the standard setters can not take into consideration all different kinds of risk management strategies existing today and always will have difficulties foreseeing new risk managements strategies, SEK believes such a high level approach would be appropriate.

SEK has, since January 1, 2001, applied SFAS 133 under U.S. GAAP in reconciliation from Swedish GAAP. The hedge accounting method chosen under U.S. GAAP is the Fair Value Hedge Accounting method. Our conclusion, based on that experience, is that SEK's risk management strategy and business model is not reflected in the income statement and equity under U.S. GAAP. This is to a great extent due to the detailed regulation under SFAS 133, which prohibits SEK from reporting economically hedged transaction as hedged transactions under SFAS 133. SEK anticipate that many of the problems it has encountered when reporting under U.S. GAAP will be similar if trying to apply Fair Value Hedge Accounting under IAS 39.

C) Do not make the changes/restraints to Fair Value Option in the amended proposal. Develop further the Fair Value Option towards a full market valuation method including all financial transactions.

The restraints proposed are based on the following argumentation (page 4 in draft of April 2004) which are commented each one of them below:

(a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine the fair value in a way that inappropriately affects profit or loss.
Comment: The problem addressed occurs in all situations where fair value measurements should be used for accounting purposes, not specifically for the Fair Value Option. Already in relatively highly

liquid assets as in a trading portfolio or a available-for-sale-portfolio the fair value can be difficult to establish due to low liquidity in many markets. The approach to this problem has been addressed in IAS 39 in a consistent manner as to a step by step approach how to establish a fair value. It is inconsistent with this approach to have another theoretical background and method for establishing fair value under Fair Value Option.

(b) use of the option might increase, rather than decrease, volatility in profit or loss, for example, if an entity applied the option to only one part of a matched position.
Comment: The main reason why Fair Value Option was proposed was the serious criticism that was directed towards IAS 39, where hedge accounting is "a privilege, not a right". Companies that apply a prudent hedge technology would not be able to apply hedge accounting for certain hedged positions, and thereby, increase volatility in profit or loss. This problem, which SEK truly believes is the weak spot in the entire IAS 39, is what in the draft is referred to as the "Mixed Measurement Model". Therefore, the Fair Value Option, if correctly applied as intended by the standard setter, will contribute to reducing volatility generally, especially in the financial industry.
It is difficult to imagine a financial institution that would want to pick up one part of a hedging relationship and measure it differently from the other part. It is also difficult to imagine a financial institution that would want to increase volatility in its profit and loss. As there is a one-time-choice of whether or not to apply Fair Value Option on a transaction it would not be possible to manipulate profit and loss by entering into or exit from Fair Value Option. On the contrary, the discussion so far within the financial industry has almost entirely been related to how to prove that there is a hedge relationship. The purpose of that is to achieve hedge accounting and thereby measure the hedged and hedging items with the same method, thereby reducing volatility when derivative instruments has been used with the purpose of reducing volatility.

(c) if an entity applied the fair value option to financial liabilities, it might result in the entity recognizing gains or losses in profit or loss for changes in its own creditworthiness.
This is a correct statement for the current debt outstanding. The problem needs to be considered further. If the company continuously issues new financial liabilities, the new liabilities will be issued at market values which will give an opposite effect. If, for example the creditworthiness of the company decreases the value of the company's debt will decrease, thereby generating an unrealized gain. If the company, at the same time, have need for further funding the new debt will be issued at a higher interest rate. This will increase the market value of the new issue, creating an unrealized loss. If the company has a continuous funding need the market value of new transactions, therefore, will reflect the decreased creditworthiness and create an unrealized loss which (at least partly) balances the unrealized gains from current debt.

Question 2

Question:
Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

Answer:

(a) please give details of the instrument(s) and why it (they) would not be eligible.

Yes. Financial liabilities.

(b) is the fair value of the instruments verifiable(see paragraph 48B) and if not, why not?

No or at least uncertain. Already in relatively highly liquid assets as in a trading portfolio or an available-for-sale-portfolio the fair value can be difficult to establish due to low liquidity in many markets. The approach to this problem has been addressed in IAS 39 in a consistent manner as to a step by step approach how to establish a fair value. It is inconsistent with this approach to have another theoretical background and method for establishing fair value under Fair Value Option. A requirement of a low variability in the range of reasonable fair value estimates is a very subjective approach that will increase uncertainty about how to apply the rules. The variability in the range of a specific instrument could also change over time, going from low to high, which will make it very difficult to apply Fair Value Option in a consistent manner.

(c) how would applying the fair value options to instruments simplify the practical application of IAS 39?

It will simplify many of the issues that are complicated when applying Fair Value Hedge Accounting or Cash Flow Hedge Accounting. Firstly, no need to amortize, on a contract-by contract yield-based basis, items from other comprehensive income since market valuation will affect profit or loss directly. Secondly, no need to bifurcate embedded derivatives and valuing them initially and on an ongoing basis in such a manner that a day-one profit not arises and with a market value easily verifiable. A theoretical correct bifurcation according to the standard is in practical application very difficult to achieve. There are few, if any, accounting systems supporting such complicated accounting. Thirdly, no need to prove effectiveness. This will not be a problem since the ineffective part anyway will be captured in the profit or loss.

Question 3
No comments.

Question 4
No comments.

Question 5
No comments.

Question 6
No comments.

July 21, 2004
AB Svensk Exportkredit

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AB Svensk Exportkredit

Appendix 1

Background

SEK is a public stock corporation wholly-owned by the Swedish State. SEK was founded in 1962 in order to strengthen the competitiveness of the Swedish export industry by meeting the need for long-term credits. SEK's objective is to engage in financing activities in accordance with the Swedish Financing Business Act and in connection therewith primarily promote the development of Swedish commerce and industry as well as otherwise engage in Swedish and international financing activities on commercial grounds.

SEK provides long-term financial solutions tailored for the private and public sectors. Business activities include export credits, lending, project financing, leasing, capital market products and financial advisory services. SEK funds its activities by public issues and private placements of debt securities in the international capital markets. SEK's high creditworthiness ensures borrowings at low cost. SEK's long-term debt rating is AA+ from Standard & Poor's and Aa1 from Moody's Investors Service. At December 31, 2003, SEK's total assets amounted to Skr 151.8 billion (USD 20.9 billion)

Risk Management Strategy

In connection with its borrowing, lending, and placement of liquid funds, SEK uses a variety of financial instruments, such as interest rate swaps, currency swaps, futures, and options. These instruments are used to hedge or reduce exposures.

SEK uses all major capital markets to fund its activities. In anticipation of on-lending borrowed funds, which normally have long-term maturities and fixed interest rates, the funds are swapped into floating interest rates, and invested in liquid assets. Later, when the lending transactions materialize, the liquid assets are sold and the swaps are unwound or, in most cases, new swaps are entered into. Due to the fact that SEK uses the techniques described above and complex funding structures that may include, for example, embedded options or formulas to determine repayment amounts, SEK becomes a party to a large number of interest rate- related and currency-related contracts as well as equity-related and commodity-related contracts.