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*Reference*  
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**Exposure Draft of Proposed Amendments to IAS 39,**

**Financial Instruments: Recognition and Measurement - *Fair Value Hedge Accounting for a Portfolio of Interest Rate Risk.***

The comments in this letter represent the views of Skandinaviska Enskilda Banken, which is one of the largest Swedish Banks actively operating in the Nordic countries, the Baltics and Germany.

We appreciate the efforts being made by IASB in order to improve the Standards to facilitate and incorporate the use of efficient interest risk management practices. We have been working with hedge accounting for some five years now and have faced some of the problems IASB are now trying to resolve. One big difference will be introduced for us when ineffectiveness from the hedges will pass the profit and loss. Today this is deferred and reported in a note on derivatives showing unrecognized (unrealized) future values in the interest rate swap portfolio. Our adjusted approach will serve as a comment for you to consider in order making the current proposal more practical and in line with the current interest rate risk management practices.

Presenting our approach we hope to answer your questions.

Q1:

- A. The key question is to define the hedged items. We argue that designations of all financial transactions that should qualify for hedge accounting have to take place at inception. All these are earmarked per currency because they have to be managed and valued separately. This

implies that all fair value changes due to changes in predefined reference rates will be pass profit and loss.

- B. To avoid the problem with ineffectiveness the bank has to decide to designate all transactions it wants to become eligible for hedge accounting. All impacts of over- or under-hedging will pass profit and loss.
- C. All amounts will automatically be removed from the portfolio and the balance sheet when they have expired.

This approach indicates that cash items are used as hedges might cause some concerns. The logic being that hedge accounting is an exception from the normal accounting principles caused by the fact that all derivatives have to be fair valued in contrast to those applicable for the hedged item, that follows amortized cost. This disqualifies a cash item to be a hedging item. Secondly a “partial” fair value method will become a mix of existing methods. A full fair value option exists already.

We would argue that interest rate risk management is focusing only on income streams from future cash flows and the mismatches created from all transactions conducted, regardless whether the cash flow flows are generated from cash transaction or derivatives. Products are irrelevant from interest rate risk perspective since they all they can substitute each other. Thus a fixed rate loan leg in a swap could equal to a fixed rate loan or a bond with fixed coupon. The exception for hedge accounting should focus on the interest rate risk being measured, which is best accomplished by extracting the other irrelevant risk elements from contractual rates. Full fair value would include other risk factors that should not be part of interest rate risk portfolio. Credit spreads are i.e. not relevant in this context.

The exception for hedge accounting needs to be reformulated since only a portion of the cash flows builds up the interest rate risk position. Else the ineffectiveness issue can never be resolved reflecting economic reality.

Other issues raised in the proposal are linked to valuation challenges, often connected to repricing dates. Expected dates should be used if deviations from contractual dates are *not* separately priced, i.e. through prepayment fees.

A similar issue is connected to the second questions concerning demand deposits (DDA). From a portfolio perspective DDAs can be modeled for interest risk management purposes as fixed term deposits. These accounts can be viewed term money with early withdrawal options for the clients and variable pricing options for the banks. These options are more difficult to separate from the underlying than it is to isolate the any free prepayment options imbedded in loans.

From a portfolio perspective the liability value of the DDAs will normally be below the nominal amount deposited, because each deposit generated will create a shareholder value (e.g. €1 of asset value can be funded with, let's say, €0.80 of liability value, creating €0.20 of net worth.) The reason is that low interest bearing DDAs cost less than alternative money market funding sources. The liability value of a DDA portfolio is roughly the current balance *minus* the discounted present value of its future economic profits. We would argue that the fair value of the DDAs could be less than the nominal value even though the value on balance sheet is represented by the nominal amount. The excess fair value is always being generated in the future and it can be estimated. Thus we don't agree that DDAs value cannot be less than the nominal amount and therefore could never qualify as hedged items in a fair value hedge. The nominal value in this respect represent both the current liability value *plus* the future value which is exposed to interest rate movements and is the focus for interest rate risk management. The problem with the DDAs is to estimate the repricing dates, for which statistical methods are being employed. For hedge accounting it is very strange that assets with uncertain re-pricing dates are qualified but not liabilities with similar features because of measurement methodology problems. Keep in mind that banks are trying to fair value hedge the interest rate risks. At the same time cash flow hedging strategies are recommended for hedging DDAs based on expected payments. However cash flow hedging is constructed to artificially increase equity volatility, with negative consequences on regulatory risk capital. Thus these cash flow hedging strategies are viewed as an extra cost for banks. Since they are not motivated for the protection of Net Asset Value, they need to be transformed or translated to be in line with prudent risk management.

- A. To sum up we would argue against the board's decision that fair value of these liabilities could not be less than the amount payable on demand.
- B. The future value of the deposits will be realized over time and will never give rise to a gain on initial recognition. An analogy would be that an interest rate swap's initial value is always nil but its value will vary until actual maturity. This is why interest swap can be efficient hedges to DDAs.

It is our belief that using a pragmatic principal based macro approach could make room for demand deposits to qualify as hedged items.

Sincerely Yours,

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