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Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

Dear Ms. Thompson:

J.P. Morgan Chase & Co. appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB" or the "Board") August 21, 2003 Exposure Draft of the Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement *Fair Value Hedge Accounting for a Portfolio of Interest Rate Risk* (the "Exposure Draft").

We strongly support the IASB's effort to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. We welcome the Board's continued sensitivity to the concerns about the feasibility of certain types of hedges under various national and international standards, as evidenced in this Exposure Draft and in areas of IAS 39 itself. However, we do not believe the IASB's stated objective of developing an approach that is workable in practice for entities that manage interest rate risk on a portfolio basis has been met with this Exposure Draft. In addition, we are concerned that the operational burdens and costs associated with complying with IAS 39 will be extensive, perhaps more extensive than under the derivatives accounting rules in the United States.

The main theme of our concerns is that the Exposure Draft does not go far enough to accommodate the risk management differences between portfolio and individual item hedging. For a macro hedging standard to be practicable, its requirements must be aligned with the basic tenets of portfolio management: that

entities seek to manage the behavior of the portfolio as a whole, and not the behavior of individual items separately. A summary of our major concerns follows.

I. Risk Management Practices and the Impact on Designation Approach

We support the Exposure Draft's proposal that the hedged item may be designated in terms of an amount of currency rather than as individual assets or liabilities, as well as in terms of expected rather than contractual repricing dates. This is an acknowledgement of the economics and risk management practices underlying portfolio hedging, as well as a necessary foundation of an operationally viable portfolio hedge accounting model. However, we have concerns with the designation approach D selected by the IASB. Under approach D, an entity would calculate its net risk position in a portfolio of offsetting interest rate assets and liabilities, and hedge a percentage of gross assets or liabilities that corresponds to the amount of net risk in a particular maturity time period. This percentage would stay constant, but the amount hedged for purposes of ineffectiveness calculations would increase or decrease as gross amounts change due to prepayments that are less or more than originally expected.

In the following discussion, we illustrate actual risk management practices and the corresponding designation approach using the example of a residential mortgage. Such instruments with negative convexity are the most difficult to fit into a hedge accounting model, and are in most need of a practicable portfolio solution. Many of the issues raised here are not applicable to simpler instruments such as callable bonds, and our comments are not intended to be applied to all types of instruments with prepayment risk features.

In simple terms, the fair value of a mortgage is modeled by forecasting its future cash flows based on current prepayment speeds, and discounting those cash flows back to a net present value. To determine the change in fair value of all mortgage cash flows due to a change in benchmark interest rate risk, an institution would change all the pricing parameters affected by changes in the benchmark interest rate that drive the forecast of future cash flows (including estimated prepayment speeds) and discount the revised cash flows at the new discount rates.

A key issue to clarify at the outset is the difference between changes in prepayment speeds during the period versus actual prepayment receipts collected during the period. In our view, the two issues are not sufficiently distinguished in the Exposure Draft, which may lead to the interpretation that ineffectiveness would be recorded on both. Prepayment speed is a mortgage pricing parameter measuring expected future prepayment rates and is used to forecast future cash flows in the valuation process. Prepayment speed changes immediately upon changes in the benchmark interest rate, extending or abbreviating the expected life of a mortgage. The mortgage fair values at the beginning and end of the hedge measurement period would reflect the effect of changes in prepayment speeds as a result of changes in the benchmark interest rate. Those instantaneous fair value changes would be measured and subject to potential ineffectiveness during the current period.

In contrast, actual prepayments receipts in the current period are unrelated to interest rate changes in the current period. Due to the nature of the mortgage prepayment option, a borrower cannot immediately exercise the option to prepay a mortgage when interest rates fall. The borrower must collect and file

financial information, obtain credit approval, obtain a rate lock, and complete the close, a process that takes several months. Therefore, an interest rate change that occurs in the current period does not result in a prepayment in the current period; it results in a change to expected future prepayments and a corresponding change in fair value. As they are unrelated to changes in the benchmark interest rate in the current period, prepayment receipts are not a source of ineffectiveness in the current period.

Actual risk management practices for mortgage portfolios reflect designation approach C in paragraph BC 19. Risks of assets and liabilities naturally offset for a portion of the portfolio. For the net amount remaining, the institution chooses what portion of that net amount it wishes to hedge. From the risk management perspective, the portion of the net amount not hedged is specifically left “naked” as a cushion for changes in prepayment speeds. The portion of the net that is designated as hedged is not expected to be affected by prepayment, as reductions in assets during the hedge period are not expected to be greater than the amount of the cushion. Reductions greater than expected would be allocated to the net cushion first, and only then to the designated hedged amount.

We encourage the Board to modify the fair value portfolio hedge accounting model to accommodate these risk management realities. The lack of such risk management recognition under US accounting standards has resulted in the need for daily redesignations of derivative hedge proportion percentages in order to ensure ongoing “effectiveness”. This creates undue operational burdens not only due to daily designation, but also from the need to maintain a constantly changing basis adjustment amortization schedule. These operational burdens based on requirements at odds with risk management lead many portfolio managers of prepayable assets and liabilities to conclude that fair value hedge accounting may not be workable under US accounting standards.

Furthermore, we are concerned with the Board’s arguments against approach C. Most assertions have one flaw in common – a desire to recognize ineffectiveness arising from a portion of the portfolio that is not designated as hedged.

As an example, we do not agree with the assumption in BC 21 (c) that an upward revision to an amount in a maturity time period is an underhedge that would give rise to ineffectiveness. A true underhedge exists when the derivative amount is not sufficient to offset the changes in the originally designated hedged amount. Slower than expected prepayment speed impacts a mortgage by adding assets to later maturity time periods beyond the date at which prepayment was expected. Such an increase in assets is in fact a new asset which was not designated as hedged. Consistent with the treatment of new assets in paragraph A37, new assets resulting from mortgage maturity extension should be excluded from the measurement of hedge ineffectiveness, and considered in the determination of a new hedge amount in the next measurement period. Our view of the designation of a specified number of cash flows prior to expected prepayment is also equivalent to that in IGC 128-2’s discussion of partial term hedging.

Finally, for a macro hedging standard to be practicable, its requirements must be aligned with the group nature of portfolio risk management. Paragraph 128 A recognizes this distinction, but the Exposure Draft retreats from these portfolio principles in key arguments, such as in paragraph BC 21 (f).

In summary, current fair-value hedge accounting recognizes ineffectiveness only on the designated portion of a hedged asset or liability. If an asset or liability is partially hedged, no hedge accounting is allowed (and thus no ineffectiveness is recorded) on the undesignated portion. Approach D creates results inconsistent with this principle and risk management practice through its requirement to change the originally designated hedge amount for prepayment speeds that are either faster or slower than projected. In an effort to ensure recognition of all ineffectiveness, Approach D does not differentiate between changes in prepayment speeds (which are related to changes in benchmark interest rates in the current period) and changes in prepayment receipts (which are not). Approach D also does not differentiate underhedges from new assets or overhedges from proportional hedges. In our view, approach C is superior in principle and practice to approach D.

II. Removal of Basis Adjustments from the Balance Sheet

Consistent with the exposure draft in paragraphs A38 and BC 28, unamortized adjustments to carrying amounts (“basis adjustments”) arising from hedge accounting in approaches A through C would be removed from the balance sheet when the maturity time period to which they relate expires. Basis adjustments would be tracked by maturity time period. Selection of approach C would not impact the timing of the removal of balance sheet items.

Further to the derecognition issue, the application of the Board’s intent at the end of paragraph 154 is unclear (“Amounts included in these line items shall be removed from the balance sheet when the assets or liabilities to which they relate are derecognized”). The principle is that balance sheet amounts should be removed when hedged assets or liabilities are derecognized through maturity time period expiration, sales or prepayments. As currently written, the sentence seems to require individual identification of instruments as hedged or unhedged items in order to determine the appropriate timing for balance sheet removal of the basis adjustment. This possible interpretation contradicts the group nature of the designation allowed in paragraph 128 A. An interpretation that necessitates tracking of individually designated assets in each maturity bucket in each hedging period would create a nearly equivalent operational burden to that existing under the current individual designation rules. Without a clarification that focuses on determining derecognition based on reductions in amounts of asset and liability types versus removal of individual instruments, the operational burden from derecognition requirements may preclude the use of portfolio hedge accounting.

We request that the Board clarify the last sentence in paragraph 154 in such a way that ensures that individual financial instrument tracking is not required.

III. Demand Deposits – Existence of Interest Rate Risk and Designation as a Hedged Amount in a Portfolio Hedge of Interest Rate Risk

We do not support the Board’s decision to preclude fair value accounting for demand deposits for any time period beyond the shortest period in which the counterparty can demand payment. If a demand deposit

has an economic maturity greater than one day, that liability carries the risk of changes in fair value due to changes in interest rates. Demand deposits have interest rate risk similar to and hedgeable by offsetting fixed rate assets or derivatives. This risk, and the expected maturity upon which it is based, is recognized by the deposit-taking institution in its risk management practices, by rating agencies who monitor its liquidity, and by competitor institutions who seek to acquire its deposit base.

A bank will use a cash capital surplus as one tool to manage its liquidity, and supplement this approach with stress tests. A key test measures the ability of each banking entity under the holding company to withstand a funding contraction over a period of time. This test assumes a contraction of secured and unsecured funding capacity, collateral calls related to downgrades, and drawdowns of unfunded commitments. Some tests may include multiple notch downgrades and the attendant changes to funding cost and funding availability. The availability of funding from demand deposit sources is included in these stress tests, and the availability estimate is based on the expected maturity of those liabilities. (Deposits are analyzed to determine how much will remain at the disposal of the institution over time. This percentage is considered to be the “core” and portions of it are allocated various maturities based on past consumer withdrawal behavior.) The rating agencies’ liquidity assessments use these same funding stress tests, and include demand deposit sources of funds based on expected maturities.

In addition to the use of expected maturities in internal and external assessments of liquidity, the determination of fair value for the acquisition of a deposit portfolio also includes the use of expected maturities. As in the liquidity stress tests, the deposits are analyzed by type and split into portions with different expected maturities. The analysis results in a projection of the availability of funding at certain rates over time, which is the basis for both the buyer’s and seller’s negotiation of an arm’s-length transaction price. While it is true that the final transaction price may include other elements such as a branch network, the presence of those components does not nullify the existence of compensation based on the expected maturity of deposits.

We are concerned with some of the Board’s arguments against the designation of demand deposits in a fair value hedge for a portfolio of interest rate risk. For example, paragraph BC 14 (a) does not acknowledge the difference between a portfolio versus an individual item approach to designation and hedge accounting. The paragraph states that demand deposits are not a static amount, but are constantly withdrawn and replaced, and thus the liability being hedged is a forecasted receipt and rollover of new deposits. However a portfolio approach does not require the existence of a specific item during the life of the hedge as long as the total amount hedged continues to exist.

Furthermore, the conclusion in BC 14 (c) (ii), that the market price is the price at which the demand deposits are originated between the customer and the deposit taker, is based upon a flawed assumption. The price at which a financial intermediary transacts with a retail customer is not the value at which the financial intermediary could buy or sell the position with another financial intermediary, but reflects the markup resulting from the differing access of the parties to the financial markets. The definition of fair value need not be driven by the transaction participant with the least access to the marketplace. It appears that certain accounting standard setters have begun to recognize the unique nature and valuation issues of demand deposits. In the original SFAS 107 Fair Value Disclosure Project, the Financial Accounting Standards Board (“FASB”) decided that contracts that provide settlement options and are

exchanged in portfolios at prices that cannot be approximated by conventional option-pricing models should be measured at the total price of the contracts and related relationships if transferred as part of a portfolio.

The Board's assertion that it would be inconsistent to permit fair value hedge accounting based on expected repayment dates, but to measure the fair value of the deposit on initial recognition on a different basis, is confusing as this is the fundamental architecture of fair value hedge accounting. Loans are not recorded at fair value and are allowed to be hedged, even if fair value has changed significantly after inception from carrying value. The initial difference between the loan at hedge designation date and carrying value is not recorded, but this does not prevent subsequent changes in carrying value during the hedge period to achieve hedge accounting.

We submit that hedge accounting would not change the value of deposits on the face of the financial statements. The liability would be recorded at its nominal amount at inception under current accounting principles. In a fair value portfolio hedge, the change in value of the hedged item attributable to the hedged risk shall be presented in a separate line item within liabilities pursuant to paragraph 154. For example, deposits in the nominal amount of 100 which have an initial fair value of 90 would not result in a change of 10 recorded on the balance sheet at inception. Under portfolio hedge accounting, only subsequent changes from the starting fair value of 90 would be recorded as a basis adjustment on the balance sheet.

We ask the Board to reconsider its conclusion that demand deposit fair value does not change in response to changes in interest rates based on the institutional, rating agency, and acquisition price evidence, as well as the observable payment of hedging costs by deposit-takers. The Exposure Draft itself is inconsistent on the issue, seeming to acknowledge that demand deposits have risk that offsets that of portfolio assets in arriving at a net risk position. We ask the Board to allow the designation of demand deposits as a hedged amount in a portfolio fair value hedge of interest rate risk.

IV. Additional Concerns and Comments

Almost Fully Offset - Although not specifically related to the comments solicited in the Exposure Draft, we believe that the recent conclusions regarding prospective effectiveness testing may reduce the availability of hedge accounting for a portfolio of interest rate risk, as well as that of individually designated hedges. Requiring "almost fully offset" prospectively may prevent the use of hedge accounting for some of the most intuitively perfect interest rate hedges if the swap rate differs significantly from the hedged item fixed rate due to credit spreads. The divergent result of a hedging relationship meeting "Shortcut" requirements under US hedge accounting standards but failing to achieve hedge accounting under IAS 39 is quite possible. In addition, we believe non-financial hedged items such as commodity contracts will be particularly impacted, as limited derivative types are available, many of which offset only component risk and not the overall changes in fair value or cash flows. We believe that the Board should consider the approach taken under US accounting standards, which uses the same "highly effective" requirement for both prospective and retrospective testing, and which emphasizes the recognition of ineffectiveness rather than an overly narrow constraint of qualifying hedging relationships.

Fair Value Option - We understand that the Board may view the entity's option under IAS 39 to allocate financial instruments to a fair value trading portfolio as a hedge accounting alternative. This is indeed an alternative for the entity who seeks to hedge the overall change in fair value with derivatives; however it is not a solution for those who seek to hedge only a portion of the overall risk, such as interest rate risk, or only a portion of the instrument's life. As there may not be cost effective derivatives to hedge each component of overall fair value, a feasible hedge accounting model for separately measurable risks is required.

Other Alternatives – In the event that the Board cannot resolve these macro hedging concerns, a separate hedge accounting model for negative convexity portfolios may be an alternative. For example, in 2000, the Derivatives Implementation Group ("DIG") considered in Statement 133 Implementation Issue Number F8 whether a company may designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of a mortgage servicing right ("MSR") asset that each corresponded to a specified independent variable. In its designation, the company would specify expected changes in the fair value of an MSR for a given change in interest rates. Based on those changes and those expected in a hedging derivative under the same rate movements, the entity would designate the scenario-specific hedge coverage ratios. At the end of the hedge period, the expected changes for the scenario that had occurred would be the benchmark of 100% effectiveness, with any variances from expectation resulting in ineffectiveness. While the DIG concluded that such a designation would not be allowed under Statement 133, we believe the application of reasonable constraints around the approach would present an alternative in keeping with the principles of IAS 39. Constraints might include strict designation and documentation requirements, limitation to a single independent variable identified as the hedged risk, and the prohibition of retroactive changes to hedge ratios or other determinants of ineffectiveness described in the documentation. Such a matrix approach would be more consistent with negative convexity risk management practices, recognize ineffectiveness due to any variance from expectations, and minimize the operational and hedge cost burdens required under other models to meet effectiveness requirements.

Credit Risk Portfolio Hedging – We keenly welcome the board's efforts to ease the restrictions and operational burdens of hedging a portfolio of interest rate risks. However, we would also like to take this opportunity to request that the Board consider similar relief for portfolios of credit risk. Diverse portfolios of credit instruments are less likely to share the same risk or to experience proportionately similar changes in fair value than are some interest rate risk portfolios. However there are additional incentives to manage credit risks in a portfolio. As in equity diversification theory, drawn and undrawn credits exhibit both company-specific and market-wide risks. The company-specific (idiosyncratic) risks can be minimized through diversification in a well balanced portfolio, leaving the market-wide (systemic) risks in need of hedging. Hedging on a systemic basis also makes sense in certain markets where company-specific hedging derivatives do not exist. If an entity chooses to manage its credit portfolio in this manner, it will likely fail the proportional fair value change requirement. As IAS 39 is currently written, portfolios of companies, industries, and maturities that might be managed together for economic purposes are forced for accounting requirements to be managed and hedged discretely, creating operational burdens not based on economic risk management needs. In fact, most firms find that passing hedge effectiveness tests requires credit and maturity boundaries too narrow to be practicable, and so cannot avail themselves of

hedge accounting. Furthermore, even if fair value hedging were available for drawn loans, undrawn assets, which are integral components of a portfolio of credit risks, do not meet current hedge accounting requirements as they are not considered firm commitments. For these reasons, we believe that hedges of portfolios of credit risks would benefit from the Board's further consideration.

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In conclusion, we believe the Exposure Draft, as currently written, will not result in an improvement to the accessibility of fair value hedge accounting for entities that manage their interest rate on a portfolio basis. For this reason, we strongly urge the Board to consider the comments in this letter.

We appreciate the opportunity to submit our views and would be pleased to discuss our comments and share our experiences with Statement 133 *Accounting for Derivatives and Hedging Activities*, as they are particularly relevant to the issues currently being reviewed by the Board, with you at your convenience. If you have any questions, please contact me at 212-270-7559.

Very truly yours,]