FAR

FAR is the institute for the accountancy profession in Sweden

CL 71

International Accounting Standards Board
Attn: Ms Sandra Thompson
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

17 November 2003

Dear Ms Thompson,

Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments, Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

In response to your request for comments FAR has the following comments on the proposed amendments to IAS 39.

Overall comments

We support the aim of the proposed amendments, i.e. to enable fair value hedging to be applied more readily to a portfolio hedge of interest rate risk. It is important to find – within the principles of hedge accounting in IAS 39 – approaches that allow appropriate and accepted risk management methods to be reflected in hedge accounting without major systems changes. We agree with the industry that inconsistencies should be avoided between the approach followed for risk management and the hedge accounting.

We, therefore, believe that the methodology set out in the ED is too prescriptive. We would support an approach under which a net position may be designated as the hedged item. That would, in our opinion, not be much different from the permission in IAS 39 to hedge "portions" and layers of risk. Consequently we believe that an entity should be permitted to exclude prepayment risk from the risk being hedged as long as it can be measured reliably. We would in this context point at ICG 121 that states "the fair value exposure attributable to prepayment risk can generally be hedged with options".

We are concerned that the prescriptive approach in the ED may not allow entities to apply it without significant tracking requirements and systems changes. The proposals further provide but one possible solution based on the allocation of amounts into time-periods and we believe that other approaches should be allowed, e.g. statistical ones.

We understand that the ED largely responds to issues raised by the banking industry. We would take the opportunity to point at other risks also managed on a "net basis", viz. the fact that foreign currency risk management by a corporate entity often uses a central treasury "netting centre" which creates similar issues in terms of the need for a practical solution that aligns risk management and hedge accounting. We believe the Board should reconsider these issues.

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We would respond as follows to the questions raised in the Invitation to Comment:

Question 1

(a) How should the hedged item be designated and why?

We believe the hedged item should be designated consistent with the way in which – generally – a bank manages interest rate risk, i.e. allowing a net position within a specified repricing/expected maturity time-band to be designed as the hedged item.

If the net position were designated as the hedged item, much of the concerns voiced in BC 18 – BC 29 about the apparent "cushion" from ineffectiveness that some of the possible methods for testing effectiveness may create. The cushion arises only when the existence of offsetting liabilities is ignored.

We recognise that designating the net position as the hedged item would be difficult to support in a conceptual asset/liability accounting model; we might argue that aligning the accounting hedged item with the economic hedged item is a justification good as any since it would mean that the accounts measure what they are supposed to measure. If the Board is not prepared to make that concession, we propose that at least for effectiveness testing it is recognised that the hedged item is the net position. In that case, we believe Approach C in BC 19 to be appropriate for measuring the impact of over-hedging, i.e. when the net asset or liability position is less that the notional amount of the (portfolio of) hedging instruments.

(b) Our approach

We are not convinced that there should be an income statement effect of under-hedging, e.g. when prepayments are expected later than previously estimated. Doesn't that simply mean that the entity has an un-hedged exposure with respect to part of the term of the hedged item? We believe that the proposal should be limited to establishing a principle that ineffectiveness due to over-hedging is recognised when prepayments take place, or are now expected to take place, earlier than previously estimated. We also believe that this would require the least change to appropriate policies and/or systems for risk management in place.

(c) How and when would hedging adjustments be removed from the balance sheet?

We generally support the proposal in the ED to release the adjustment in respect of each time-period into income at the latest when that time-period expires. The rules set out in A39, however, would at first glance seem to require tracking of the amounts deferred in different periods related to the same hedged item which would seem impractical. The practical solution set out towards the end of A39 (and further explained in A40) could be more predominantly presented.

Question 2

We agree that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair value hedge accounting if they had been designated

individually. We also agree that the fair value of a liability that the counterparty may redeem on demand is not less than the amount payable on demand since that is the amount that the depositors have provided in an arms' length transaction. It is further clear that IAS 39 currently does not contemplate valuation adjustments based on portfolios or large holdings.
However, as a practical solution for the purpose of portfolio hedging of interest rate risk only, we would support an approach that allows such deposits ("core deposits") to be classified into time-bands based on their *expected* maturities. We fail to see that as being significantly different from allocating assets into time-bands based on expected maturities, although it does involve increasing maturities beyond the contractual term rather than assuming prepayments before the contractual term is complete. Recognising that no individual item is being adjusted under the proposed model but rather an amount that forms part of a portfolio that contains such deposits, we believe it is distinguishable from a hedge of changes in the fair value of the deposits themselves.

However, we would expect something more of the entities than a mere simple allocation of deposits to time periods based on their expected maturities. The industry's criticism of the hedge accounting rules should be underpinned by risk models that do more than so, i.e. the entities should be able to demonstrate that the fair value of the allocated deposits responds to changes in interest rates in a similar way to other items included in that maturity band.

You will note that we would support such an approach only for the purpose of hedge accounting; we would not allow the portfolio fair value concept to be used on initial recognition to recognise a gain from transactions with depositors.

Yours faithfully

FAR

Jan Buisman
Chairman, Accounting Practices Committee

Björn Markland
Secretary General