

Via website posting: <http://www.iasb.org/>

Dear Sir / Madam

**Re: Exposure Draft Comment: Hedge Accounting(ED/2010/13)**

I am generally supportive of the ED proposals for hedge accounting and think that they make important steps towards producing appropriate accounting treatments of economically rationale risk hedging activity. However, I wish to comment on several hedging situations that my clients in New Zealand have faced that IAS 39 was unable to produce an acceptable outcome for and for which I am concerned IFRS 9 does not accommodate either. I describe these below.

***Blend and extend interest rate swap transactions (IRS)***

The majority of corporate debt is floating rate and is swapped to fixed rates using vanilla IRS to eliminate the impact of changes in rates on funding costs. During the financial crisis floating rates were cut dramatically and these hedges became significantly out of the money. Some clients entered into blend and extend transactions whereby the term of their IRS were extended by some years and in return they paid a lower blended rate between that of the initial swap and current market rates. They paid no consideration to enter into these (ie the NPV of the new swaps were the same as those of the old ones). The result of the transaction was immediately lowered cash funding costs and continued protection from changes in floating interest rates, albeit over a longer period.

Under IAS 39 the change in swap terms required the disestablishment of the old hedge relationship and the designation of a new hedge relationship. As a result, the terms of hypothetical derivative for the new period were significantly different from those of the hedge instrument and effectiveness within the 80-125% rule could not be maintained. An example of this is provided below.

- Initial hedge relationship
  - Instrument: 31/12/05 – 31/12/2010, Pay fix 6.725% Receive Float IRS
  - Hypothetical Derivative – same terms
- On 31/12/08 blended to:
  - Instrument: 31/12/08 – 31/12/2013, Pay fix 5.681% Receive Float IRS
  - Hypothetical Derivative: 31/12/08 – 31/12/2013, Pay fix 4.649% Receive Float IRS

Date	FV of New Hedge Instrument	FV of Hypo. Derivative	Cum Mvmt in Hedge Instrument FV	Cum Mvmt in Hypo. Derivative FV	Effectiveness
31/12/2008	(2,285,331)	(0)			
31/03/2009	(1,404,833)	(778,689)	880,498	(778,689)	113%
30/06/2009	(1,035,896)	(1,046,580)	1,249,435	(1,046,580)	119%
30/09/2009	(609,876)	(1,353,664)	1,675,454	(1,353,664)	124%
31/12/2009	(469,299)	(1,383,648)	1,816,032	(1,383,648)	131%
31/03/2010	(1,252,389)	(511,848)	1,032,942	(511,848)	202%
30/06/2010	(1,939,578)	274,177	345,753	274,177	-126%
30/09/2010	(2,621,138)	1,055,446	(335,808)	1,055,446	32%
31/12/2010	(2,123,976)	674,860	161,355	674,860	-24%

Under the proposed IFRS 9 requirements, despite the removal of the 80-125% rule, it is unclear if the effectiveness criteria would be met due to the requirement that the hedge not systematically over or under compensate the change in the hedged item. Over the life of the relationship the new hedge instrument will lose its day 1 value and so a “systematic” variance will occur. Alternatively, should effectiveness criteria be met then the ineffectiveness recorded in profit and loss is clearly a distortion and of little relevance to users of the financial statements.

In my view the use of blend and extend hedging does still meet a valid risk management objective – movements in floating rates are being hedged and therefore a mechanism to accommodate such hedges ought to be provided in a manner that results in a representation in the P&L of the actual impact of the hedge instrument on the hedged item that is relevant to financial statement users.

I suggest that as with the new hedging mechanism or options, the day 1 value on a hedge instrument (which can be seen as similar to option premium) ought to be able to be excluded from a hedge designation and amortised to P&L on a rational basis for time period related hedges or adjusted to the value of the hedged item for transaction related hedges.

### ***Hedging with cross currency interest rate swaps (CCIRS)***

CCIRS are used extensively to swap the proceeds overseas funding back into local currency while managing foreign exchange risk across the life of the debt as well as potentially interest rate risks as well. Economically, the hedge is perfect; the foreign currency flows associated with the funding are matched perfectly by those of the CCIRS.

However, from a hedge accounting perspective issues arise in that CCIRS are valued of “basis curves” that adjust the swap curves used in valuing the CCIRS flows for what is in effect the liquidity charge from by banks for providing the instruments. This basis element is absent from the foreign currency debt that comprises the hedged item and it is this “basis mismatch” that creates hedge accounting difficulties.

Hedging fixed-to-floating (FX and benchmark IR risk) or floating-to-floating (FX only) across currencies does not work from a fair value hedge model perspective due to the basis mismatch in how the items are valued. The hedged item is valued using vanilla swap and FX curves whereas the CCIRS is valued using basis adjusted swap curves. Under IAS 39 this basis mismatch caused ineffectiveness that could lead to the 80-125% thresholds being breached.

The removal of the 80-125% effectiveness test within IFRS 9 does address this risk, but allowing this level of ineffectiveness to be recorded in the P&L does not provide useful information for users as the CCIRS flows are not impacted by changes in basis spreads – it is simply valuation noise created by changes in market conditions.

Trying to designate these instruments into cash flow hedges (under IAS 39 and IFRS 9) is problematic as they do not result in a fixed amount of functional currency being payable or receivable.

Conceptually however, a float-to-float CCIRS does hedge the FX risk on the hedged item for its principal and benchmark interest rate value components in functional currency terms. In order to eliminate the impacts of basis mismatch on the P&L – and so provide economically useful information users - a cash flow hedge model needs to be available so that basis can be imputed into the hedged item (see below).

Currently under IAS 39 various hedge accounting structures are used to attempt to deal with the basis mismatch. They typically involve designating a portion of the foreign currency debt into a cash flow hedge as a hypothetical CCIRS. There is no specific guidance regarding whether this representation is correct as it involves imputing a risk characteristic into the hedged to match that of the hedge instrument. This could be seen as similar to imputing optionality into items hedged for one sided risk – which was specifically prohibited by an adjustment to IAS 39 via AG99BA.

The case for representing foreign currency monetary items as CCIRS rather than as a series of forward exchange contracts relies on the fairly short horizon over which liquid quotes for forward exchange contracts are available – FEC extending beyond a year are unusual.

To address both these issues I suggest that the implementation guidance for IFRS 9 provide specific guidance or an illustrated example allowing the use of cash flow hedge accounting with a float-to-float CCIRS with the hypothetical derivative representing a foreign currency monetary item constructed as a hypothetical CCIRS.

#### *Transition of IAS 39 hedges to IFRS 9 hedges*

The transition requirements require that IAS 39 compliant hedges must be converted to IFRS 9 compliant hedges if they are to be hedge accounted from the date of transition. In practice this is likely to require the amendment of existing hedge documentation for how effectiveness will be assessed, sources of ineffectiveness and the determination of the hedge ratio.

It is highly unlikely that hedges that meet IAS 39 effectiveness criteria will fail the effectiveness requirements and objectives of IFRS 9. As a result this re-documentation becomes an administrative exercise of no benefit to preparers of financial statements and will be completely invisible to users.

I suggest that all IAS 39 compliant hedges designated before the client's transition date be grandfathered and treated as meeting IFRS 9 qualifying criteria with respect to documentation and effectiveness requirements as long as they continue to meet the IAS 39 effectiveness criteria.

If you wish to discuss my views or seek further information on the issues above please feel free to contact me at [sicole.nz@gmail.com](mailto:sicole.nz@gmail.com)

Your sincerely

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