

9 March 2011

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David,

Exposure Draft ED/2010/13: Hedge Accounting

Thank you for the opportunity to comment on the Exposure Draft (ED). Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange and remains one of a select group of banks who continue to be AA rated. Our operations are predominately based in Australia, New Zealand and Asia and our most recent annual results reported profits of USD4.5 billion and total assets of USD534 billion.

We acknowledge the extensive outreach which the Board has undertaken in considering how best to address the number of concerns raised in respect of the existing hedge accounting requirements in IAS 39. We support the majority of the proposals raised in this ED and believe that this should enhance the quality of financial reporting and the ability of entity to align hedge accounting with its economic hedging activities.

Whilst this ED takes many positive steps forward we are concerned that the ED has not addressed portfolio/macro hedging. The outcome of these discussions could have a significant impact on many financial institutions. Accordingly, we encourage the Board to complete its proposals relating to portfolio/macro hedging as soon as possible. Given the potential crossover between this ED and the Boards proposals relating to portfolio/macro hedging would encourage the Board to reserve finalising this ED until the proposals for this significant component has been exposed for comment.

We have attached our comments on the questions raised by the Board in the appendix to this letter and have set out the matters of greater significance below:

Mark-to-market (MtM) measurement of currency basis risk

As noted in paragraph B9 (b) of the ED it is a common hedge strategy to issue foreign currency (FC) debt which is then converted into local currency (LC). The strategy may also include changing the interest rate exposure of the debt. When implementing this strategy an entity will often enter into a cross currency swap (CCS). This results in an anomalous situation whereby a mismatch is created by the forward points and basis spread built into the CCS valuation compared to the spot translation in the valuation of the debt being hedged, commonly referred to as basis risk. This mismatch occurs even when the exposures are perfectly matched in an economic sense. Whilst the impact of re-measurement of 'basis spread' returns to zero over the life of the hedge relationship, should the hedged item be designated into a fair value hedge, the remeasurement of basis spreads can result in material ineffectiveness over the life of the hedge relationship.

Under the current application of IAS 39 (which, based on our reading, is not impacted by the ED) if floating FC debt is swapped to a fixed LC exposure (cash flow hedge) the impact of currency basis is deferred in other comprehensive income. However if fixed FC debt is swapped to a floating LC exposure (fair value hedge), the impact of currency basis is reflected in profit or loss as hedge ineffectiveness.

We propose that the ED be amended to permit the basis spread movement on the derivative to be deferred in OCI to the extent that the hedge is economically effective. Given the basis spread movement always returns to zero at the end of the trade there would be nothing deferred in OCI at maturation. Should the derivative or the hedged item be terminated early, the amount deferred in OCI would be immediately recycled to profit or loss.

Under both the existing and the proposed requirements, the recognition of this impact is misleading to users of the financial statements and presents an inaccurate picture of the entity's risk management activities.

Hedge accounting for change in exposure from one floating exposure to another

Unlike most corporate entities, financial institutions commonly manage risk by converting fixed interest rate exposures to a floating basis. One component of this strategy is to align the timing of the reset on each floating exposure (such as from 90 day reset to 30 day reset) and it is not uncommon to enter into a derivative to convert one floating exposure to another floating exposure. This type of hedging strategy currently does not qualify for hedge accounting on the basis that it is neither a fair value hedge (the entity has not hedged the exposure to the changes in fair value of the hedged item) nor a cash flow hedge (as the entity has not hedged the variability in cash flows) but merely changed them from one variable cash flow to another.

We propose that the definition of 'cash flow hedge' in paragraph 21 (b) be broadened to permit hedge accounting this type of economic hedging strategy to closer align the accounting and the entity's risk management strategy.

Dividend hedging in a Consolidated Group

Hedge accounting currently requires that the hedged risk could affect profit or loss. Our Group has a number of operations with functional currencies different from the parent. In order to obtain certainty relating to the LC dividends that can be paid to our shareholders, the Group takes out foreign exchange contracts to convert the FC dividend into LC. The repatriation of this dividend will more often than not take place after a financial year end which means that the MtM exposure on the derivative is reflected in one period while the dividend is paid in the next. As the current objective is aligned with the particular risk impacting profit or loss (the dividend does not impact the consolidated profit or loss) this economic risk cannot be hedge accounted even though there is a rational economic reason for entering into the transaction.

We propose that hedge accounting be permitted for this type of strategy and that the effective portion of the derivative be deferred in OCI and recycled to profit or loss when the dividend is repatriated.

'Lower of test' for cash flow hedges

Whilst we are supportive of the continuation of the 'lower of test' for cash flow hedges in respect of 'off balance sheet' exposures we question the inconsistency with the treatment of cash flow hedges and fair value hedges where the hedged item is a recognised asset and liability. For example, an entity may take out an interest rate swap (IRS) and designate it as a fair value hedge for the interest rate exposure on a fixed interest rate asset. Another entity could have the same IRS and designate this as a cash flow hedge of a floating rate liability. We believe that the treatment of under/over hedging should be the same between these two relationships. We would propose that the 'lower of test' be restricted to highly probable forecast transactions where there is no existing balance sheet position.

Transitional provisions

We anticipate that there may be relationships that either did not qualify for hedge accounting under the existing standard or were not designated into hedge relationships for various reasons. The proposed transitional provisions do not easily cater for these hedge relationships and may create unnecessary ineffectiveness if an entity were to designate them prospectively. This arises as the hedging derivatives are likely to have a fair value other than zero at the transition. We propose that the ED include an option for entities to elect to apply hedge accounting retrospectively on a relationship by relationship basis.

Detailed comments on the questions raised in the ED are attached to this letter. Should you have any queries on our comments, please contact me at Rob.Goss@anz.com.

Yours sincerely



Rob Goss
Head of Accounting Policy, Governance and Compliance
Copy: Chairman, Australian Accounting Standards Board (AASB)

Appendix

Question 1

Do you agree with the proposed objective of hedge accounting?
Why or why not? If not, what changes do you recommend and why?

We agree with the principal that hedge accounting and an entity's risk management strategies should be aligned however we have two concerns:

- 1) Whilst we are supportive of the principal that a financial report should fairly present the economic hedging strategy adopted by an entity we are concerned that there could be unintended consequences from rigidly linking hedge accounting with an **entity's** risk management strategy. A complex consolidated group may consist of entities with different business models; for example many financial institutions have both insurance and a banking business where the risks and strategies for managing those risks differ. As a result there could be entities whose risk management strategies are out of line and possibly inconsistent with other entities within the consolidated group. One reading of the current ED would be that hedge accounting applied at the entity level would need to be reversed on consolidation if there are inconsistencies in the risk management strategies.
- 2) Furthermore, as a result of requiring that the particular risk 'could affect profit or loss' the economic hedging of a subsidiaries net profit (and subsequent dividend repatriation) would continue to be exempt from hedge accounting. Our Group has a number of operations whose functional currencies are different to the parent. In order to obtain certainty relating to the Local Currency (LC) dividends that can be paid to our shareholders, the Group takes out foreign exchange contracts to convert the foreign currency (FC) dividend into LC. The repatriation of this dividend will more often than not take place after a financial year end which means that the mark-to-market (MtM) exposure on the derivative is reflected in one period while the dividend is paid in the next. As the current objective is aligned with the particular risk impacting profit or loss (the repatriation of the dividend does not impact consolidated profit or loss) this economic risk cannot be hedge accounted even though there is a rational economic reason for entering into the transaction. We propose that hedge accounting be permitted for this type of strategy and that the effective portion of the derivative be deferred in other comprehensive income (OCI) and recycled to profit or loss when the dividend is repatriated.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments?
Why or why not? If not, what changes do you recommend and why?

Yes. We consider the current distinction between the financial and non-financial asset and liabilities to be arbitrary.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item?
Why or why not? If not, what changes do you recommend and why?

We are supportive on the direction taken in this ED to more closely align the hedge relationship with the economic hedging strategy and to remove artificial hurdles such as the requirement in IAS 39 that a derivative could not be designated as a hedged item. However, we believe there are additional improvements that could be made to the ED that would further enhance a preparer's ability to implement meaningful hedge accounting.

As noted in paragraph B9 (b) of the ED it is a common hedge strategy to issue FC debt which is then converted into LC. The strategy may also include changing the interest rate exposure of the debt.

Whilst the ED will enhance an entity's ability to dynamically hedge the FC and interest rate exposures over the life of the hedging relationship, the impact of the MtM measurement of currency basis spreads in the derivative used in these relationships continue to contribute to 'accounting ineffectiveness' in an otherwise perfect economic hedge.

With the hedging strategy described above, the hedging instrument is generally a cross currency swap (CCS). Even where the CCS economically closes off the full risk on the foreign currency exposure (i.e. notional of the CCS and interest rates align with the hedged item in amount and timing) the MtM valuation of the CCS includes the impact of currency basis spread whereas there is no such 'fair value' adjustment on the hedge item. The revaluation of the FX component of the foreign currency debt (FC to LC) and the FX component of the fair value adjustment on the CCS largely offset but the revaluation of the CCS includes the impact of movement in basis spread which gives rise to earnings volatility over the life of the relationship. The basis spread is the premium or discount required by the swap counterparty to enter into a cross-currency swap. As basis spreads narrow, the contractual "pay" leg on the CCS records a MtM loss and visa versa for widening of the basis spreads. This is priced into the instrument when initially traded (trade value is zero on day one) and then revalued against spot basis spreads over the life (MtM movement). Changes in the spread impact the CCS while there is no impact on the fair value measurement of the FC debt. Whilst this is a fully effective hedge strategy, there is hedge ineffectiveness between the spot retranslation of the hedged item and the MTM retranslation of the derivative. This ineffectiveness always reverses over time and will be zero at the end.

Under the ED if floating FC debt is swapped to a fixed LC exposure (cash flow hedge) the impact of currency basis is deferred in other comprehensive income. However if fixed FC debt is swapped to a floating LC exposure (fair value hedge), the impact of currency basis is reflected in profit or loss as hedge ineffectiveness.

Under both the existing and the proposed requirements, the recognition of this impact is misleading to users of the financial statements and presents an inaccurate picture of the entity's risk management activities.

We propose that the ED be amended to permit the basis spread movement on the derivative to be deferred in OCI to the extent that the hedge is economically effective. Given the basis spread movement returns to zero at the end of the trade there would be nothing deferred in OCI at maturation. Should the derivative or the hedge item be terminated early, the amount deferred in OCI would be immediately recycled to profit or loss.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable?

Why or why not? If not, what changes do you recommend and why?

Yes we believe this is a pragmatic approach which will enhance a preparer's ability to closer align the economic hedging to the accounting for the hedge. However, we do partially support Mr Smith's view set out in AV2 and agree with his statement that the requirement for a portion of an item to be designated as a hedged risk if it is separately identifiable and measurable is substantially undermined by permitting this to be inferred without restriction rather than contractually specified. We believe the Board should include the requirement that an inferred risk only be permitted where there is a reliably measureable price for the component parts and the sum of those prices equal to the price of the whole.

Question 5

(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item?

Why or why not? If not, what changes do you recommend and why?

Yes. We would support the additional flexibility which will further align an entity's accounting and economic risk management strategy.

Question 5

(b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk?

Why or why not? If not, what changes do you recommend and why?

We agree with this proposal when applied to an individual instrument as the impact of the prepayment option is binary (i.e. they either exercise the option or they don't).

We note that whilst the Board has not released its position on portfolio/macro hedging, we strongly believe that this requirement would not be applicable to a portfolio of instruments. Prepayment risk would be considered in devising the risk management strategy across the portfolio. As part of this strategy management includes the impact of portfolio diversification and hedges layers of the portfolio accordingly. We believe that a layered component of the portfolio should qualify as an eligible hedged item even where it included a prepayment. If the entity's strategy does not adequately cater for the optionality of the hedged portfolio, this will result in the appropriate recognition of ineffectiveness and possibly de-designation if the hedge would no longer be expected to achieve unbiased offset going forward.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting?

Why or why not? If not, what do you think the requirements should be?

In principal we support the direction taken. However we propose that paragraph B29 which prevents hedge accounting if it is likely to represent a biased result (systematically exceed or be less) be amended. We are concerned that the current wording may be interpreted to preclude any hedge relationship where there is a reasonable expectation of a biased result but where this is the optimal hedge strategy/instrument. For example; an entity may, for cost or other reasons, designate an existing instrument into a hedge relationship even though the fair value at inception of the hedge relationship is not zero. This may be interpreted as creating a biased result and hence would be precluded from hedge accounting.

We propose that the requirement of paragraph B29 be amended as follows:

"This means an entity has no reasonable expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item such that they would produce a biased result, which could be avoided through a reasonable alternative weighting of the hedged item and the hedging instrument."

Should the Board elect to retain the existing wording of paragraph 29 we believe additional guidance on what is mean by the term biased would be useful.

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

Yes, we believe this flexibility does enhance the application of hedge accounting. However, we believe that rebalancing for accounting should only be mandatory when proactive risk management activity is required (i.e. it is part of the entity's risk management strategy to adjust either the hedging instruments or the hedged item to achieve a more effective hedge relationship). This will more closely reflect the actions taken by management to manage the economic risks and will closer align risk management with accounting.

Question 8

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

Whilst we are supportive, we propose that there should be flexibility to permit an entity to continue hedge accounting where it is required to rollover or replace an instrument the roll over or replacement could not reasonably have been envisaged at the inception of the hedge relationship.

Question 8

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

Yes. This aligns with the principle in the standard to align hedge accounting with the economic and risk management strategies of the entity.

Question 9

(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?

Yes, with the exception of the matter noted in response to question 3, where we propose that the impact of basis spreads be deferred in other comprehensive income.

Question 9

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not?
If you disagree, when do you think linked presentation should be allowed and how should it be presented?

Yes, on the basis that this will assist users of financial statement to more understand the hedge related adjustment.

Question 10

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

We are supportive of the proposal to treat the option premium as a 'transaction cost' associated with the transaction. However, we note that there appears to be an inconsistent treatment between non-financial items and financial item that is carried at amortised cost. We propose that in respect of financial items carried at amortised cost that this be included as an incremental cost and deferred as part of the effective yield.

Question 10

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

Yes. This aligns with the general requirement for cash flow hedge accounting without adding additional complexity.

Question 10

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Whilst we agree with the concept of determining the 'aligned time value' to determine the amount of option premium to defer, we believe that this may create unnecessary complexity. We propose that where an entity's risk management strategy is to use exchange traded options as hedges, and as a result, the entity is unable to match the terms exactly, it is better in principle to treat all MtM movements as part of the hedging relationship.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

Yes. However, we are concerned that the ED has not addressed portfolio/macro hedging and any response to this question would be qualified in that it is very dependant to the outcomes of the proposals relating to portfolio/macro hedging. We encourage the Board to resolve its position in this matter as soon as possible.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items?

Why or why not? If not, what changes do you recommend and why?

No. A key measure of a financial institutions performance is 'Net Interest Income' which includes the line items 'Interest Income' and 'Interest Expense'. We are concerned that the inclusion of a separate line that is not included in Net Interest Income will add confusion and would not be in line with how the entity manages or monitors its interest rate exposure.

Question 13

(a) Do you agree with the proposed disclosure requirements?

Why or why not? If not, what changes do you recommend and why?

(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

Whilst we believe that on an individual item by item basis, each disclosure has some relevance and there will be a user who may find it useful, we question the merits of continually increasing the volume of mandatory disclosures. We consider that the disclosure requirements as drafted are onerous and would result in many more pages of notes to the accounts. We encourage the Board to embark upon a review of the full suite of disclosures within the accounting standards and limit disclosure to the most relevant items. The development of clear principles and a limited number of key mandatory disclosures would enhance the clarity of disclosures provided.

More specifically we raise the following concerns in respect of the proposed disclosures:

- We believe that principal set out in paragraph 40(a) and 40(b) should be reworded to clarify that the principal only relates to those risks where the entity elects to apply hedge accounting.
- The requirements of paragraph 47 as currently drafted may create a burdensome exercise to demonstrate that all potential sources of ineffectiveness have been considered. We would encourage the Board to include the word 'significant' in the assessment of sources of ineffectiveness that could impact the hedging relationship.
- Paragraph 49, 50 and 51 mandate specific disclosures to be provided without setting out the overall principle. Whilst the presentation in a tabular format by category of risk and type of hedge may be straight forward in single hedge relationships, we are concerned that the disclosure would be confusing where a single derivative is designated as a hedge of more than one risk which may also be in both a fair value hedge and a cash flow hedge relationship. We would propose that the board mandate the principle behind the disclosure and permit preparers to provide disclosure that most effectively meet that principle.

- We are not supportive of the requirement in paragraph 52 to provide detailed reconciliations of movements in Other Comprehensive income as we do not believe it adds to a users understand the results of the entity which is not already achieved in the other disclosures. Once again we would be more supportive of a clear disclosure principle rather than mandating the disclosure of reconciliations.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

Yes. However, we question why there is a requirement that an entity manage the risk to a net position to 'nil or close to nil'. Many entities take out derivative contracts together with 'own use' contracts that are managed on a fair value basis with the intention of fixing a profit margin. Our interpretation of the proposed amendment would be that this would not qualify for fair value measurement as the 'net exposure' is not maintained close to nil as there is still an exposure on the profit margin.

We would propose that the requirement to manage to a 'net nil or close to nil' position be removed or clarified.

Question 15

(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?

(B) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

We do not believe that the alternatives presented would add unnecessary complexity to accounting for financial instruments. Currently a large number of international banks employ some method of portfolio management to their institutional loan book to achieve optimal capital, credit and/or concentration outcomes. Credit Default Swaps (CDS) are a common tool employed to provide risk transfer, and are accounted for on a MtM basis, compared to the historic cost accounting applied to the loan book. We agree that this mismatch provides a distracting source of noise in prepared accounts that is almost always contra to the economic rationale for undertaking portfolio management in the first place. Addressing this mismatch, by the alternatives described, would decrease the complexity of accounting for loan financial instruments considerably, and hence improve the usefulness of presented accounts to investors.

The key impediment of the current practice is the restriction on when the designation into fair value can occur. If circumstances change after initial recognition (i.e. through an altered view of that borrower's credit, or a build up in concentration to that borrower), it is necessary to be able to designate that loan at fair value to align with changes in the management of the risk. Additionally, for capital management purposes, it may at times be necessary to only hedge a portion of a loan exposure, rather than the entire facility. This type of optimisation activity will become more common place as banks move to economic capital based pricing, where concentration (i.e. the marginal additional dollar loaned) will drive much hedging activity.

Of the three alternatives suggested, we strongly support further consideration of alternative 3 which most closely aligns with how we manage hedges of credit exposures.

This alternative is superior to option 1 which does not permit the designation after inception. Circumstances may change after inception of the loan for example, altered views of the borrower's credit, or a build up in concentration to that borrower. Prohibiting designation after inception does not align with how the risks are managed and would create accounting earnings volatility.

Whilst option 2 permits subsequent designation, the decision to switch loans between the two accounting treatments should be driven by the bank's written portfolio management principles, not by attempting to manage earnings on a quarterly basis. By requiring a fair value adjustment to pass through the accounts at the time of redesignation, the hedging analysis may be clouded by the earnings impact.

Question 16

Do you agree with the proposed transition requirements?
Why or why not? If not, what changes do you recommend and why?

We propose that in addition to the existing hedges continuing under the new standard that an entity be given the option to perform a one-off designation exercise as though the hedges had been designated at inception where it is practicable to do so.