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cc Mr Warren McGregor
International Accounting Standards Board Member

cc Mr Kevin Stevenson
Chairman and CEO of Australian Accounting Standards Board
Via email

Tuesday 8 March 2011

Dear Sir David

Exposure Draft/2010/13 - Hedge Accounting

We congratulate the International Accounting Standards Board (IASB) on the improvements that have been incorporated within **Exposure Draft/2010/13 – Hedge Accounting**. In particular, we appreciate the fact that you have incorporated aspects of our letter to the IASB dated 30 July 2010 and some of our subsequent dialogue.

The Finance & Treasury Association (FTA) is the peak professional body in Australia for corporate treasurers and senior financial risk managers with around 850 members primarily from Australasia's largest 300 companies. The FTA has been operating for over 25 years in different forms and has established its reputation as a premier provider of continuing professional development (CPD) for finance and treasury forums in Australia.

Many of our members utilize financial instruments to manage key financial risks within their corporate entities and therefore we are pleased to provide further comments in the development of this important Accounting Standard.

We sought feedback from our members through a number of medium including:

- The IASB Outreach meeting with Martin Friedhoff, Technical Principal, Judith Li, Technical Manager and Bob Garnett, Chairman of the IFRS Interpretation Committee in Sydney on

Tuesday 25 January. This meeting was attended by a number of senior FTA Members/ Corporate Treasury professionals.

- Feedback from the FTA Technical Committees – for details of the committees please visit <http://www.finance-treasury.com/Member-Committees>
- A series of professional development workshops on the key aspects of **Exposure Draft/2010/13 – Hedge Accounting**. These workshops held in six capital cities in Australia throughout February, were attended by over 200 senior finance & treasury professionals.
- A discussion with the Group of 100 (G100) Technical Committee. The G100 is an association of Chief Financial Officers from Australia's largest 100 public and private companies.
- A discussion with Qantas Treasury executives. The Qantas Treasury team is a large member of the FTA.

We certainly agree with the bulk of the amendments to IFRS 9, however in our opinion there are a number of areas where the exposure draft could be further improved as detailed in our attached submission and summarised below.

- a. Foreign investments categorized as fair value through OCI should be capable of being hedged for foreign currency risk
- b. Zero cost collars (and any other nil premium based option products which do not create a net sold position) should attract the same accounting treatment as options
- c. Net foreign income from subsidiaries should be eligible as a qualifying hedged item
- d. The transition rules should permit a once off adjustment to realign hedge relationships to take advantage of the greater hedge flexibility with the exposure draft
- e. The hypothetical derivative measurement basis should be clarified that it can be utilized for fair value measurement of the hedged item in fair value hedges
- f. Disclosures should be principle based and not prescribed
- g. Clarification and possible amendment is required in respect of the fair value option for physical contracts that can be net settled
- h. A practical solution is required for hedges acquired as part of an acquisition to avoid duplicate record keeping
- i. CVA adjustments of a derivatives own credit risk should be reconsidered given the current divergence in practice
- j. Long term cash flow hedges should be able to hedge cash flows on a real basis and not just a nominal basis

The following document details the FTA's response to **Exposure Draft/2010/13 – Hedge Accounting** with supporting arguments from members of the FTA proposals.

The FTA would welcome the opportunity to discuss the information contained in this letter and I can be contacted for further explanation on +613 9653 9532 or via email mike@dontschuk.com.

Yours faithfully

Mike Dontschuk, FFTP
President



Tuesday 8 March 2011

FTA submission to IASB Exposure Draft/2010/13 - Hedge Accounting

Q1 Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

Subject to our comments below the FTA agrees with the proposed objective that hedge accounting should faithfully represent the economic consequences of the risk management activities of the entity. However, the current definition restricts the ability to hedge under the following circumstances.

- Investments that are fair valued to other comprehensive income – such investments should be able to be hedged for foreign currency risk despite the fact the fair value changes on the investment do not impact the profit and loss account. It is possible to achieve this outcome by holding such investment in a foreign currency functional currency entity align with the currency of the investment, however the FTA sees no reason why companies should restructure the ownership of investments into different functional currency entities to achieve a hedge accounting outcome.
- We note that some risk management strategies do not align with the current requirements of the exposure draft; i.e. macro hedging. Accordingly we await further details on this aspect of the exposure draft when it is released later in the year.

We agree that an objective for hedge accounting is helpful in setting the scene for hedge accounting and to lay the foundation for a more objectives-based approach. We agree with the Board's proposal that the objective of hedge accounting is to '...represent in the financial statements the effect of an entity's risk management activities...'. However, we do not believe the objective of hedge accounting is limited to that as not all risk management activities will necessarily need, or meet the requirements of, hedge accounting. We believe that one of objectives of hedge accounting is to mitigate the recognition and measurement inconsistencies that may arise from the normal accounting requirements applicable to hedging instruments and hedged items. A hedge accounting objective should reflect therefore both the risk management and accounting dimensions. The risk management and accounting objectives are complimentary, not mutually exclusive. We therefore recommend that the Board refine the objective to reflect this. For example, the hedge accounting objective could be stated as:

“Hedge accounting is an optional accounting presentation to overcome recognition and measurement accounting mismatches that may arise from presenting the effect of an entity's risk management activities.”

Q2 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. The FTA agrees it is appropriate that non-derivative instruments measured at fair value through the profit or loss qualify as hedging instruments because this would be consistent with the risk management strategies of some entities. However, if an instrument/item operates as an effective hedge instrument consistent with an entity's risk management strategy the FTA believes that it should also qualify for hedge accounting.

Q3 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?

Yes. This approach also enables hedge accounting to better reflect the risk management strategies of the entity than occurs under the present requirements. As such, the removal of the impediment means that hedge accounting will better reflect the application of the risk management strategies of the entity.

Q4 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 (ie 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. The proposal will result in a better alignment of hedge accounting and the entity's risk management strategy. However we do suggest that the commentary in the standard be amended, as it singles out credit risk as a particular issue, when in principle the issues on credit risk are the same as any basis risk in any imperfect hedge relationship.

The ED paragraph IN 46 and BC 220 imply that it is not possible to hedge account CDS's (credit default swap) against credit risk in a loan due to the operational difficulty (if not impossibility) to isolate and measure the credit risk of a financial item as a component that meets the effectiveness criteria for hedges; it further states that this is due to the spread and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements.

It would seem appropriate that if a loan is covered for its entire life against default risk by a CDS and a CDS perfectly hedges the cash flow uncertainty of default risk on the loan, the CDS should qualify for hedge accounting and achieve a perfect cash flow hedge of the stated risk without concern of the valuation of the liquidity and funding risk component.

As an aside, if the CDS qualifies as a financial guarantee contract then it is not within the scope of the standard despite it hedging the same risk – and is not even subject to fair value.

Finally if B44 allows the use of hypothetical derivatives to measure the fair value attributes of the credit risk component of the loan (see detailed comment at section 2.1) then it would be possible to achieve a perfect hedge under the fair value approach. Such an amendment would be far more logical and practical than the current approach and commentary in the standard.

Suggest the wording in from BC 219 to BC 246 be dropped as it adds nothing to the standard and suggests operational difficult with does not exist when you hedge on a cash flow basis.

Q5 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.

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?

Yes.

Q6 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?

Yes. The FTA believes that this proposal will remove a major practical impediment to the operation of hedge accounting. The 80:125 rules for assessing hedge effectiveness precluded the use of hedge accounting even though the risk management objectives of the entity were being achieved.

Q7 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?

Yes. The proposal introduces a flexibility which is present in the management of ongoing hedging relationships where entities would 'rebalance' their hedge book in response to changing circumstances. This approach would remove the frustrations, inefficiencies and costs associated with re-designation and re-classification of hedging relationship.

However, in practice we have a concern that depending on the interpretation of one's auditor it may be a disproportionately complex assessing when a mandatory rebalancing is required. For example, assume an entity has a derivative and a hedged item where basis risk exists between the two. At inception of the hedge the entity determines that the probability of the basis risk giving rise to an under or over hedge is equal and in doing sets its hedge ratio (say one-to-one). At the end of the first reporting period the gain/loss on the hedged item is larger than the gain/loss on the hedging instrument. The ED would require the entity to investigate whether this difference which arises from actual basis risk which confirms its initial assessment that the basis risk could result in an under or over hedge (and it turned out to be an under-hedge) or whether it represents a structural shift in the hedging instrument and hedged item that is expected to continue in the future (and therefore require a rebalancing). Often this can be assessed by the treasurer on a judgmental basis however there is a concern that detailed analysis may be required on such matters. We consider that if the hedge ratio is determined at inception to be unbiased and the hedging instrument and hedged item are unchanged then there is no greater risk of abuse due to under-hedging that needs to be corrected through a mandatory rebalancing. The financial statements will reflect the hedge ineffectiveness of the hedge relationship.

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.

Q8 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?

The FTA agrees with discontinuation in these circumstances.

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. We understand that this does not preclude an entity from revisiting/reviewing its risk management objective and strategy.

Q9 a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized 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.

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?

No. Paragraphs 38 and 50 of the ED state that the fair value adjustment to the fair value of each group of hedged items shall be put on a separate line of the financial statements. The concern with this requirement is that it may require a significant number of additional lines on the statement of financial position - hence the issue is a matter of information overload in the statement of financial position.

We understand from the IASB outreach meeting held with senior FTA members on Tuesday 26 January 2011 in Sydney, Australia that this requirement originated from IAS 1.59 which states that “The use of different measurement bases for different classes of assets suggests that their nature or function differs and, therefore, that entity presents them as separate line items.” We understand that this was the basis for recommending separate line presentation. However this clause is not currently complied with in practice due to:

- i) the complexity it adds to the statement of financial position; and
- ii) to make any sense it requires every line of the financial statements to be referenced to its cost basis.

We do not believe this causes any misunderstanding in the financial statements currently.

The practical solution would be to disclose the separate line for the fair value adjustment in the notes to the financial statements, rather than on the face of the statement of financial position.

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?

This was the only matter on which the membership was split in respect of its comments, with some members of the view that linked presentation would make it easier for users to understand the economics of the business when operating on a going concern basis and others agreed that given the different counterparties there should be no linkage in the approach. Accordingly the FTA is of the opinion that there should be an election available as to whether a linked presentation is utilised or not. This is on the basis that there are sound arguments for both approaches;

i) Non-linked

The FTA believes that a non linked presentation clearly reflects the rights and obligations to different counterparties and in this respect it can be argued that it presents users of financial statements with useful information.

On the other hand

ii) Linked

The FTA believes that a linked presentation of foreign currency debt which has been hedged for interest rate risk and foreign currency risk could enhance the user's ability to understand the debt position of the company. Over the last two years gyrations in the AUD (of more than 30% against the USD) has meant that companies with foreign currency borrowing (despite the fact such borrowing are switched back to AUD to create synthetic debt) have been negatively assessed despite the fact that the economic substance of the debt is AUD. Hence a linked approach in limited circumstances would better reflect the debt position of the corporation. Naturally such linked approach is inappropriate if the entity is no longer a going concern, but it is appropriate whilst the entity is a going concern.

Q10 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 (eg like a basis adjustment if capitalized 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?

Yes.

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.

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 (ie 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?

Yes.

Q11 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?

The FTA supports an approach which is consistent with the risk management strategies of the entity and the outcome of the Board's deliberations on macro hedging. However, as previously mentioned we await the distinction between hedging groups of items and macro hedges.

Q12 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 (eg in a net position hedge), any hedging instrument gains or losses recognized 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 to you recommend and why?

No. The FTA does not support the separate presentation of the outcome (net position) in the profit and loss. Companies should be able to allocate the net gain or loss in a way that is most meaningful to understanding the results of the company, we accept that companies should be required to disclose the location of the net gain or loss in the profit and loss but this would be in the notes to the accounts.

Q13 a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

No. In general the FTA agrees with the disclosure principles in AASB 7 however the exact content and presentation should be a matter for the directors to determine. Application of this approach is more likely to result in more meaningful disclosures reflecting the objectives and outcome of hedging as part of the risk management strategy of the entity.

Whilst we agree that disclosure should cover how companies manage financial risk and the nature of the hedges in place. We do not agree that companies that hedge should disclosure more about their underlying economic position than those companies that don't hedge.

Specifically, the ED currently states in paragraph 46 that an entity shall disclose its position for each subsequent period, the concern expressed is that each period must be set out such that for an entity hedging 20 years there would be 20 different lines that would need to be completed. The solution would be that such information could be summarized into time bands; e.g. up to 1 year, 1-2 years, 3-5 years and greater than 5 years.

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

The FTA believes that these are best left to the directors in meeting the disclosure principles and objectives outlined in AASB 7 providing transparency of the hedging activities.

Q14 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. The FTA supports these proposals which remove some of the practical problems under the existing requirements. However the current amendments are unclear and the requirement that contracts be net cash settled may prejudice some sensible outcomes.

The ED permits certain physical commodity contracts in a fair valued based risk management strategy that can be net settled in cash to be treated as derivatives, despite the fact that such contracts continue to be held for the purpose of receipt or delivery. This is a welcome change as it saves costs such company's the administrative burden of applying hedge accounting.

However many physical commodity contracts may not satisfy the net cash settlement requirements in the exposure draft. This will reduce the potential benefits of the amendments. It should also be noted that as the wording of paragraph 5 and 6 are not provided in the exposure draft the full impact of this amendment cannot currently be properly assessed as to its breath of operation.

Many commodity contracts – such as coal will not satisfy the “readily convertible to cash” definition due to the significance of transport cost to the closest market but are nevertheless often hedged on a FV basis. For example, major mining companies have a policy of converting fixed price contracts to floating such that they have a floating price profile for results.

This restriction that contracts must be “net settled in cash” would appear to have no justification, as it is inconsistent with how the standard treats embedded derivatives in IAS 39; i.e. companies that have an embedded FX derivative in a purchase contract are required to fair value the embedded derivative in the contract without the necessity of the embedded derivative being net settled in cash.

We further note that the net settlement definition can be satisfied in paragraph 6 were it states “the non financial item subject to the contract is readily convertible to cash”. It is possible under the current definition with the proposed amendment to value physical “electricity” contracts despite the fact that there are no markets for such contracts. Furthermore to compare such contracts to short dated coal contracts that are not “readily convertible to cash” due to transport costs, the coal contracts may well have a more reliably determined market price than the electricity contract and yet may fail the tests for qualification under the proposed amendment.

In addition we note that the current standard has caused some confusion based on the understanding of what contracts actually defined by paragraph 6. In particular:

- (b) what meets the definition of “practice of net settlement”;
- (c) “taking delivery and selling within a short period” – as more frequently than not wholesalers traders sell prior to even taking delivery and in some markets (such as electricity where no inventory is ever held); and
- (d) should more accurately reference to “trading” in all its different guises.

We suggest the removal of the technical definition that refers to a very antiquated trading model. Often a trading model involves no physical stock holdings as stock is purchased in the spot market as required, is sold based on forward physical contracts and the price exposure is managed via derivatives – such a trading model does not satisfy the current wording in IAS 39.6 (c).

We know for a fact that the actual words of the standard are frequently ignored currently. There have been a couple of interpretative disputes on this topic due to the difficulty on fitting modern trading models into this definition.

(Technical note: US GAAP achieves this election by stating in paragraph 10.b. that a company shall document why physical contracts satisfy the definition of “normal purchases and sales”, failure to do this documentation means that such contracts that meet the definition of a derivative will be treated as derivatives. Although we accept that the definition of derivatives under USGAAP is narrower than IAS 39 (USGAAP requires derivatives to be net settled).)

A change of paragraph 6 (c) to refer to trading in all its different guises would resolve many issues for wholesale/ trading companies which currently attempt to rely on the hedge accounting process but find it inconsistent with what they are ultimately trying to do; ie match their price risk on their purchases, sales and inventory. The true exposure for such companies is also best measured by fair valuing all contracts.

It is understandable that the board may be concerned with possible abuse, but it is difficult to abuse a true fair value approach for such operations.

Request:

1. We need the exact wording to be used in Para 5 and para 6 to enable a proper assessment of the standard.
2. Or a preferred approach would be to amend the standard to allow commodity contracts that:
 - a. Satisfy the definition of a derivative
 - b. Are managed on a risk basis on a FV approach
 - c. To be treated as derivatives if so elected
3. Alternatively Para 6 (c) of the current standard could be changed to permit a wider definition of managing profit on a fair value basis.

Q15 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?

Yes.

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?

See response to Q15(a).

Q16 Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

No, based on the following reasons.

1. Proposed approach does not revert companies to a level playing field on divergent accounting treatments

It is clear that different companies have taken different interpretations to the complex IAS 39 rules, this is especially the case with combining derivatives on synthetic debt; ie some companies have been permitted to hedge synthetic debt with IRS's whilst other companies have kept the IRS out of the hedge relationships based on advice of their auditors. For example a company may raise funds in USD fixed for 10 years, use a CCIRS to swap to floating AUD and then subsequently put in place an IRS for 5 years followed by another IRS for the remaining period at the completion of the first IRS.

Currently one Big 4 firm permits the hedging of IRS against synthetic debt created by combining the CCRIS and the Foreign currency debt. Other firms require a re-designation of the IRS into the hedge relationship when the second IRS is put in place— this effectively denies perfect hedge accounting for those companies that have complied with the current accounting standard.

Hence whilst the former companies will have perfect hedge relationships, the later companies will continue to suffer ineffectiveness when they apply the new rules as the IRS's will be inserted in the hedge relationships with a fair value at inception other than zero. This ineffectiveness will continue until these hedge relationships roll off.

2. Unable to modify on transition to take advantage of the new flexibility

The standard states that existing hedges that qualify under IAS 39 that also qualify according to the criteria can be regarded as continuing hedges, but it is unclear whether such continuing hedges can be re-documented to take advantage of the new rules – and whether this will have any impact on reversing previous ineffectiveness and time that may have been recorded.

It would appear such hedges must be de-designated immediately prior to adoption to take advantage of the new rules. But this in turn will create ineffectiveness of the balance of the life of such hedges, due to the fair value not being zero at re-designation.

3. Some companies will wish to restructure all their entire hedge relationships

For example, an electricity company that previously hedged physical sales from spot purchases using derivatives to match the sales in a cash flow hedge of the spot purchases, may wish to take advantage of the FV hedge strategy they have with their customer sales contracts as this is more aligned with their risk management strategy. They have three approaches under the new standard – either continue the cash flow hedge (unlikely due to the administration involved and the fact that the equity volatility caused by this hedge approach), hedge on a fair value basis (unlikely as this is not dynamic and still a lot of administration) or simply fair value the sales contracts as derivatives on the basis that this is part of their fair value hedge strategy of their overall electricity portfolio (most likely).

It is difficult to imagine how they would sensibly be able to do this over the life of their hedges, as some old derivative contracts would continue under the transition rules to be hedged on a cash flow basis whilst all sales would be treated as fair value through profit and loss. It is unclear whether the sales contracts would be fair valued from inception or it would just apply to new sales contracts post

implementation. Needless to say the rules do not currently permit a clean changeover from one hedge approach (cash flow hedge of purchases) to an approach more aligned with the company's risk management strategy and objective of fair valuing all sales contracts as derivatives and ceasing hedge accounting on the current portfolio of derivatives.

To take advantage of the new rules entities would need to de-designate all hedges just prior to transition and redesignate post transition. This has the disadvantage that previous hedges gains and losses would be left in the hedge reserve and it is not clear whether pre-existing customer contracts would be valued from inception or just valued from transition in which case it would not be a true fair value. Hence, a) it is not clear how this would work and b) it is likely to result in a confusing period between transition date and until the hedges completely roll off. This is likely to be true in many situations.

Most significant adjustments in the hedge approaches will be with:

- Electricity retailers
- Trading wholesale companies
- Financial institutions that have previously fair valued their entire books

Suggested response:

Permit companies with a once off adjustment at transition to realign hedges to comply with the new standard. This would allow entities to realign all their hedges to suit the new more flexible arrangements in a once off change. This change would be appropriately disclosed such that users of accounts have a much better understanding of the entity's risk management approach

Additional Comments

1. Clarification of B44 application to fair value hedges

Many fair value hedges have ineffectiveness in the hedge relationship due to the measurement approach taken of comparing the FV of the hedged item for the change in the applicable risk factor with the fair value of the hedged instrument. This approach results in ineffectiveness even in a perfect fair value hedge of interest rate risk when all the terms of the hedge instrument and hedged item match. This result is contrary to common sense as the hedge has perfectly achieved its hedge objective of converting the fixed rate debt item to floating rate debt. The same can be said of many forms of CCIRS fair value hedges, resulting in many companies splitting the CCIRS hedge into part FV and part cash flow to avoid the artificial ineffectiveness and volatility caused by not using a hypothetical as a surrogate for measuring the fair value of the hedge item.

B44 appears to permit a welcome expansion of the use of the hypothetical derivative to fair value hedges – previously such an approach was only accepted for cash flow hedges.

This is a welcome development as it means that fair value interest rate hedges and fair value CCIRS hedges can now be perfectly effective. This approach facilitates that calculation of the FV adjustment of the hedged item and will simplify system designs.

However, there is a lack of clarity in the standard that the intent of this change is to make this fundamental shift and accordingly it should be confirmed that this is the correct reading of the exposure draft.

We could also recommend a degree of flexibility in setting the floating leg of a hypothetical derivative; ie the floating leg should not need to be daily, but ideally from daily to semi annually to reflect the hedge instrument that is likely to be utilized in practice. This again will increase the alignment in fair value hedges to the actual hedges that in practice are being utilized.

This change would have a significant benefit to all fair value hedgers and would simplify systems and interpretation of results.

2. Macro hedging

The FTA awaits the release of the IASB's macro hedge proposal

3. Hedges with fair value other than zero at inception

Often hedges must be placed in new hedge relationships part way through their lives, this will certainly be true of companies re-designating to take advantage of the greater flexibility for hedging under the new standard.

This is a major issue for any acquisition, and potentially requires that two sets of books be maintained for the same hedges.

Unfortunately as all such derivatives will have a fair value other than zero at inception of the hedge, this will result in ineffectiveness in such relationships despite the fact that had they been able to designate at inception no such issues would have arisen.

A derivative with a fair value other than zero is the same as a derivative with a fair value of zero plus an annuity stream of payments or receipts or a combination of both. Hence it is possible to have a bank split a derivative with a fair value other than zero into its component parts (at significant cost) and achieve a perfect hedge result, but accounting standards do not permit the componentised approach in substance.

As a practical solution to this issue we request consideration be given to permitting the split of the derivative into its component parts. In respect of consolidation permit a roll off of the underlying acquired hedge reserve to replicate the impact of the acquisition on the acquired entities results rather than performing hedge accounting at the two different levels.

4. CVA adjustments

Currently in Australia very few corporations use CVA adjustments to derivatives for two reasons:

- Many consider that it artificially reduces the value of the derivative, as the banks will not recognise the benefit of the CVA adjustment on early settlement, furthermore when we have seen derivatives transferred to different banks normally there is an additional cost to the entity of transfer or novate rather than a reduced cost.
- CVA adjustments cause ineffectiveness in the hedge relationship and can easily cause long dated derivatives to breach the hedging rules

One Big 4 firm has advised clients that it will technically accept derivative fair values whether or not they are adjusted for own credit risk.

It is expected that CVA adjustments for own credit risk will become much more common as on a qualitative basis one could argue that the adjustments have no impact on the effectiveness of cash flow hedges. This in turn will mean that derivative liabilities are likely to be significantly understated in further periods. For example a 10year CCIRS can be reduced by up to 50% due to a CVA adjustment.

We suggest the IASB relook at CVA adjustment for own liability credit risk given the divergence in practice and the fact that CVA adjusted derivative liabilities often do not reflect the value for which the liability can be extinguished.

5. Net income of foreign subsidiaries

Investors expect directors to manage all risks associated with a company's results including FX risk on net income from foreign investments. This is not current permissible under the standard.

We suggest that the definition of hedged item be expanded to include net income from foreign operations.

6. Hedging real cash flows

A cash flow hedge is about fixing cash flows in nominal dollars, whereas for long term hedges companies often wish to seek to hedge on a real basis. However currently a hedge that locked in the commodity price at nominal plus CPI would be compared to a nominally fixed contract for effectiveness purposes. The FTA is of the view that long term hedges should be able to lock in a real cash flow and the exposure draft should be modified to permit such hedges as perfect.

7. Ability to add sold options to a combination hedge instrument

Whilst we agree that sold options and net sold option structures should not qualify for hedge accounting, we disagree with the continued restriction in the exposure draft of preventing a sold option being used in a combination of derivatives. This restriction is not necessary and prevents sensible corporate activity. For example it means a corporation cannot source a sold option from a different counterparty to the purchased option if the corporation wishes to create a collar rather than buy a collar. It also means a corporation cannot add a sold option to a combination at a latter point in time.