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Dear Board Members

Exposure Draft 2010/13 Hedge Accounting

Westpac is one of the four major Australian trading banks. At 30 September 2010 we had total assets of A\$618 billion of which loans represented A\$478 billion. Total liabilities were A\$578 billion including total foreign currency debt of A\$117 billion. Our current market capitalisation is A\$70 billion.

Westpac utilises all three forms of hedge accounting in its risk management strategy including:

- Hedging of foreign currency fixed rate borrowings (including fair value hedges of the interest rate benchmark risk and cash flow hedges of the foreign currency (FX) risk);
- Cash flow hedging of the FX risk on floating rate foreign currency debt;
- Fair value hedging of interest risk on Australian dollar fixed rate debt (including instruments in the Available for sale (AFS) portfolio);
- Portfolio CF hedging of pools of variable rate assets (mortgages) and liabilities (deposits);
- Portfolio FV hedging of fixed rate loans (which is out of scope of the current exposure draft) and;
- Net investment hedging of overseas operations.

Westpac welcomes this opportunity to respond to the Board in relation to the ED 2010/13 regarding phase three of the IFRS 9 Financial Instruments replacement project in relation to hedge accounting.

Westpac supports moving towards a principle based approach which more closely aligns with an entity's risk management practices. However, we would like to highlight for the Boards consideration the matters outlined below. These matters are also discussed in more detail under the relevant questions posed by the Board in the hedge accounting exposure draft.

The key matters we would like to highlight for the Boards consideration are:

1. Clarity of terminology (refer questions 1 and 6).

As noted above we agree with the alignment of hedge accounting to an entities risk management strategy, however we would seek more clarity regarding the "risk management activities" contemplated by the exposure draft and the required relationship to the manner in which the actual hedge accounting activities are conducted.

We agree with the Board's removal of the 80-125% test on hedge effectiveness in order to qualify for hedge accounting. However, we are concerned that some of the terminology in the exposure draft regarding a qualifying hedge is not sufficiently clear. In particular, the phrase "minimise expected ineffectiveness" is not clear. It seems to imply an entity needs to seek to enter in to the most effective hedge regardless of a cost versus benefit analysis or other similar considerations. This does not seem to be the intent of the standard and so further clarity regarding this term would be welcomed.

2. Eligible hedged items or components (refer questions 1, 4, 11 and 15).

Future profits of subsidiaries

We note that the exposure draft does not permit hedging of the future profits of subsidiaries with functional currencies different to the parent entity. Where these subsidiaries are intended to form part of the reporting group's long term stable operations, economic hedging of the future profits often forms part of the entity's risk management strategy. Therefore we would ask that the Board reconsider this position.

Hedging a layer including a prepayment option

However, we do not agree that a layer which is inclusive of a prepayment option where the options value may change in response to the hedged risk should be specifically excluded as an eligible hedged item. It is not clear why this would be the case when this would not prohibit the instrument as a whole being eligible for hedge accounting. In addition, any ineffectiveness caused by this between the hedged item and the hedging instrument would be captured and reflected appropriately.

Eligible hedged items in groups

The requirement that each item in a group of hedged items be eligible for hedge accounting does not necessarily align with risk management strategies.

In addition, we have concerns regarding the requirements for cash flow hedges of groups. Specifically we are concerned about the requirement for the cash flows to impact profit and loss in the same period particularly for entities required to prepare interim accounts.

Credit risk

Alternative three of the proposed approaches is our preferred option. However, we note that the discussion in the detailed analysis of proposals other than hedge accounting in the basis of conclusions implies that credit risk which is economically hedged with a credit derivative cannot achieve hedge accounting. We believe this commentary should be removed or modified so that this implicit conclusion cannot be drawn. If an entity can satisfy the principle based requirements of the standard and reliably measure the credit component then they should not be prohibited from applying hedge accounting.

3. Hypothetical derivative for fair value hedges (refer question 4).

Entities which have a significant amount of foreign currency funding have a specific issue which is the different impact of basis risk dependant on whether a cash flow hedge or a fair value hedge relationship is entered into using a cross currency swap. We do not believe that it is appropriate that this results in two different outcomes particularly as in both cases the cash flows are often perfectly matched.

Given that one of the objectives of the exposure draft is to reduce the complexity in IAS 39 due to different accounting treatment of cash flow hedging and fair value hedging we would encourage the Board to address this anomaly.

We propose that a hypothetical derivative be permitted to test effectiveness for both cash flow and fair value hedge relationships and that the wording in the exposure draft be amended to reflect this.

4. Presentation requirements (refer question 9(b)).

Rather than require a separate line item presented on the balance sheet for each balance sheet class for which fair value hedge accounting is applied we propose two possible alternatives. Firstly that one net amount is shown on the balance sheet, or alternatively that one amount is shown in the assets and one in the liabilities. Further details as to which balance sheet line items they relate to could be provided in the notes.

5. Disclosure requirements (refer questions 12 and 13).

We believe that the principles of materiality should be applied in the first instance to determine whether or not the hedging instrument gains and losses of a group of item which affect different income statement line items would need to be presented as a separate line item on the face of the income statement rather than in the notes.

When disclosing the expected impact of hedge accounting by risk for subsequent periods, we would propose that appropriate buckets of maturities be permitted similar to those utilised by entity's when complying with the disclosure requirements of IFRS 7, for example, <1 year, 1-5 years, 5-10 years, >10 years). This would avoid lengthy disclosures which do not add significant value.

6. Transition (refer question 16).

We believe there should be a one off election on transition to revisit and restructure/redesignate, if applicable, current hedge accounting relationships. In addition, there should be a one off ability, on transition, to retrospectively designate an economic hedge into an accounting hedge relationship under IFRS 9 if it now meets the relevant criteria.

Other matters we highlight for the Boards consideration are detailed below:

7. Rules based requirements regarding rebalancing and discontinuation (refer questions 7 & 8).

We support the ability for an entity to rebalance a hedging relationship. We also support discontinuation of hedge accounting where the hedge no longer meets the qualifying criteria. However we do not believe that rebalancing should be mandatory or that discontinuation should be prohibited. We support a less rules based approach allowing an entity to take account of other factors, e.g. cost versus benefit analysis in making such determinations.

8. Ineffective portion of hedging gains and losses taken to OCI and then transferred to profit and loss (refer question 9(a)).

We believe this creates undue complexity and operational issues and propose that the ineffective portion is taken directly to profit and loss.

9. Rules regarding linked presentation (refer question 9(c)).

While we agree that linked presentation should not be required on the face of the balance sheet, we do not believe it is necessary to preclude an entity from presenting in this manner.

10. "Aligned time value" of options (refer question 10(c)).

The aligned time value approach introduces unnecessary complexity and somewhat judgemental determination of the appropriate portion of the time value to attribute to the hedge relationship. We believe that if the entity complies with the qualifying hedge criteria that the entire time value of the option should be treated in the manner described in paragraphs 33(a) and 33(b) of the exposure draft.

Our detailed responses to each of the questions set out in the hedge accounting exposure draft are set out below.

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?

A defined objective of hedge accounting is useful in establishing the principles which hedge accounting should be based on.

We agree that the proposed objective of hedge accounting “to represent in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss” is an appropriate objective.

However, we believe some clarity is required regarding the “risk management activities”. In particular, to fit the hedge accounting requirements an entity’s hedge accounting strategy may differ from its documented risk management strategy. For example, many financial institutions may economically hedge their interest rate risk exposure by swapping from fixed rates to floating rates. Rather than designate this as a fair value hedge of fixed rate assets, for hedge accounting purposes this may be designated as a cash flow hedge over floating rate liabilities. We would encourage the Board to clarify that this would meet the objective of hedge accounting given the instruments are entered into for risk management purposes.

In addition, we note that the exposure draft does not permit hedging of the future profits of subsidiaries with functional currencies different to the parent entity. Where these subsidiaries are intended to form part of the reporting group’s long term stable operations, economic hedging of the future profits often forms part of the entity’s risk management strategy. Therefore we would ask that the Board reconsider this position.

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?

Westpac supports the decision by the Board to permit non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit and loss to be eligible hedging instruments.

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 believe that an aggregated exposure that is a combination of another exposure and a derivative should be permitted to be designated as a hedged item. This more closely aligns hedge accounting to many entities risk management practices.

However, in order that there is consistent interpretation and application of this we propose that the Board include more guidance in the standard. Specifically, we would seek clarity regarding the proposed accounting for the derivative which is included in the aggregated exposure, particularly where the derivative may be executed for a period shorter than the other exposure. We suggest that the examples provided in the exposure draft of aggregated exposures in paragraphs B9(a) and B9(b) be expanded to show illustrative accounting entries.

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?

We support the Boards proposal in the exposure draft to allow a risk component to be a hedged item where the component is separately identifiable and reliably measurable.

We note that as an Australian financial institution we have a significant amount of foreign currency funding. An issue that is specific to this is the different impact of basis risk dependant on whether a cash flow hedge or a fair value hedge relationship is entered into. This basis risk represents the premium or discount required by the counterparty when entering into a cross currency swap.

Where we swap foreign currency floating rate funding to fixed rate funding in our functional currency we apply cash flow hedging over both the interest rate and foreign currency risk. To test effectiveness we use a hypothetical derivative and in doing so no ineffectiveness results (assuming the critical terms match). As a result the basis risk is effectively captured in other comprehensive income and reverses over time.

However, where we swap foreign currency fixed rate funding to floating rate funding in our functional currency we apply fair value hedge accounting. In this scenario, as a hypothetical derivative is not used to measure the ineffectiveness, the cross currency basis risk creates ineffectiveness and therefore profit and loss volatility even though it will reverse over time.

We do not believe that it is appropriate that this results in two different outcomes particularly as in both cases the cash flows are often perfectly matched. Given that one of the objectives of the exposure draft is to reduce the complexity in IAS 39 due to different accounting treatment of cash flow hedging and fair value hedging we would encourage to Board to address this anomaly.

We propose that a hypothetical derivative be permitted to test effectiveness for both cash flow and fair value hedge relationships and that the wording in the exposure draft be amended to reflect this.

Also, please refer to our response to question 15 regarding credit risk as an eligible component.

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?
- (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 that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item as it allows an entity to align its hedge accounting with the way in which it manages the risks in its business.

However, we do not agree that a layer which is inclusive of a prepayment option as described above should be specifically excluded as an eligible hedged item. It is not clear why this would be the case when this would not prohibit the instrument as a whole being eligible for hedge accounting. In addition, any ineffectiveness caused by this between the hedged item and the hedging instrument would be captured and reflected appropriately.

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?

We support the removal of the highly effective (80%-125%) test in IAS 39 for determining whether a relationship qualifies for hedge accounting. We believe it is more appropriate to align hedge accounting with an entity's risk management practices.

In our discussions we have heard confusion as to how to interpret "unbiased" and "minimise expected ineffectiveness". Therefore, the Board may wish to consider providing more guidance as to how this terminology should be interpreted to avoid divergence in practice.

Specifically, we have interpreted "unbiased" as the expected change in the fair value of the hedging instrument will move inversely to the expected change in the fair value of the hedged item. There would be no leverage which would distort this relationship.

We have concerns over the interpretation of "minimise expected ineffectiveness" and seek clarity from the Board as to the interpretation of this phrase or otherwise for the Board to use alternate wording.

The terminology "minimise expected ineffectiveness" could be interpreted as requiring an entity to take sufficient action in order to reduce ineffectiveness to the minimum level possible. The implication of this is that the cost of entering into the best possible hedging instrument to achieve this may exceed the benefit of doing so. As such, the costs of establishing a hedge relationship of this nature could be such that it would preclude the entity from applying hedge accounting.

This interpretation seems to be contrary to what the Board intends given paragraph B29 states that "this does not mean that a hedging relationship has to be expected to be perfectly effective in order to qualify for hedge accounting." However, it is not clear what interpretation would be applied to this terminology.

Given that the Board is seeking to align hedge accounting with an entity's risk management practices we would interpret this phrase as minimising the ineffectiveness outside of the documented risk management strategy rather than providing the best offset to the risk being hedged. If there is no ability to apply judgement and materiality to the level of ineffectiveness, the proposal in the exposure draft would be more restrictive than the current requirements in IAS 39.

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?

While we support the ability for an entity to rebalance a hedging relationship we do not believe that this should be required. Our view is that the standard should not impose a rule that an entity must rebalance a hedging relationship. We believe the standard should be drafted, as much as is possible, as a principle based standard and not impose mandatory actions.

The requirement to re-balance and the restriction on discontinuing a hedge relationship seems to contradict the fact that utilising hedge accounting is a voluntary election.

An example of a scenario where this would be inappropriate is where the cost versus benefit does not justify such action. If the accounting rules require rebalancing then an entity could be forced to make an inappropriate business decision.

Another situation where an entity may justifiably wish not to re-balance or to discontinue a hedge relationship is where the entity subsequently enters into a transaction which provides a natural offset.

While it may be possible to include scenarios such as these in the documented risk management strategy, it will not be possible for an entity to pre-empt and document all scenarios that may justify not re-balancing or terminating a hedge accounting relationship in the future.

Even in the case of a cost versus benefit analysis, the judgement of whether or not it justifies such action needs to be fluid to respond to the internal competing priorities of an organisation and therefore it would be difficult to capture prescriptively in a risk management strategy.

In addition, there seems to be no consideration of materiality both in relation to the need to re-balance and also the requirement in question 8 below to discontinue. We would encourage the Board to amend the wording to make it clear that an entity would be permitted to take materiality into account in both these scenarios. Otherwise we consider that there would be a frequent need for re-balancing and result in more stringent criteria for hedge effectiveness than under the current requirements of IAS 39.

Also, re-balancing or discontinuation of a hedge relationship is a decision which only has a prospective impact, and therefore it is unlikely to create significant opportunities for abuse.

Finally, we would encourage the Board to clarify if a change in the risk management strategy of an entity would be classified as a re-balancing or a re-designation under the proposed changes to hedge 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?

(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?

We refer the Board to the comments made to question 7 above.

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?

(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?

Response to Question 9 part (a)

We believe it reduces complexity to more closely align the treatment of hedging gains and losses for fair value hedges to cash flow hedges.

However, we believe that complexity could further be reduced. We are of the view that the requirement to reflect all of the hedging gain or loss in other comprehensive income and then transfer out the part which

relates to the ineffectiveness creates unnecessary complexity and operational risk. It also increases complexity in understanding the movements in other comprehensive income.

Therefore we propose that only the effective portion be recognised in other comprehensive income with the ineffective portion recognised directly in the profit and loss. This is consistent with the recognition principles regarding the effective and ineffective portions for cash flow hedges.

Response to Question 9 part (b)

Under the current standard, the fair value attributable to the hedged risk in a fair value hedge relationship is included in the carrying amount of the hedged item. Where this hedged item is measured at amortised cost this results in a “mixed measurement” model, i.e. the hedged item is neither fully measured at amortised cost nor fair value.

We support the Board in addressing this issue by requiring a separate line item for the fair value attributable to the hedged risk.

However, we do not support a requirement for a separate line item for each asset and liability line item from the balance sheet in a fair value hedge relationship. We believe this adds unnecessary complexity to the face of the balance sheet. This is particularly the case for financial institutions which generally use fair value hedges over a number of different assets and liability line items in their balance sheets.

We propose that the standard allow the total fair value attributable to the hedged risks in all fair value hedge relationships be shown as one line item on the face of the balance sheet. Alternatively, we also support one line item relating to assets in a fair value hedge relationship shown within assets and one line item relating to liabilities in a fair value hedge relationship shown within liabilities. Further details could be shown in the notes to the financial statements to disclose the relevant portion of the total fair value attributable to the hedged items.

We note that showing the total fair value attributable to the hedged risks in all fair value hedge relationships as one line item seems to have been initially considered (refer staff agenda paper 20A and 20B). Staff agenda paper 20A states in the appendix that “The Board tentatively decided to present the cumulative gain or loss on the hedged item attributable to the hedged risk as a separate line item in the balance sheet. That line item is presented within assets (or liabilities) for those periods for which the hedged item is an asset (or liability).” Staff agenda paper 20B makes a similar statement.

However, we do note the conceptual issue this raises regardless of whether the hedging gains or losses are reflected as one (or two) net items on the balance sheet or for each line item. That is, the separate line item does not meet the definition of an asset or liability.

As a related issue, we also believe that there should be no requirement to gross up, on the balance sheet the gain or loss relating to each hedged item in a hedge of a group of items as required by paragraph 38. Again, this creates complexity on the face of the balance sheet. We are of the view that this information would be better presented in the notes to the financial statements.

Response to Question 9 part (c)

We believe that linked presentation on the face of the financial statements should not be required by the hedge accounting standard. However, we do not believe a mandatory rule prohibiting this type of presentation is required. Where an entity believes that the users of its financial statements would benefit by this type of presentation on the face of the financial statements rather than in the notes an entity should be permitted to present their financial information as such.

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?

(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?

(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?

We support the Boards proposals which address the issues under the current IAS 39 regarding accounting for the time value of options. As noted in the exposure draft basis of conclusions, when using an option in a hedge relationship often the time value will be excluded from the hedge relationship to improve the effectiveness of the hedge. This however, results in volatility in the profit and loss due to the requirement to fair value the time value component. We agree that the view taken by the Board that the time value can be considered as an "insurance premium" and therefore a cost of entering into this type of hedging strategy better aligns with an entities risk management approach.

We agree that the two methods proposed as they are in line with current accounting principles in the treatment of transaction costs and support the Boards proposals.

However, we have concerns with the "aligned time value" approach as we believe it introduces unnecessary complexity. This approach may require an entity to use significant judgement to determine what the time value of an option would have been had the critical terms of the option and the hedged item matched. Rather, we believe that the entire time value should be treated as proposed in paragraphs 33(a) and 33(b).

As an entity's hedge accounting is required to be documented as part of its risk management strategy it would be expected that an entity would enter into an option which best aligned with this documented risk management strategy and not one which would result in unnecessary deferral in other comprehensive income of the time value of options.

In addition, transparency would not be compromised given an entity is required to disclose its risk management strategy, how it is applied to manage risk and the impact of hedge accounting on the financial statements

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?

We cannot appropriately respond to this question without having also considered the Board's proposals for portfolio fair value hedge accounting.

However, we note that the exposure draft currently requires that each item in a group of items being hedged need to be an eligible hedged item itself. This does not align with our risk management strategy. Specifically, in a financial institution's asset-liability management ("ALM") portfolio, the group of items considered in determining the net risk position to be hedged include items which themselves would not be eligible hedged items. The management of risk in this case looks at the total funding across the bank including capital and non-interest bearing and sub-benchmark rate liabilities to determine the net position required to be hedged.

Also we have some concerns regarding the restriction on cash flow hedges of groups to only those where the cash flows are expected to affect profit and loss in the same reporting period. This is particularly significant for entities which are required to prepare interim financial statements.

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?

We believe that the principles of materiality should be applied in the first instance to determine whether or not this would need to be presented as a separate line item on the face of the income statement rather than in the notes.

However, we agree that whether this is disclosed on the face of the income statement or in the relevant note, the hedging instrument gains or losses mentioned should be presented in a separate line item rather than attributed across the line items to which they hedge.

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?

Westpac acknowledges the need for appropriate disclosure of its risk management strategy and hedging activities in order for appropriate interpretation of the financial statements. However, we have some concerns regarding the quantum of disclosure the exposure draft currently seems to require.

Firstly, paragraph 46 requires, for each subsequent period that hedge accounting is expected to affect profit and loss, certain quantitative disclosures. Westpac has some hedge accounting relationships that span up to 20 years. This would result in a significant amount of disclosure in addition to that already provided under IFRS 7 regarding financial instruments.

We propose that, similar to the requirements of IFRS 7, an entity uses its judgement to determine appropriate time bands for which to disclose this information, for example, an entity may use:

- Not later than one year
- Later than one year but not later than five years
- Later than five years but not later than ten years
- Later than 10 years

This would balance addressing the users' feedback for more information regarding the time horizon of hedge relationships with the quantum of disclosure in the financial statements. We note that this type of maturity analysis is specifically mentioned in an example provided on the IASB website in relation to these disclosures. However, the current terminology without further guidance either in the standard itself or the basis of conclusions may lead to an interpretation that this disclosure is required to be shown for each individual reporting period.

Secondly, and on a more general note, we are concerned that an entity that does not apply hedge accounting but which has similar risks is not required to disclose the same level of details regarding its risk management strategy.

We note that the Board considered this and has documented its views in the basis for conclusions. We understand that the view is that this would go beyond the scope of the hedge accounting project. However, we believe that the scope of the hedge accounting project specifically contemplates an entity's

documented risk management strategy and that on this basis it is appropriate for the Board to address disclosure requirements regardless of the hedge accounting strategy applied.

In particular, not requiring a comparable level of disclosure leads to difficulty for users in comparing and interpreting the financial statements of entities with similar risks but with different hedge accounting strategies.

We note that once the disclosure amendments are finalised that they will be incorporated into IFRS 7. We propose that the Board amend required disclosures such that similar risk management disclosures are required regardless of whether or not an entity applies hedge accounting.

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?

We have no objections to the proposal but note that this is not an issue likely to impact us.

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?

Westpac views on each of the three alternative accounting treatments are provided below:

- Alternative 1 – Westpac agrees with the Board's conclusion that only permitting an entity to designate a credit exposure on initial recognition to be measured at fair value through profit and loss is unlikely to align with an entity's risk management strategies and therefore is not likely to be effective in addressing the issue of accounting mismatches arising from hedging loans (or loan commitments) with credit derivatives.
- Alternative 2 – This alternative addresses the need to be able to designate a credit exposure to be measured at fair value through profit and loss after initial recognition to be able to align with an entity's risk management strategy and therefore, as suggested by BC236, provide more relevant and consistent information as it is flexible. However, it also creates volatility in the profit and loss by requiring any difference between the carrying value and the fair value at the point of designation to be taken to the profit and loss.
- Alternative 3 – This alternative suggests that same treatment as alternative 2 above but rather than take any difference between the carrying value and the fair value at the point of designation to the profit and loss, it is to be amortised or deferred.

Of the three alternatives proposed we believe alternative three best reflects the appropriate accounting and provides users with more useful and relevant information to users of the financial statements.

However, as noted in the staff agenda papers (particularly staff agenda paper 21B), both preparers and users have raised the hedging of credit risk with credit derivatives as a significant issue and weakness with the current IAS 39.

We believe that this review of hedge accounting should incorporate changes so as to address the significant issues identified during the outreach programs conducted by the Board. The scope of the hedge accounting project in terms of addressing these significant issues should be consistent with and

achieve the stated objective of hedge accounting; i.e. to represent in the financial statements the effect of an entity's risk management activities.

We do not see the issue regarding hedging of credit risk as any less significant than other issues which have been addressed. These include the time value of options, hedges of aggregate exposures and component hedging of non financial items. Therefore we do not believe that addressing the issues relating to the hedging of credit risk should be viewed as outside the scope of the current project. We believe that without addressing the issue of credit risk hedging the stated objective of hedge accounting is not met.

The proposed standard indicates in BC220 that financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item as a component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, it is operationally difficult to isolate and measure the changes in fair value that are attributable solely to credit risk for the purpose of hedge accounting.

While we acknowledge these difficulties, we note that the accounting standards currently require separate measurement of credit risk, for example:

- IFRS 7 provides guidelines to determining the portion of the fair value attributable to credit risk as either the "amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or by using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset. The resulting information is disclosed in the notes to the financial statements in relation to loans and receivables designated at fair value through profit and loss.
- IFRS 9 requires an entity to measure the portion of the fair value of a financial liability designated through profit and loss which relates to the entities own credit risk and present this separately in other comprehensive income.

It seems inconsistent to suggest that the above can be measured on a basis which is sufficiently reliable to appear in the financial statements and yet suggest that credit risk cannot be measured reliably in the context of hedge accounting. Where an entity can demonstrate a robust and reasonable approach for determining the credit risk we believe they should be able to applying hedge accounting.

We believe the determination of the credit spread component of a margin is akin in principle to determining the cracking spread referred to in the example provided in B15(b) of the exposure draft.

Westpac believes that the proposed requirements in the exposure draft to hedge a component which is separately identifiable and reliably measureable should be able to be applied to credit risk just as it is applied to other components (refer question 4). The hedge accounting standard should not either explicitly or implicitly prohibit an entity from hedging credit risk with a credit derivative if it can demonstrate that it has satisfied the requirements to hedge a component.

To this end, we are of the view that the commentary regarding the ability to achieve hedge accounting with credit derivatives that is currently in the basis of conclusions should be removed as it implies that an entity can never achieve hedge accounting of credit risk even in the case where an entity enters into a specifically tailored credit derivative.

Question 16

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

We believe that entities should be permitted a one-off election on transition to the new hedge accounting standard allowing them to revisit and restructure/redesignate, if applicable, current hedge accounting relationships.

For example, an entity may wish to redesignate a hedge relationship to better align it with the underlying risk management strategy or such that it results in a more effective hedge relationship under the revised standard. Paragraph 55 states that hedge relationships that qualified for hedge accounting under IAS 39 would be regarded as continuing hedge relationships under the new hedge accounting standard and therefore does not seem to allow this redesignation. However, allowing this on transition is akin to the principles of rebalancing proposed in the exposure draft. Therefore we seek clarity from the Board as to whether this would be permitted on transition.

Similarly, we note that if an economic hedge meets the criteria in the revised standard hedge accounting could be applied. However, as it is to be applied prospectively and therefore only designated from the transition date, it is likely that these hedge relationships would have significant ineffectiveness. Therefore, we again would support a one-off exception on transition to the new hedge accounting standard to permit entities to retrospectively apply the hedge accounting standard to such relationships.

We also note the operational burden of having to effectively administering hedge accounting under two different frameworks, one under the current IAS 39 requirements and the second under the proposed standard if it is only adopted prospectively. This is particularly onerous for organisations such as Westpac which have hedge accounting relationships spanning multiple decades.

Summary

In summary we believe the Board has made significant improvements to the hedge accounting standard in the exposure draft. We support the move towards a principles-based standard and the overall direction of the exposure draft.

However, we have some concerns regarding the proposals in the exposure draft including:

- Clarity of terminology such as “to represent in the financial statements the effect of an entity’s risk management activities” and “minimise expected ineffectiveness”;
- Restrictions on eligible hedged items or components including layers including subsidiary future profits, layers including prepayment options, eligible hedged items in groups and credit risk;
- Hypothetical derivatives used to test effectiveness for both cash flow and fair value hedge relationships;
- Presentation requirements relating to fair value hedges in recognising hedging gains or losses as a “separate line item” on the balance sheet;
- Unnecessarily voluminous disclosure requirements that may as a result lack transparency;
- Inflexible transition requirements;
- Rules based requirements regarding rebalancing, discontinuation and linked presentation; and
- Unnecessarily complex rules regarding the aligned time value of options and recording the effective and ineffective portions of fair value hedges.

We would like to thank the Board for the opportunity to provide our comments on this exposure draft and trust that these comments will prove useful.

If you have any questions related to these comments, please contact me at *rgoudie@westpac.com.au*.

Yours Sincerely

Ross Goudie
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Group Financial Control