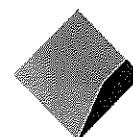


# **Commonwealth Bank**

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Michael Venter  
Deputy Chief Financial Officer

9 March 2011

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC 4M 6XH  
UNITED KINGDOM

Dear Sir David

## **Comments on Hedge Accounting ED/2010/13**

Thank you for the opportunity to comment on this Exposure Draft. The Commonwealth Bank of Australia (CBA) is one of the four major Australian banks with a market capitalisation of approximately \$80bn, annual revenue of \$42bn and over 784,000 shareholders. We have prepared financial statements under IFRS since 2005, having previously prepared financial statements under Australian GAAP (AGAAP) and US GAAP.

Our comments on the specific questions raised by the Board are addressed in the Appendix; however we have set out below our general thoughts on the Exposure Draft.

We strongly support the Board's efforts to improve the current hedge accounting requirements. The current requirements under IAS 39 are too restrictive and result in accounting outcomes that do not reflect the economic relationships established by an entity's risk management strategies. Many users of financial statements simply ignore what they term "accounting noise", usually created from income statement volatility arising from accounting mismatches.

Our main concerns are:

- That ineffectiveness is created as a result of the IFRS fair value hedge accounting model even when a hedged item and hedging instrument have matched terms and have been transacted one for one, this is expanded in question 4;
- We do not agree with the specific rules relating to hedging credit risk that have been added over and above the general principles in the Exposure draft;

- That the Exposure Draft does not permit the hedging of future profits (at least for 12 months into the future) from foreign operations despite this being part of many entities risk management strategies;
- We recommend that the IASB include an option for entities to elect to apply hedge accounting retrospectively on a relationship by relationship basis;
- The unnecessary length of new disclosures;
- Existing hedge accounting designation approaches have been developed by industry to comply with the existing standard and may not align with economic risk management strategies. Will these be allowed to continue?
- Whether the timing and content of the macro-hedging exposure draft, when it is, issued provide an alternative to existing strategies employed by Asset and Liability Management and allow parallel implementation with this part of the ED;
- Whether the risk management strategy to be considered for a Group's consolidated financial statements is the Group's strategy or, where a business unit has a narrower strategy, then that strategy. This issue also extends to situations where a consolidated entity (e.g. special-purpose entity) has a risk management strategy that is narrower than the Group's strategy;
- We do not agree that fair value hedging is precluded for the foreign currency risk arising from foreign-denominated equity securities that are carried at Fair Value through Other Comprehensive Income 'FVTOCI' under IFRS 9;
- We do not agree with including the time value of money when measuring ineffectiveness, if time value has been excluded from the designated hedged risk (e.g. hedging for changes in spot foreign currency risk only);
- We consider the two step approach to fair value hedges and the use of Other Comprehensive Income 'OCI' unnecessary as it gives rise to the same result as the current fair value hedging model with an extra step that creates additional operational risk.

Our response to matters on which specific comment is requested is included in the attached Appendix 1.

Please contact myself with any questions or comments.

Yours sincerely



Michael Venter

## Appendix 1 – Answers to questions in the ED

### Objective of hedge accounting (paragraphs 1 and BC11–BC16)

#### 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 proposed objective of hedge accounting being to convey the consequences of risk management activities in the financial results. We suggest that it could be expanded to convey the principle of removing accounting mismatches in the P&L due to different treatments of hedges and the underlying risks, because we consider that the economic purpose of hedging is to protect the financial results of an entity from volatility generated by asymmetric accounting.

We would raise fact that our and a number of other entities include hedging of revenue and profits generated in subsidiaries with functional currencies that are different to their parent's functional currency in their risk management strategy, however that the hedging standard does not allow hedging of the risk this exposure creates. We would ask that this be reconsidered.

In addition we would highlight that following the implementation of IAS 39 a number of entities and particularly financial institutions developed 'IFRS hedge accounting designation approaches' in addition to their pre-existing economic risk management strategies. The goal of the former was to achieve IFRS hedge accounting whereas the goal of the later was to manage economic exposure. By now trying to align IFRS hedge accounting designation approaches with economic risk management strategies, some approaches of hedge accounting that were adopted may be no longer qualify for hedge accounting. An example of this is where a financial institution manages its interest rate risk exposure by converting to floating rates economically whilst for hedge accounting hedging of other cash flows back to fixed. We would ask that such hedge accounting strategies continue to be considered appropriate under the new standard on the basis that the hedging instruments have been entered into for risk management purposes and so are 'hedging' rather than 'trading' in nature.

We don't agree that fair value hedging is precluded for the foreign currency risk arising from investments in foreign-denominated equity securities that are carried at FVTOCI under IFRS 9. The basis for the Board's decision pre-empts any public due process on the use of OCI conceptually – we highly recommend that the Board addresses the use of OCI conceptually rather than continue making decisions on the basis that this will be addressed at a later stage.

We ask for clarification of whether the risk management strategy to be considered for a Group's consolidated financial statements is the Group's strategy or, where a business unit has a narrower risk strategy, then that strategy. This issue also extends to situations where a consolidated entity (e.g. special-purpose entity) has a risk management strategy that is narrower than the Group's strategy.

**Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47)**

**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?

We agree that non-derivative or natural hedges should be eligible hedging instruments. We agree that if the risk management strategy makes use of non-derivative instruments, then hedge accounting should be permitted.

**Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)**

**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 agree that derivatives should qualify for designation as hedged items, and support the move to increase the flexibility in what may qualify as a hedged item and hedging instrument. Risk management policy contemplates the hedging of synthetic instruments.

For example we consider that when managing risk an entity will aggregate risks by type across a range of financial instruments rather than hedge instruments individually. For example, a bank will aggregate all market risk across different asset classes. This will include any derivative positions.

We would point out though that in order to create a combined derivative and underlying 'synthetic' hedged item it appears an entity will need to hedge account for the relationship between the components of the synthetic item. This will create further documentation and administrative efforts around what is already a very resource intensive process. We would support a level of assumed effectiveness being allowed for the creation of synthetic hedged items that are to be part of hedge accounting relationships.

We question whether the examples provided in paragraph B9 were intentionally requiring that the duration of the derivative included in the combined exposure be the same as the duration of the combined exposure. If this was intentional then we consider the rules of combining ought to explicitly require this.

**Designation of risk components as hedged items (paragraphs 18, B13–B18 and BC52–BC60)**

**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 change in hedge accounting to applying it to risk components as that is the method used in our risk management strategy.

However we would ask that risk components created as a result of IFRS hedge accounting rather than an entity's risk management strategy is deemed not to create ineffectiveness when a hedged item and hedging instrument have matched terms and have been transacted 1 for 1.

For example in a hedge of foreign currency debt if all cash flows are perfectly matched so the foreign currency debt cash flows are hedged all the way back to functional currency then we should see minimal functional currency ineffectiveness.

However currently when valuing the swap we have to take into consideration the basis curve which represents the premium or discount required by the swap counterparty to enter into a cross-currency swap. The basis curve is excluded when valuing the debt and this asymmetric treatment can result in large amounts of volatility despite the underlying foreign currency being perfectly hedged.

Although it is possible to adopt a split designation methodology which achieves hedge effectiveness by splitting the hedging instrument into two notional instruments and designating one as a fair value hedge of currency and interest rate risk and the other as a hedge of the debt issue credit margin, this does not address the underlying issue of risk components being created as a result of accounting rules.

We would further point out that should the foreign currency debt be hedged with a series of forwards, the basis included in the forward points would not create ineffectiveness if placed in a fair value hedge relationship and so we would ask that cross currency swaps be extended the same treatment.

**Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)**

**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?

Yes. We agree with this proposal as this will allow alignment of financial reporting to 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?

No. We do not agree with this proposal as it is not aligned with risk management. Financial institutions often fair value hedge interest rate risk on loans that are prepayable at par or another fixed amount. Prepayment risk would be considered in devising the risk management strategy. It is not clear to us why a fixed amount prepayment option disqualifies the hedged item from a layer component designation while the exposure is still eligible for interest rate fair value hedging in its entirety. In either scenario, the fixed amount prepayment option changes in value in response to the hedged risk. If the hedging strategy does not mirror the optionality of the hedged item, 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.

**Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75–BC90)**

**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 agree that the qualification should be based more on risk management objectives and that the current 80-125 rule should be removed.

We consider that principles should be sufficient to apply hedge accounting. We would reiterate our comments from question 3 that an assumed level of effectiveness for synthetic hedged items would reduce the level of additional resourcing that will be required to establish/calculate hedge effectiveness for IFRS purposes.

We don't agree with including the time value of money when measuring ineffectiveness, if time value has been excluded from the designated hedged risk (e.g. hedging for changes in spot foreign currency risk only).

#### **Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)**

##### **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?

We agree with the concept of rebalancing. However we consider that a better articulation of the principle for when a hedge relationship should be rebalanced would be when the risk management strategy requires it. For some hedges, such as 1:1 derivative hedges, the underlying instrument would be adjusted and fair value changes would continue to be deferred in equity, but for some relationships, such as the use of an existing balance sheet position (or capacity) there is a need for management to have the option to change the hedge relationship.

We would like to seek clarification on the rebalancing if it is intended that when some hedging instruments relating to a larger aggregate exposure are terminated (or closed out by entering offsetting derivatives) to rebalance the relationship, these instruments should be accounted for as the rebalancing or whether they should be de-designated.

For example if a financial institution is managing USD floating rate assets with USD/AUD cross currency swaps and the USD floating rate assets prepay (or more USD floating rate liabilities arise) we would anticipate that the swaps will be de-designated as part of the rebalancing process.

## **Discontinuing hedge accounting (paragraphs 24, B61–B66 and BC112–BC118)**

### **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 agree that an entity should be permitted to discontinue hedge accounting when this is consistent with an entity's risk management policies.

To elaborate further on the example given in question 7 currently for cash flow hedges a pool approach is used, which means that existing derivatives are designated as hedges of underlying instruments in the pool. When the pool decreases the need for the cash flow hedges decreases and some instruments in the pool are de-designated. Under the ED these would not be allowed to be de-designated even though the underlying risk has decreased. We propose that if the risk management strategy is to net the two groups of instruments this would result in a rebalancing, which is effectively the same as de-designating under the current requirements.

We would further point out that hedge accounting is an option provided under the accounting standards and the idea that this option is irrevocable once taken despite de-designation being part of an entity's risk management strategy appears at odds with the spirit of the standard.

## **Accounting for fair value hedges (paragraphs 26–28 and BC119–BC129)**

### **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?



We agree that the ineffective portion of the results of the hedging activities should be reported in P&L; however we disagree that with the requirements to report the gross movements in OCI. We consider that the ineffectiveness can be reported directly in P&L and that any necessary explanations can be made in the notes.

We do not agree that it is necessary to show the gain or loss of the hedged item attributable to the hedged risk as separate line item in the statement of financial position. We consider it adequate to report the balances in the statement of financial position as currently presented and split such components out in the notes if at all as we consider including such additional line items in the statement of financial position would distract rather than assist users.

We agree that linked presentation should not be required i.e. the derivative balance below the underlying item, as for a financial institution where multiple items on the statement of financial position are hedged it would distract rather than assist users. As the principles of the statement of financial position are determined outside of this ED, we consider that this ED should focus on how best to explain an entity's hedging activities in the notes. The notes should give a clear understanding of how the effective portion of a hedge has altered the underlying risk.

**Accounting for the time value of options for cash flow and fair value hedges paragraphs 33, B67–B69 and BC143–BC155)**

**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 agree that for transaction related items the time value should be deferred in equity until the transaction occurs, in line with the general principles of hedge accounting. In many cases the hedge accounting has skewed risk management practice towards the use of non-option derivatives (such as forward contracts or swaps) rather than option-type derivatives, as the time value of an option is separately treated like a trading derivative which gives rise to volatility in P&L.

We also agree that if the time value relates to an existing balance sheet exposure then the premium should be transferred to P&L on a rational basis, and consider that in many

circumstances a straight line amortisation would be acceptable. The mark-to-market movements would be deferred in equity until the hedge was unwound or exercised.

We agree that where terms are not matched, a portion of the option value would not qualify for hedge accounting under the principles outlined in the ED more generally and that the 'aligned time value' concept is consistent with the requirements prohibiting over-hedging. We however note that where it is part of an entity's risk management strategy to use exchange traded options as hedges, and the terms do not match exactly, it is better in principle to treat all mark-to-market movements as part of the hedging relationship. Consequently we propose that the aligned time value rules be relaxed where an entity cannot lose more than the option premium paid.

**Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)**

**Eligibility of a group of items as the hedged item (paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)**

**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 agree with the group hedging approach if it is the risk management strategy of the entity.

We would also like to note that dynamic hedges (or macro hedges) may be a natural extension of this model with the requirements around impacting P&L in the same period being removed as this rule currently restricts the groups of items that can be hedged considerably. We expect this will be covered in more detail in a separate ED but would propose that the mark-to-market movements relating to these strategies be deferred in equity and released on a systematic basis to P&L in line with the life of the underlying items.

**Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)**

**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?

Banks currently report 'Net Interest Income' which includes the line items 'Interest Income' and 'Interest Expense'. Where a net hedge is entered into the ED proposes that a third line for all hedging activities is reported. We consider that this does not reflect the nature of the business. Furthermore we consider this requirement will create volatility within line items of the income statement and confusion for users.

In addition to the above we would like to request that interest flows from hedges entered into as part of an entity's risk management strategy be presented net with the impact of the hedged item on the income statement. Specifically financial institutions that enter into economic hedges can be required to split out interest flows from net interest income if they do not currently qualify for IFRS hedge accounting despite being entered into as part of the Group's risk management strategy and included in the Group's internal measurement of net interest income.

**Disclosures (paragraphs 40–52 and BC183–BC208)**

**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?

We agree with the objectives of the disclosures but consider that the requirements should be principles based and left to the directors to implement. We consider that the disclosure requirements as drafted are onerous and would result in many more pages of notes to the accounts.

We would also like to highlight the discrepancy between entities that do not apply hedge accounting and those that do, in that the latter will need to make disclosures about their hedged positions and risks that are hedged while the former will not. It is the entity that does not apply hedge accounting that arguably has more unhedged risk positions worth disclosing.

We consider that the appropriate principle is to disclose the nature of the hedges that are hedge accounted, and that disclosure of the risk management strategy or unhedged risks is outside the scope of this ED.

We would also like to clarify how auditing referenced documents will work in practice.

**Accounting alternatives to hedge accounting (paragraphs BC208–BC246)**

**Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)**

**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 agree with the proposal and emphasise that derivative accounting should only apply if it is in line with an entity's risk management strategy. However, we disagree with the net exposure to be maintained close to nil, since most trading businesses would keep a net residual exposure.

#### **Accounting for credit risk using credit derivatives (paragraphs BC219–BC246)**

##### **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 disagree that the alternate accounting treatments are unnecessarily complex as the underlying transactions are by their nature complex. Entities also have the option of not using hedge accounting if it is too difficult.

We consider that the general principles of hedge accounting should be enough to account for any hedge. Credit derivatives pose some practical problems for hedge accounting but these are not insurmountable. We would assert that the standard allow hedge accounting if the principles set out are met rather than isolate credit risk as we consider credit risk measurable and indeed able to be hedged as part of an entity's risk management strategy.

Specifically we consider that if the underlying credit risk of a counterparty is separately identifiable and reliably measurable then it should qualify as a hedged item. Banks have sophisticated models for pricing credit risk and as a result this risk component should qualify for hedge accounting in the same way a refining spread might qualify. In addition the valuation of own credit is required elsewhere in IFRS 9 as well as other entities credit in IFRS 7 and therefore it should be possible to value other entities' credit.

#### **Effective date and transition (paragraphs 53–55 and BC247–BC254)**

##### **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 the hedge accounting changes should be prospective, with a one-off designation exercise that permits hedge relationships be retrospectively designated on a relationship by relationship basis.

We propose that any hedges that qualify for hedge accounting under the current standard should be granted a once-off grandfathering option to continue as before.

We propose that hedge accounting for relationships that did not qualify under IAS 39 should be granted early adoption where they qualify due to an expansion of the scope of the standard (for example the time value of options) without the requirement to early adopt the entire IFRS 9 standard. This could be done through the annual improvements project.

We believe that given the extensive changes required for reporting and systems upgrades, a minimum period of 3 years should be allowed before compulsory adoption of the standard is required. Those wishing to adopt earlier have the option. This is also requested in light of the fact that the ED on macro hedging, arguably one of the more complex areas of the standard, has yet to be released.

We would like to request the option given in IFRS 1 that on adoption no comparative disclosures are required.