

List of Submissions to IASB Draft Standard *General Hedge Accounting*

- 2 Visual Risk
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6th December 2012

International Accounting Standards Board
 30 Cannon St
 London EC4M 6XH

Re: IFRS 9, Chapter 6, Hedge Accounting Review Draft

We welcome the opportunity to comment on the Draft Standard. Visual Risk is a leading vendor of hedge accounting, treasury management and risk management software. Our client base covers both financial institutions and corporates spanning a broad range of industries in several countries. The majority of our clients are active derivatives users, rendering us well qualified to comment on this Draft.

Visual Risk believes that the new approach to using the hypothetical derivative in hedge accounting as currently detailed in paragraph B6.5.5 of the Draft and as described in the Staff Paper published in September 2010, is invalid. In the Draft, the treatment of different sources of ineffectiveness is inconsistent, specifically currency basis rates, time value of options and credit risk. However, in our opinion, credit risk is a special case which should be treated differently.

When using the hypothetical derivative to determine hedge effectiveness, it is not correct to state that “the hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change [in the fair value of the cash flows of the hedged item] was determined by a different approach”.

By its very nature, a derivative hedging instrument that is designated in a cash flow hedge relationship is composed of variable cash flows which offset the hedged item and fixed cash flows whose fair value will initially offset the fair value of the variable cash flows. For an entity which is hedging, this achieves a reduction in the variability of future cash flows that affect the income statement.

When an entity calculates hedge effectiveness by determining the change in fair value of the variable cash flows of the hedged item and of the hedging instrument and these offset exactly, then clearly there will be no offset for any change in fair value of the fixed cash flows of the hedging instrument. This will result in ineffectiveness. For example, the fair value of future interest flows of floating rate debt based on LIBOR will exactly offset the fair value of future interest flows on the floating leg of a matching LIBOR swap. However any change in value of the fixed flows will not have an offset and will flow through P&L. This situation is clearly not sensible when the true economic outcome is reduced cash flow variability.

The IASB Staff paper circumvented this problem by “calibrating a fixed bond” to determine the change in the fair value of the cash flows of the hedged item. This resulted in a comparison of fixed interest flows from the calibrated “fixed bond” for the hedged item with fixed interest rate flows of an interest rate swap leading to a perfectly effective hedge. However, this method does not make sense for a number of reasons:

- The cash flows of the underlying debt are variable so any change in value of the cash flows should refer to future variable interest cash flows rather than fixed interest cash flows.
- This method will lead to the value of the floating rate set on the interest rate swap being ineffective and potentially affecting P&L. If the floating rate set of the swap exactly matches the floating rate set of the debt, then this outcome would be illogical.
- This method could actually hide ineffectiveness which is present in the economics of the hedge. For example, consider a case where the underlying floating interest rate flows of debt were based on six month LIBOR, but the interest rate swap was paying three month LIBOR floating and receiving fixed semi-annually. The method of the staff paper would lead to a comparison of fixed semi-annual flows leading to a fully effective hedge, whereas there is economic ineffectiveness and potential variability in cash flows that will affect P&L.
- It is unclear how this method would apply to other hedge relationships. For example if the hedge was a cross currency swap converting fixed foreign currency debt into functional currency debt, would the calibrated instrument then be based on fixed functional currency debt?

As others have pointed out, when an effective economic hedge results in no variability of cash flows, then it is logical that there should be no ineffectiveness in P&L. To put it another way, if the objective of hedge accounting is to represent “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” then if the effect of a hedge is to eliminate P&L volatility there should be no volatility in P&L. In our opinion, the only approach that will achieve this outcome is to compare the change in fair value of the hedging instrument with the hypothetical derivative to determine ineffectiveness.



However, we also understand that there are many examples where the hedge is economically effective but the economic value of the combination of the hedged item and hedged instrument can change. The Standard does address some of these examples, albeit in an inconsistent manner as will be shown by considering the three issues below:

Time value of options: This is now allowed to be amortised with any change in time value taken to the hedge reserve. This is because “entities typically consider the time value of an option (at inception, i.e. included in the premium paid) as a cost of hedging” and an accounting treatment which required a change in time value to affect P&L would be “disconnected from the risk management view”.

This seems sensible to us, but we would note that the value of an option can change significantly due to volatility as well as spot movements. So the economic value of an entity can change without this change being reflected in P&L.

Currency basis: The draft standard is quite clear in B6.5.5 that the change in value of a cross currency swap due to currency basis needs to be taken to the income statement. We think this is completely inconsistent with the treatment of time value. Currency basis is also considered to be “a cost of hedging” foreign debt back into domestic debt and thus taking this change in value to P&L is also “disconnected from the risk management view”. For this reason, any change in value of the hedging instrument due to movements in currency basis should be posted to the cash flow hedge reserve.

We agree with the Swedish Banker’s Association who stated in their submissionⁱ that debt investors will include “a basis risk element in the pricing of debt instruments when there are reference debt instruments traded in other markets”.

Credit risk: In the September 2010 paper, the IASB Staff noted that the approach suggested in the FASB Accounting Standard Update for ASC 825 and ASC 815 would allow entities to “ignore ineffectiveness caused by the changes in the credit quality of the hedging instrument”.

We agree that this is a valid concern. We think this is a different issue to the previous two issues because while the cash flows are still fixed, the present value of these cash flows will have changed for reasons other than considering the time value of money. In this case, the fair value may also have changed because the likelihood of receiving these cash flows has changed.

We would make the following qualifications:

- It is difficult to adjust the value of derivatives for creditworthiness. Each future cash flow may need to be discounted at a different rate. There is a question as to whether credit spreads that are derived from debt instruments are applicable for derivatives. Also potential credit exposure may have to be considered as detailed in IFRS 13 and the calculation of this can be very complex.
- If credit spreads are used, then this will lead to frequent ineffectiveness because these numbers vary with market movements. However, it could be argued that small movements in credit spreads reflect supply and demand and changes in investor risk preferences rather than any change in the creditworthiness of a counterparty. Note that we believe this argument is also applicable for currency basis swaps.
- For derivatives, a small move in credit spreads will lead to a very small move in the valuation adjustment for credit. For example if a foreign exchange derivative with one year to maturity has a value of five per cent of notional and the applicable spread moves by 20 basis points, this will lead to a change in value of 0.01% of the notional of the hedge. As this would generally be true for derivatives with stable investment grade counterparties, it could be argued that these value movements could be ignored unless there was significant improvement or deterioration in the credit quality of a counterparty to a derivative. Long dated cross currency swaps would be an exception to this.

In summary, Visual Risk believes it is correct to compare the hedging instrument with the hypothetical derivative to determine ineffectiveness in cash flow hedge relationships as it is consistent with the risk management principle that there should be no income volatility when there is no underlying cash flow volatility. Finally, we think it is correct that changes in fair value due to changes in credit should affect P&L, but we think this effect will generally be relatively small and, given the complexity in its calculation, should be monitored and approximated rather than calculated exactly.

Yours sincerely

Paul Nailand
Managing Director

ⁱ Swedish Bankers Association, Position Paper: IASB: Draft Standard IFRS 9, Chapter 6, Hedge Accounting, 16 October 2012

Finance and Treasury Association

ABN 70 006 509 655



Tuesday 11th December 2012

Mr Hans Hoogervorst
Chairman
The International Accounting Standards Board (IASB)
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM
(Via email to hhoogervorst@ifrs.org)

cc Mr Kevin Stevenson
Chairman and CEO of the Australian Accounting Standards Board
(Via email to kstevenson@aasb.gov.au)

Dear Mr Hoogervorst,

IFRS 9 – Draft of Chapter 6, Hedge Accounting

The Finance and Treasury Association (FTA) is the peak professional body in Australia for corporate treasurers and senior financial risk managers, with around 900 members primarily from Australasia's largest 300 companies.

As previously communicated to the Board, the FTA strongly supports the project to improve financial reporting for hedging activities. In this regard, subject to the comments that follow, we commend the Board on the conclusions reached to date as published in the draft of the proposed hedge accounting requirements. We believe that the proposals will significantly enhance the usefulness of reporting of hedging activities to financial statement users. We also believe, for the most part, the requirements of the standard, application guidance and implementation guidance provide a model for reporting hedging activities that will enable preparers to meet the hedge accounting objective outlined in Paragraph 6.1.1. The approach will convey the context of hedging activities to users in a manner that will assist them to obtain insight into their purpose and effect.

The one significant concern that the FTA holds in relation to the proposals is in relation to the treatment of currency basis risk as outlined in B6.5.5 of the application guidance. We believe this specific aspect will force preparers to report certain hedging activities in a manner that will

fail to meet the hedge accounting objective. We have further concerns that this specific requirement gives rise to a technical inconsistency that will result in uncertainty as to the correct application of the standard. Finally, we hold somewhat grave concerns that this element of the proposals will have a substantive negative impact on the efficient flow of funding in the global capital markets.

The hedge accounting objective

The companies represented by our members enter into cross currency interest rate swaps (CCIRS) in conjunction with the issuances of foreign currency debt into the global capital markets. This is done with one overriding objective of securing a sufficient quantity, diversity and tenor of funding to enable the company to meet its business objectives, while protecting the strength of the balance sheet and therefore the interests of all stakeholders, including investors and lenders. With this in mind, the choice of whether to issue in domestic currency, or in foreign currency and hedge is based primarily on a comparison of the net cost of funds of a foreign currency issuance, inclusive of all hedge costs, against the domestic borrowing rate. These transactions are typically done by contracting to receive under the CCIRS a stream of cash flows that exactly match the cash flow obligation under the foreign currency debt, and committing to pay domestic currency cash flows at the current prevailing fixed or floating market rate.

As a consequence, it is our view that the only measurement outcome that achieves the hedge accounting objective for this set of circumstances is the one which reflects the net cash flows in the income statement each period. In other words, an approach which avoids reporting ineffectiveness each period and presents to users a measurement outcome that is consistent with the purpose and effect of the hedge.

Technical inconsistencies of the basis risk treatment

Our concerns as to the technical accounting validity of the requirement proposed in B6.5.5 stem from the difficulty we have in identifying the principle that is being reflected, and the inconsistency between the treatment of currency basis risk in CCIRS and similar elements of other instruments.

We understand that B6.5.5 is attempting to explain that the calculation of the fair value of the hedged item cannot include elements that are not already present in the hedged item. However if the hedged risk is foreign currency risk, and the hedged item is calculated based on forward rates (rather than spot), the currency basis spread is included within the forward rate.

Therefore we believe it would be acceptable to calculate the “hypothetical derivative” based on forward rates observed in the market therefore including currency basis spreads.

The forward premium in single currency interest rate swaps, and the forward points in foreign exchange forward contracts are two examples of similar pricing mechanisms in other derivatives that as far as we can tell, would not give rise to ineffectiveness in equivalent circumstances. For example, a hedge of the FX risk of a forecast sale or purchases transaction with a forward contract would not normally give rise to ineffectiveness if all of the terms match and if assessment and measurement is based on forward rates. Each of these pricing mechanisms is factored into the pricing decision made by market participants when issuing domestic floating rate debt, or buying widgets from overseas. In the same manner, the currency basis spread in CCIRS will be considered by all debt investors for the bonds in question. This will occur directly for those planning to hedge those bonds, and indirectly for those who are not, but who will be mindful of the pricing considerations of other market participants.

Our concern is these inconsistencies between the treatment of the different instruments mentioned may give rise to structuring by market participants to avoid the outcome of CCIRS. In this regard, we note that any CCIRS or currency basis swap, be it fixed to fixed, fixed to floating, floating to floating or floating to fixed, could be replaced by a combination of single currency interest rate swaps and foreign exchange forward contracts, for the exact same cash flow outcome, but potentially a different accounting result.

The efficiency of global capital markets

Experienced treasury professionals are ever mindful of the critical importance of maintaining a diverse range of funding sources and ensuring such funding is for a sufficiently long term to provide financial stability. This point tends to be particularly at the forefront of the minds of Australian treasurers, given that the Australian economy is a significant net borrower, and both banks and corporates rely heavily on wholesale funding markets to support the local economy.

One of the more beneficial outcomes of the Global Financial Crisis is that company boards and treasurers are more mindful of this point than perhaps they may have been in the past. Despite this, the reality is currency basis risk can give rise to material amounts of income statement volatility, which has a real and detrimental impact on the cost of capital for companies. To the extent that that volatility stems from a true economic risk exposure, we would argue that this is as it should be.

Indeed, such reporting highlights the advancement IAS 39 has achieved in financial reporting relative to the measurement approaches that preceded it. By contrast however, where prudent

funding and hedging strategies that perfectly hedge the risk exposure give rise to this volatility and detrimental impact on cost of capital, the consequence of the measurement approach is clearly detrimental. The potential cost of capital implications will undoubtedly result in some companies choosing not to diversify funding sources and instead rely on local bank funding.

As an association of treasury risk management professionals, FTA believes that such an outcome at a time of great uncertainty in the global financial markets, and regulation increasingly constraining the balance sheet capacity of the banks, would be most unfortunate indeed.

Yours sincerely

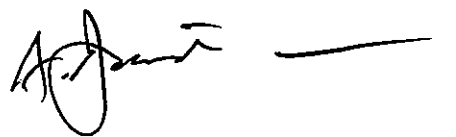
Yours sincerely,



Paul Travers FFTP

President

Finance and Treasury Association



David Michell CFTP (Snr)

CEO

Finance and Treasury Association

About FTA

The Finance & Treasury Association (FTA) is the Australian professional association for executives working across all aspects of treasury and financial risk management. The FTA provides training and skills development and access to current information, facilitates networking and builds a community in this specialised area of business. It seeks to increase recognition of the skills of members and to convey the views of members on key technical issues facing the profession to government, other associations and the wider community.