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17 February 2011

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Victoria 8007
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Dear Sir,

Re: Exposure Draft 208 Hedge Accounting

QBE Insurance Group Limited (QBE) is an Australian-based public company listed on the Australian Securities Exchange. QBE is Australia's largest international insurance and reinsurance company with operations in 49 countries. We are also one of the top 25 global insurers and reinsurers as measured by net earned premium.

QBE fully supports the AASB and IASB in their aim to clarify, simplify and improve the consistency of the application of hedge accounting. We welcome the opportunity to comment on the exposure draft issued.

Most of our operational hedging activities involve assets and liabilities that are valued at fair value and therefore derivatives used for hedging are not required to be accounted for as hedges. However, we have substantial foreign currency exposures through holding net investments in foreign operations and through our funding activities where we may seek to apply hedge accounting. Our replies are reflective of our experience of hedge accounting in these areas.

Overall, we support the recommendations set out in this exposure draft which result in hedge accounting better reflecting the economic realities of the hedging process. We are concerned that there are some deficiencies that need to be addressed in order to ensure consistency of outcome across entities. We draw your attention to the areas set out below where we believe that recommendations in the draft standard require your further review before the standard can be considered to be workable in practice.

The proposed standard removes the ability to revoke a hedge relationship. We consider that the introduction of the concept of rebalancing in the proposed standard will remove most of the situations where a hedge relationship will need to be revoked. We note, however, that there are situations when it may still be necessary to revoke a hedge relationship, for example where an entity is managing a number of different and potentially competing risks such as solvency, liquidity and profit volatility.

We agree with the proposed changes to the treatment of the time value of options, which will be treated as a cost of the transaction and amortised to profit and loss. We are concerned, however, that this will introduce inconsistency with the treatment of the time value of other instruments used in hedging such as forward foreign exchange contracts where the time value may also be considered a cost of the transaction but would not be amortised to profit and loss and would continue to introduce the full extent of fair value volatility into profit and loss. Refer to our example in response to IASB question 10. We encourage the Board to further consider extending this change to encompass the time value of other similar hedging instruments.

As noted in our comments on previous exposure drafts, we are concerned that there are remaining differences between the approaches being advocated by the IASB and FASB. This is likely to result in inconsistencies in practice. We would prefer to see convergence of approach before this exposure draft is issued as a standard. The US market is a significant source of funding for companies

worldwide and there may be major commercial consequences as a result of adopting different accounting treatments under IASB and FASB.

Yours sincerely,

Neil Drabsch
Chief Financial Officer

EXPOSURE DRAFT - Hedge accounting
IASB specific questions

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?

Response: The focus of the objective is on "management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss." Given the requirements to disclose both profit and loss and other comprehensive income (OCI) in the primary financial statements it seems unnecessarily restrictive to only consider hedging of items impacting profit and loss. Possible circumstances exist where an entity may manage items reported in OCI as follows:

- *A strategic investment which is revalued through OCI may be hedged for foreign exchange risk using a forward foreign exchange contract – hedge accounting could not be achieved under this stated objective and the proposed standard.*
- *Entities which use hedge accounting to manage their exposure to net investments in foreign operations may present the results of their hedging through OCI until the net investment is sold – which could be a substantial period of time, if ever. Whilst we agree that the amounts hedged do ultimately impact profit and loss, if and when, the net investment is sold, the management activities are managing exposures which are in OCI for potentially long periods which does not align with the stated objective of the proposed standard and which could therefore cause confusion to users.*

In relation to the points above it is also worth noting that under the proposed standard an entity may achieve hedge accounting for foreign exchange risk exposure for a foreign currency borrowing as a hedge of a net investment in foreign operations (where revaluation of the net investment is reported in OCI) but it appears that you could not achieve hedge accounting for foreign currency risk for a foreign currency borrowing as a hedge of a strategic foreign equity investment which is valued at fair value but with movements reported in OCI.

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?

Response: Agree.

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?

Response: Agree as will avoid unnecessary complexity required to split transactions into component parts to facilitate hedge accounting.

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 (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

Response: Agree, as such an approach will improve consistency of hedging.

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?

Response: No comment.

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?

Response: Agree with wording proposed and particularly the removal of the bright line test.

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?

Response:
(a) Agree with the proposed approach as it better reflects hedging in practice where underlying hedged items may vary over time. It reduces the need to revoke and redesignate hedges.
(b) Agree with proposed approach.

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?

Response: The proposed ED removes the ability to revoke a hedge relationship. Whilst many of the circumstances when revocation may have been used can now be replaced with rebalancing there may still be circumstances where revocation is still deemed necessary for example:

1. Consider a foreign currency borrowing valued at amortised cost which is initially not in a hedging relationship. The borrowing exposes the entity to foreign exchange risk requiring purchase of derivatives with associated increase in liquidity risk.
2. In order to reduce liquidity risk associated with purchase of foreign exchange derivatives an entity may decided to designate the borrowings as a hedge of the foreign exchange risk associated with holding net investments in foreign operations. Whilst this approach reduces liquidity risk it increases solvency risk.
3. An entity needs to constantly monitor the many variety of risks including foreign exchange risk, liquidity risk and solvency risk. In the example above both scenarios protect the entity from foreign exchange risk but require proactive management of liquidity risk and solvency risk. It is quite reasonable to consider a scenario where the level of solvency risk exceeds internal tolerance levels and the designation of the hedge needs to be revoked and the situation in 1. above reinstated.

This type of scenario is realistic and would require the ability to revoke hedges for good management practice within an approved risk management strategy. Such a voluntary revocation of the hedge relationship would not be arbitrary and unjustifiable as suggested in BC117.

Under the proposed standard a possible alternative may be to include the triggers for discontinuation in the designation documentation by reference to the risk strategy. Funding transactions may extend over considerable time periods and this would need to be sufficiently flexible to allow for the management of different and competing risks.

We therefore recommend that the ability to revoke a hedge relationship be maintained.

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:
(a) Agree as improves consistency with treatment of cash flow and net investment hedges.
(b) Agree as maintains clarity especially when the adjustment reflects only one risk component.
(c) Agree with proposal as linked presentation could cause confusion in relation to non-hedged components.

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 (eg 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 (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Response: We agree with the proposed treatment for the time value of options but consider this approach leads to inconsistency with treatment of other instruments with time value.

For example a net investment in a foreign operation may be hedged using forward foreign exchange contracts which have a time value (forward points) and intrinsic value (changes in spot foreign exchange rates). The foreign operation is revalued to presentation currency according to IAS 2/AASB 121 using spot foreign exchange rates. Under the existing standard in order to achieve effective hedging you may exclude the forward points from the hedge relationship – with only the spot components being reported in OCI and associated translation reserve until sale of the foreign operation. The forward points are reported in profit and loss and, being valued at fair value, can be subject to significant volatility even though management's intention and past practice may demonstrate that such instruments are held until maturity and then replaced.

Whilst it is still be possible to establish hedging relationships under the proposed standard for the scenario above we are concerned with the inconsistency of treatment in the profit and loss between the time value of options and other derivatives which also have a time value. Fair value volatility for the time value of options is removed from profit and loss but not for foreign exchange forward contracts and potentially other instruments. Similar to the argument for the proposed treatment of the time value of options, forward points of a forward foreign exchange contract may be considered an interest cost (or in some cases income) which is determined at the outset of the contract and would be better reflected by amortising to profit and loss.

Whilst forward point volatility may be reduced by maturing contracts prior to reporting dates this is an example of the requirements of the current standard driving timing of business decisions – not a desirable outcome.

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?

Response: Agree with approach proposed.

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 (eg 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?

Response: No comment.

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?

Response: In general we only support increased disclosures where this presents more meaningful information for users of the financial statements. There is a risk that the increased disclosure proposed places too much emphasis on hedging where it is not core to an entity's operations. This may lead to more and not less confusion for users.

The disclosures also place more emphasis on management of risks which require hedge accounting whereas many or more risks may be actively hedged but do not require hedge accounting.

We consider there is sufficient information in current disclosure requirements combined with the requirements of IFRS 7.

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?

Response: No comment.

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?

Response: No comment.

Question 16
Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

Response: Agree.

EXPOSURE DRAFT - Hedge accounting
AASB specific matters for comment

The AASB would particularly value comments on the following:

1. whether, overall, the proposals would result in financial statements that would be useful to users;

There is a risk that the current proposals add costly additional disclosure requirements which may be necessary for some entities where hedging is a major part of their operations but could cause confusion in other financial statements by placing unnecessary focus on a relatively minor area.

In addition the increased hedge accounting disclosures may place inappropriate significance on hedge accounting without taking into account the potentially significant hedging which may occur for which hedge accounting is not required.

2. whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
(a) not-for-profit entities; and
(b) public sector entities;

No comment.

3. whether there are any implications for GAAP/GFS harmonisation;

No comment.

4. whether the proposals are in the best interests of the Australian and New Zealand economies; and

Global consistency in hedge accounting is most likely to be in the best interests of the Australian and New Zealand economies and therefore convergence of FABS and IASB views are considered a key area.

5. unless already provided in response to specific matters for comment 1 – 4 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

In general preparers of financial statements will be able to more easily reflect in their accounting treatment the economic realities of their hedging transactions. Subject to some areas of concern raised in our IASB responses we consider that the proposed standard represents an improvement on the currency position. We do note that there may be considerable cost and undue emphasis placed on hedge accounting under new disclosure requirements.