



21 November 2012

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst,

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

Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange. Our operations are predominately based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of US\$5.9 billion and total assets of US\$672 billion.

We have reviewed the recently released hedge accounting review draft (Review Draft) and support the majority of the proposals believing that this should enhance the quality of financial reporting and the ability of entity to align hedge accounting with its economic hedging activities. We encourage the Board to complete the macro hedging component as soon as possible.

We do however wish to bring to the Board's attention the inconsistencies and potential adverse consequences of the proposed treatment of cross currency basis when measuring ineffectiveness in hedge relationships where a cross currency interest rate swap (CCIRS) is designated as the hedging instrument. In particular, we question the Review Draft conclusion that cross currency basis must be excluded from the hypothetical derivative when measuring hedge ineffectiveness and be treated as ineffectiveness through the income statement¹. As a consequence, where an entity utilises a CCIRS as a hedging instrument, it will be exposed to hedge ineffectiveness and related earnings volatility arising from shifts in the cross currency basis spread. Based on the recent past, cross currency basis spreads have the potential to create significant earnings volatility.

Our organisation makes extensive use of economic hedging to manage risks and wherever possible we employ hedge accounting to align our accounting with our risk management strategies. We frequently seek funding from sources other than Australian dollar (ANZ's functional currency) because many debt investors are located offshore. To effectively and efficiently hedge this foreign currency funding exposure we use CCIRS. The cross currency basis inherent in the CCIRS is akin to the cost of hedging with CCIRSs in the same way that option premiums or forward points are a cost of taking out options and forwards respectively.

¹ Section B6.5.5 of the Review Draft states that "A hypothetical derivative cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item). An example is debt denominated in a foreign currency (irrespective of whether it is fixed rate or variable rate debt). When using a hypothetical derivative to calculate the change in the value of such debt or the present value of the cumulative change in its cash flows, the hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a charge (e.g. cross-currency interest rate swaps)".

In our view, the cross currency basis component at inception of a CCIRS entered into for hedging reasons reflects a cost of hedging that should be recognised progressively over the life of the hedging relationship. To the extent that the CCIRS is an effective economic hedge, the subsequent mark-to-market changes should not result in earning volatility unless the hedge is terminated and the gain or loss realised. The basis for our view is summarised below, followed by further detail on each point.

- The proposed treatment of cross currency basis is contrary to the objective of the hedge accounting Review Draft, which notes that hedge accounting outcomes should reflect an entity's risk management practices.
- The proposed treatment of cross currency basis will create periodic accounting earnings volatility – as the changes in cross currency basis subsequent to inception do not reflect the costs incurred over the life of the hedging strategy.
- Cross currency basis at inception is akin to the cost of hedging with CCIRSs in the same way that option premiums or forward points are a cost of taking out options and forwards respectively. Thus, the proposed treatment of cross currency basis (post inception) is inconsistent with the proposed treatment of time value of options and forward points under the Review Draft.

Furthermore, the proposed treatment of cross currency basis is an impediment to the efficient management of capital globally, as it penalises entities that seek to raise foreign currency debt and hedge foreign currency exposures with a CCIRS.

Objective of the hedge accounting Review Draft

The previous hedge accounting model was described by entities as complex, not reflective of risk management strategies and excessively rules based, resulting in arbitrary outcomes. The IASB has indicated that the Review Draft was crafted to address these criticisms by:

- aligning hedge accounting more closely with risk management activities;
- addressing inconsistencies/weaknesses in the existing model; and
- establishing a more principles-based approach to hedge accounting.

Each of these objectives has been examined in light of the proposed treatment of cross currency basis in the Review Draft.

With respect to aligning hedge accounting with risk management activities - the proposed treatment does not reflect intended or actual risk management outcomes since an entity can effectively economically hedge a non-functional currency denominated hedged item with CCIRS, but not achieve the same outcome for accounting purposes. Furthermore, as the financial statements are prepared on a going concern basis, a going concern business (which uses CCIRS for hedging) will never actually realise (cash received or paid) the MtM caused by the cross currency basis. The requirements in the review draft in accounting for cross currency basis is thus misaligned with the risk management activities of a going concern business, thus creating a divergence between the accounting and economic outcomes.

On the second point - the Review Draft actually introduces a new inconsistency as the time value of purchased options and forward points are allowed to be accounted for in OCI whilst cross currency basis is not. A criticism of the previous hedge accounting model, specifically focussing on the accounting for time value of options through earnings, has now been replaced by the treatment of cross currency basis in the Review Draft.

On the third point - the review draft is more rules based, explicitly requiring cross currency basis recognised in earnings, instead of taking a principles approach which may be more flexibly aligned with the risk management activities of a going concern business.

Accounting earnings volatility

The Australian banking industry obtains significant funding from offshore, denominated in various foreign currencies. The key objective in doing this is to obtain the best cost of funds, create additional sources of liquidity and diversify funding risk. The efficient sourcing of capital is not unique to just the Australian Banks, but a common objective of any corporation across the world.

The sourcing of funds in currencies other than an entity's functional currency has become more prominent particularly as credit conditions have altered in recent years. Most corporates and banks reliant on non-functional currency funding (other than investment banks and hedge funds) do not seek to speculate or profit from foreign currency movements and therefore hedge their non-functional currency denominated exposures. One of the most popular hedging instruments to achieve this is the CCIRS, because it provides a match of the principal and interest exposures.

Prior to the Global Financial Crisis (GFC), cross currency basis represented a small element of the CCIRS valuation with little volatility. Post GFC and still prevalent today, cross currency basis can create significant and undesired earnings volatility for both corporates and banks alike.

Given the magnitude and volatility of cross currency basis, the increasing need to source the most cost effective capital across the globe, the need to hedge non-functional currency denominated exposures and widespread use of CCIRSs to achieve such hedging, the proposed treatment of cross currency basis in the review draft penalises any entity that seeks to hedge non-functional currency denominated exposures (with CCIRS) through unnecessary non-economic earnings volatility.

Inconsistent treatment of vanilla derivatives

The proposed treatment of cross currency basis is inconsistent with the manner in which hedge ineffectiveness is measured for purchased options and forward contracts, where MtM movements due to features/terms not prevalent in the hedged item are allowed to be accounted for in Other Comprehensive Income (OCI) or the cash flow hedge reserve. We support the Board proposals in respect of forward points and option premiums and believe that this more accurately reflects the costs of hedging and the risks associated with hedging. We believe that a consistent approach should be applied to cross currency basis and explain the inconsistency in more detail below.

Treatment of Options - Under the Review Draft, an entity may separate the intrinsic value and the time value of a purchased option contract and designate only the change in intrinsic value as the hedging instrument in either a fair value or cash flow hedge. The change in the time value of the option is recognised in OCI (paragraph 6.5.15). Incorporated in the non-intrinsic component are a number of components (time value, vega, theta, gamma etc) which are generally not features of the hedged item. Hence, the review draft permits that any non-intrinsic option component to be accounted for in OCI even though they are not present in the hedged item.

Treatment of Forwards - Similar to the accounting for purchased options, an entity can separate the forward element and the spot element of a forward contract and then designate only the change in the spot element as the hedging instrument in either a fair value or cash flow hedge. The forward element is generally not a feature of a hedged item and the review draft allows the change in the fair value of the hedging instrument relating to the forward element to be recognised in OCI (paragraph 6.5.16).

The forward component of forward contracts and the time value component of purchased options (which include the option Greeks) are generally not a feature of the hedged item, however they are accounted for in OCI as proposed by the IASB in the Review Draft. The cross currency basis component, which the IASB implies is not a component of the hedged item, is instead accounted for in earnings. It is thus unclear why a distinction is made between derivatives and is unclear why there is a penalty imposed by the IASB on the use of CCIRS versus options and forwards.

Conclusion

Sourcing the most cost-effective capital from around the world is a key objective of many entities (both corporates and banks alike) and has become more critical post the GFC. Given the size of the movements in cross currency basis, and the need to hedge non-functional currency denominated capital, the treatment of cross currency basis in the review draft creates an unnecessary burden through earnings volatility and does not reflect the economic costs incurred by non-speculative going concern businesses.

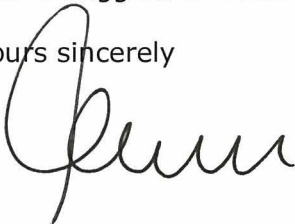
It is also unclear why the IASB has differing accounting treatments for vanilla derivatives, where features within hedging instruments which are not generally features of the related hedged items are accounted for in OCI for some, but in earnings for others.

In addition we also encourage the IASB to consider one of the key purposes for revising the hedge accounting requirements, was to address the inconsistencies/deficiencies of the old rules and ensure that the new rules are better aligned with the risk management activities of an entity. The review draft however has not achieved these objectives in regard to the treatment of cross currency basis.

Accordingly we request the IASB to re-consider its proposed treatment of cross currency basis when measuring hedge ineffectiveness and align the treatment with the treatment applied to other vanilla derivatives. In our view this will ensure better alignment of the accounting requirements to the risk management activities of the entity.

Should you have any queries on our comments, please do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely



Shane Buggle
Deputy Chief Financial Officer

Copy: Chairman, Australian Accounting Standards Board (AASB)