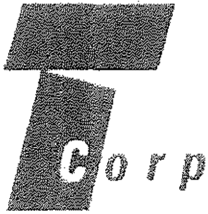

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11 June 2010

The Chairman
Australian Accounting Standards Board
PO Box 204
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VICTORIA 8007

International Accounting Standards Board
1st Floor
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Sir / Madam

Response of Australian State Central Borrowing Authorities

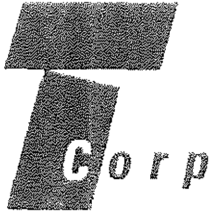
Exposure Draft ED196 / ED/2010/4 – Fair Value Option for Financial Liabilities

This submission has been prepared on behalf of the following Australian State Central Borrowing Authorities (CBAs):

- Queensland Treasury Corporation (QTC)
- New South Wales Treasury Corporation (TCorp)
- Treasury Corporation of Victoria (TCV)
- Western Australian Treasury Corporation (WATC)
- South Australian Government Financing Authority (SAFA)
- TASCORP

The CBAs welcome the opportunity to comment of the proposals contained in ED 196 / ED/2010/4 and are supportive of any initiatives that are designed to improve the clarity of financial statements to users, particularly in relation to financial instruments. However, for the CBAs whose balance sheets are almost entirely comprised of financial instruments, and who manage all of their financial assets and liabilities on a fair value basis, we believe the proposals contained in ED 196 / ED/2010/4 will likely detract from the clarity of our financial statements, and may result in a misleading reported profit or loss.

In summary, we are seeking the option to continue to account for all changes in fair value of financial liabilities (including the changes associated with credit risk) through the profit or loss.



New South Wales
Treasury Corporation

Our rationale for this view, along with background information on the CBAs, their significance to the Australian fixed interest market, the likely impacts of the proposed changes contained in the Exposure Draft and responses to your specific questions are set out in the appendix to this letter.

Please contact us if you wish to clarify any of our comments.

Yours faithfully
New South Wales Treasury Corporation

Paul Smith
Chief Financial Officer

cc Don Licastro, Director Corporate Solutions, Queensland Treasury Corporation
Peter Wyatt, Chief Financial Officer, Treasury Corporation of Victoria
Steve Luff, Chief Financial Officer, Western Australian Treasury Corporation
Craig Fowler, Director Finance, South Australian Government Financing Authority
Ignacio Welch, Chief Financial Officer, TASCORP

APPENDIX

Response to Exposure Draft ED 196 / 2010/4 – Financial Liabilities: Classification and Measurement Fair Value Option

1. Background information

The following Australian State Central Borrowing Authorities (CBAs), as major issuers of bonds on behalf of the Australian States, are making a joint submission to the AASB and IASB in respect to proposed amendments to the fair value rules for their own financial instruments:

- Queensland Treasury Corporation (QTC)
- New South Wales Treasury Corporation (TCorp)
- Treasury Corporation of Victoria (TCV)
- Western Australian Treasury Corporation (WATC)
- South Australian Government Financing Authority (SAFA)
- TASCORP

Within Australia, the State government bond market (known as the semi-government market) represents a major portion of the Australian fixed interest market. Semi-government issuers with approximately AUD$140 billion (US$120 billion) on issue represent almost 32% of the Australian UBS Composite Bond Index[1].

The size and underlying liquidity of the semi-government market allows for the bonds issued by the CBAs to be fair valued with a high degree of certainty. Quoted buy / sell spreads are generally narrow (2-3 basis points) particularly for the 3 largest issuers (QTC, TCorp and TCV), further supporting the underlying liquidity and ability to accurately fair value the debt.

Each State has its credit worthiness assessed and reported regularly by the major rating agencies (Standard & Poor's Financial Services and Moody's Investors Service).

All of the CBAs currently value their own debt (liabilities) at fair value with gains or losses recognised through profit or loss. This approach is supported by the fact that these liabilities are managed and reported internally and externally on a fair value basis.

Furthermore, each of the CBAs values its own bonds by reference to its own quoted market prices. They do not value their own bonds by reference to either the Commonwealth of Australia's bonds or the commonly used swap rates.

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[1] UBS is the provider of Australia's benchmark bond indices that are used most commonly as benchmarks for performance measurement by major investors in the Australian fixed interest market.

The accounting treatment adopted by the CBAs is consistent with the requirements of Paragraph 9 of IAS 39 (*Definition of a financial asset or liability at fair value*) on the basis that this group of financial assets and liabilities are managed and their performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entities' key management personnel and it significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains or losses on them on different bases.

In summary, the CBAs are seeking the option to continue to account for all changes in fair value of financial liabilities (including the changes associated with credit risk) through the profit or loss. This option is not currently included within the Exposure Draft.

2. Impacts of proposed amendments

All of the CBAs fully adopt the Australian equivalents of the International Financial Reporting Standards (AIFRS). The CBAs are concerned that the proposed amendments will lead to the following outcomes and problems:

a) Inconsistency with the initial intentions of designating the financial instruments at fair value through profit or loss;

b) Misleading measurement and reporting of financial risk;

c) Introduction of profit or loss volatility in annual financial statements; and

d) Practical issues of measuring fair value changes attributable to credit risk

Each of these is considered separately below.

(a) Inconsistency with the initial intentions of designating the financial instruments at fair value through profit or loss

The proposed amendments contradict the initial intentions of designating the financial assets and liabilities at fair value through profit or loss. In accordance with IAS 39 Paragraph 9 (*Definition of a financial asset or liability at fair value through profit or loss*) a financial asset or liability can be designated at fair value through profit or loss if:

"upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either:

(i) *it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or*

(ii) *a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 Related Party Disclosures), for example the entity's board of directors and chief executive officer"*

The CBA s have opted to designate the financial instruments at fair value through profit or loss since these instruments are managed on a fair value basis (measure the net financial risk) and as it eliminates or significantly reduces volatility in the profit or loss. The proposed amendments will not achieve either of these objectives and therefore make both options redundant. The CBAs see this as a major contradiction which will need to be addressed.

(b) Misleading measurement and reporting of financial risk

The business model adopted by the CBAs for each of the States requires that the CBAs borrow from the external market and then on-lend to their respective State government agencies and departments. The CBAs manage their respective balance sheets on a fair value basis for both assets and liabilities. Loans (assets) to government agencies or departments are initially advanced and subsequently revalued by reference to the quoted debt prices for each CBA, thereby providing transparency to the borrowers.

Under this current approach, where a CBA can financially match an external borrowing (liability) against a government loan (asset), changes in the fair value of liabilities will largely offset changes in the fair value of assets, and both of these will be reflected through the profit or loss. To the extent that borrowings do not match loans (e.g. where borrowings are used to purchase liquidity assets or where the term of the loan does not match the term of the borrowing), this will introduce a market risk to the CBA which will be measured and reported in the profit or loss (and has the potential to be converted to realised gains and losses as the balance sheet positions are adjusted to meet client, market or internal risk requirements). The profit or loss is therefore a true measure of the financial risks (both market and credit) that the CBA is exposed to and is required to manage.

It is important to note that each CBA and the relevant Government agencies to which they lend are authorities of their home State. The credit rating of the CBA and of the agencies derives from the creditworthiness of the State. In other words any revaluation of the CBA's liabilities will be almost fully offset by a similar revaluation of the CBA's assets.

The proposed change would require the CBAs to measure, recognise and report on one (isolated) component of its financial risk for the purposes of the annual financial statements. The CBAs would consider this approach to be likely misleading to users of financial statements as it would not reflect fully the nature of the financial risks, nor how these risks are actually managed. It would also require a significant investment into appropriate systems and infrastructure without any commercial or financial reporting benefits.

In support of this, the CBAs confirm that this proposed information would not be used by management, their Boards or by their owners and would only be produced for the annual financial statements to comply with the relevant accounting standard. The proposals would likely require the CBAs to explain the inappropriateness of the standard in discussing their financial performance, which would be seen as an undesirable outcome.

(c) Introduction of profit or loss volatility in annual financial statements

It is noted that a key objective of the IASB in introducing this amendment is to minimise reported profit or loss volatility. As demonstrated in 2(b) above, for the CBAs this treatment would have the opposite impact and introduce new and potentially very significant volatility to the reported profit or loss as the fair value movements in financial assets would be fully reflected in the profit or loss but only a portion of the fair value movement in the financial liabilities would be reflected in the profit or loss.

(d) Practical issues of measuring fair value changes attributable to credit risk

As noted, all of the CBAs value their own bonds by reference to their own quoted prices and not by reference to another benchmark such as the Australian Commonwealth government or bank swap rates. As actively traded financial instruments, prices of semi-government bonds vary due to numerous factors in addition to credit risk. These other factors include instrument liquidity, supply and demand, market sentiment and volume.

For these reasons the CBAs do not believe it is possible to accurately attribute the change in interest spreads between credit and other market risks. Although this is a concern in relation to the current disclosure regime under AASB 7 (IFRS 7), this becomes a much more significant risk under the proposed approach i.e. there is a real risk of reporting an incorrect or misleading number on a primary statement in the financial report. Furthermore, the CBAs believe the proposal introduces subjectivity into an area where data is currently adequate, objective and verifiable.

To illustrate the potential difficulty / subjectivity of this issue and to highlight the materiality of the issue, we have provided the below analysis of interest margin (spread) for TCV against the

Australian Commonwealth (risk free) interest rate. TCV is one of the larger semi-government bond issuers and is considered to have the most stable AAA credit rating of all of the Australian states i.e. TCV is the issuer least likely to be impacted by changes in their own credit risk. Despite these facts, the table below demonstrated that TCV has had considerable volatility in interest spreads against Australian Commonwealth bonds over the last 2 years to 11 May 2010.

Term of bond	Lowest spread (bp)	Highest spread (bp)	Average spread (bp)
3-year	19.5	129.3	52.9
10-year	44.2	136.3	73.7

The CBAs therefore do not accept that it is sensible, or indeed correct, to use a reference interest rate curve as a proxy for credit risk as the above example demonstrates that credit risk is not the reason for changes in relative interest rates. It is also not appropriate to value their bonds with reference to another benchmark curve when their own market price is readily identifiable.

Therefore the CBAs remain of the view that they cannot accurately attribute the fair value in changes in own credit from the overall changes in fair value and therefore could not accurately report this on a primary statement within the financial report.

3. Responses to specific questions from the IASB

Please note that these responses are specifically in relation to the CBAs.

Question 1 – Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

No. Refer to section 2 above. The CBAs have elected to designate the financial instruments at fair value through profit or loss as these instruments are managed on a fair value basis. This also helps minimise volatility in the profit or loss.

The proposed amendments contradict the initial intentions of designating the financial assets and liabilities at fair value through profit or loss. It would also result in volatility in the profit or loss as there would be a mismatch due to changes in fair value of financial assets being fully reflected in the profit or loss but only a portion of the changes in fair value of financial liabilities being reflected in the profit or loss. Furthermore, this accounting treatment is not consistent with IFRS 9 on the measurement of a financial asset.

These issues are seen as major contradictions which will need to be addressed.

Question 2 – Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in the profit or loss)? Why?

The CBAs would like the option to continue to present the entire fair value change in profit or loss – refer to section 2 above. For the CBAs, not being able to continue with this option would create a significant and misleading mismatch in reported profit or loss. Under the current approach, fair value movements in financial liabilities largely offset fair value movements in financial assets.

This question also does not consider the other key reason for designating a financial asset or liability at fair value through profit or loss i.e. that the financial instruments as a whole are managed on a fair value basis.

Question 3 – Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

No – Refer to Section 2. This would result in the risk of reporting incorrect or misleading information in a primary statement of the financial report. The example provided in Section 2(d) illustrates this point. The CBAs believe the proposal also introduces subjectivity into an area where data is currently adequate, objective and verifiable.

Question 4 – Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

No – Refer to Section 2. We believe the current practice of recognising the entire fair value change in profit or loss should continue.

Question 5 – Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

No – refer to Section 2.

Question 6 – Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in comprehensive income)? If so, why?

No – refer to Section 2. This is the least favoured option of the CBAs and potentially the most misleading.

Question 7 – Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

No. Refer to Section 2. The CBAs would like to continue to recognise all changes in fair value of its liabilities through the profit or loss.

Question 8 – For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

As set out in Section 2(d), the CBAs consider separate measurement of credit risk to be practically difficult and indeed technically incorrect. Although this is a concern in relation to the current disclosure regime under AASB 7 (IFRS 7), this becomes are much more significant risk under the proposed approach i.e. there is a real risk of reporting an incorrect or misleading number on a primary statement in the financial report.

Question 9 – Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

Yes

Question 10 – Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

Yes