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9 March 2011

Sir David Tweedie
Comment Letters
International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David

Exposure Draft ED/2010/13 Hedge Accounting

We are pleased to have the opportunity to provide our comments on Exposure Draft ED/2010/13 Hedge Accounting.

National Australia Bank is one of the four major banks in Australia. Our operations are predominantly based in Australia, New Zealand, the United Kingdom, the United States and Asia. In our most recent annual results we reported net profit after tax of A\$4.2 billion and total assets of A\$686 billion.

We view the proposals as an improvement to the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). In some circumstances IAS 39 prevents entities from reflecting their risk management activities due to restrictions on what is eligible for hedge accounting and arbitrary thresholds for assessment of hedge effectiveness.

Our comments on the specific questions raised by the IASB are addressed in the Appendix and we have set out below our key messages.

Hypothetical derivative method for fair value hedge relationships

From a risk management perspective, entities do not distinguish between a hedging instrument being a cash flow or a fair value hedge. Despite this, fair value hedge relationships almost always result in some profit or loss volatility, whereas cash flow hedge relationships have the potential to result in no hedge ineffectiveness. We believe that hedge accounting should not reflect a different outcome depending on the type of hedge relationship. We request the IASB address this issue in line with its indicated desire to simplify hedge accounting and to align the accounting approach with a risk management perspective.

One mechanism to address this concern is to allow the hypothetical derivative method to have wider application for fair value hedge relationships. Paragraph B44 of the Exposure Draft states that to calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a hypothetical derivative. The same paragraph however goes on to say that "the hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a

different approach". While we find it unclear, we interpret that paragraph B44 only allows use of the hypothetical derivative method to assess hedge effectiveness in a fair value hedge relationship in limited circumstances. Generally use of a hypothetical derivative will not result in the same outcome as if a different approach was used to determine the change in value of the hedged item.

For example, in a fair value hedge relationship of a fixed rate liability hedged for interest rate risk, using a hypothetical derivative will not result in the same outcome as if a different approach was used, unless the floating leg of a hypothetical interest rate swap resets daily. Such swaps are rarely used in practice. In our opinion the hypothetical derivative should be allowed to be used utilising a reset frequency in line with that used for risk management purposes, such as a 90 day reset.

Another example is hedging a liability denominated in a currency other than an entity's functional currency for interest rate and currency risk using a cross currency swap. The risk that the relationship between two currencies may move other than due to changes in interest rates in the two countries is referred to as currency basis risk. Currency basis risk exists in the valuation of the hedging instrument (i.e. the cross currency swap) however is not present in the hedged item (i.e. the foreign currency denominated liability). Under both IAS 39 and the Exposure Draft if a floating rate foreign currency liability is swapped to a fixed rate functional currency exposure, the impact of currency basis is deferred in other comprehensive income. However if a fixed rate foreign currency liability is swapped to a floating rate functional currency exposure, the impact of currency basis is reflected in profit or loss as hedge ineffectiveness. We recommend the IASB address this difference in accounting outcome by allowing this component of a cross currency swap fair value change to be deferred in other comprehensive income for fair value hedge relationships.

Unclear requirements surrounding alignment of hedge accounting with the risk management strategy

We find various references throughout the Exposure Draft to aligning hedge accounting with the risk management strategy unclear, in particular in relation to when we have a group of partially offsetting positions and we hedge some or all of a risk from the net position. Our interpretation is that designation of the gross positions that give rise to the net position is not mandatory, however the language in the Exposure Draft is contradictory and it could be interpreted as mandatory. We request that the IASB review the wording to ensure it is interpreted consistently.

This matter is significant for the banking industry whose hedging activities include managing the net margin between interest rates earned on assets and those incurred on liabilities. Under IAS 39 the gross positions that form part of the economics behind the use of hedging instruments are not reflected in the documented hedge relationship. Significant work would be required to alter hedge documentation and effectiveness testing if it was mandatory to designate gross positions that give rise to the net position. Consequently we do not support such a change.

Hedging credit risk

Our reading of the Exposure Draft is that there is nothing that specifically prevents a credit risk component being a hedged item provided that it is separately identifiable and reliably measurable. Our opinion is contradictory to the discussion in the section on hedging credit risk using credit derivatives in the Basis of Conclusions that accompanies the Exposure Draft. In our opinion, credit risk can be separately identified and reliably measured in the majority of cases. Where we have elected to fair value portfolios of loan assets we analyse our pricing as part of determining fair value. This analysis includes breaking down elements

of the spread between the risk free rate and the total price into pricing for credit risk, liquidity risk, funding risk and any other components.

The IASB has also requested constituents to consider whether an alternative accounting treatment relating to applying the fair value option other than on initial recognition of a financial instrument would add unnecessary complexity. We do not believe that this is the case and in our opinion, alternative 3 in the Basis of Conclusions is the most appropriate alternative to develop further. An alternative accounting treatment may be less burdensome to implement than hedge accounting in some circumstances, similar to the way that the fair value option can be used as an alternative to fair value hedge accounting

Two-step approach for fair value hedges

The Exposure Draft proposes a two-step approach for fair value hedges of recognising the gain or loss on the hedging instrument and the hedged item in other comprehensive income and then transferring the ineffective portion to profit or loss. The outcome of the proposed two-step approach is exactly the same as recognising the gain or loss on the hedging instrument and the hedged item directly in profit or loss. In our opinion because the proposed two-step approach does not provide more useful information to users, the system costs that would be incurred to implement the proposal cannot be justified.

Transitional provisions

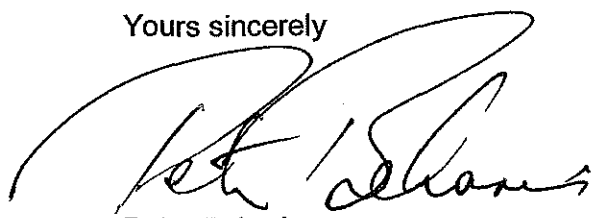
The proposed prospective transitional provisions do not easily cater for relationships that qualify for hedge accounting under the Exposure Draft unless they also qualify under IAS 39. For example, a derivative financial instrument that perfectly offsets the hedged item and qualifies for hedge accounting under the Exposure Draft and not under IAS 39 is likely to have a fair value other than zero at the transition date. Additional work will be required to define the hypothetical derivative and assess hedge ineffectiveness if the derivative is designated in a cash flow hedge relationship, despite the fact that the derivative perfectly offsets the hedged item over the life of the derivative. We recommend that an option be included for entities to apply the revised hedge accounting requirements retrospectively on a relationship by relationship basis in line with the IASB's indicated desire to simplify hedge accounting.

Open portfolio hedge accounting

The IASB decided not to address open portfolio hedge accounting as part of this Exposure Draft. If open portfolio hedge accounting requirements are finalised after the general hedge accounting requirements (i.e. after the second quarter of 2011), we request that this time difference be reflected in the effective date of the open portfolio hedge accounting requirements so as to not disadvantage the banking industry.

Should you have any queries regarding our comments, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at marc.smit@nab.com.au.

Yours sincerely



Peter Beharis
General Manager, Group Finance

Detailed Answers to Questions**OBJECTIVE OF HEDGE ACCOUNTING****Question 1 – Do you agree with the proposed objective of hedge accounting?**

No. The Exposure Draft proposes that the objective of hedge accounting is to represent the effects of an entity's risk management activities that use financial instruments to manage exposures from particular risks that could affect profit or loss. We do not believe that such an objective is appropriate as:

- Hedge accounting is optional and this is not reflected in the objective. In addition, an entity can elect to apply hedge accounting to some financial instruments and not others, which too is not reflected in the objective.
- There continues to be a number of economic hedges for which hedge accounting cannot be applied under the Exposure Draft.
- Risk management strategies vary significantly. For example, risk management strategies can be set at a macro level, with the objective of stabilising earnings and maintaining a specified credit standing. Risk management activities are designed to meet an overriding objective, and the overall risk appetite involves both closing risk exposures and gaining exposure to risk provided that financial instruments are used within allowed tolerances.

In our opinion the objective of hedge accounting is to provide a voluntary method of recognising the gain or loss on a hedging instrument in profit or loss in the same period when the item that is being hedging affects profit or loss. That said, we do believe that achieving a risk management objective should be part of the criteria to qualify for hedge accounting.

If the proposed hedge accounting objective in the Exposure Draft were to stand as is, we find it unclear whether hedge accounting can only be achieved by designating in a way that is consistent with the risk management strategy. Examples of instances where we do not designate hedge relationships under IAS 39 in a way that is consistent with the risk management strategy, and therefore may be precluded from hedge accounting, include when there is a group of partially offsetting items and we hedge some or all of a risk from the net position. We designate the net hedging instrument against part of one of gross partially offsetting items. (Refer to question 6 for further information regarding this issue).

In addition to designating the net hedging instrument against part of one of the gross partially offsetting items, we may match derivatives to unrelated exposures. For example, a bank may manage the net exposure from fixed rate interest exposures (such as from residential mortgages (assets) and term deposits (liabilities)) within allowable tolerances. The risk from the net fixed interest exposure may be managed by time buckets using derivatives to maintain the net exposure within allowable tolerances. Under IAS 39 the derivatives used to reduce or widen the net fixed interest exposure can be designated in a cash flow hedge of unrelated variable rate assets or liabilities. This would be done because of the reduced profit or loss volatility from cash flow hedge relationships.

In relation to linking hedge accounting to risk management activities we have two further observations:

a) Hypothetical derivative method for fair value hedge relationships

From a risk management perspective, entities do not distinguish between a hedging instrument being a cash flow or a fair value hedge. Despite this, fair value hedge relationships almost always result in some profit or loss volatility, whereas cash flow hedge relationships have the potential to result in no hedge ineffectiveness. We believe that hedge accounting should not reflect a different outcome depending on the type of hedge relationship. We request the IASB address this issue in line with its indicated desire to simplify hedge accounting and to align the accounting approach with a risk management perspective.

One mechanism to address this concern is to allow the hypothetical derivative method to have wider application for fair value hedge relationships. Paragraph B44 of the Exposure Draft states that to calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a hypothetical derivative. The same paragraph however goes on to say that “the hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach”. While we find it unclear, we interpret that paragraph B44 only allows use of the hypothetical derivative method to assess hedge effectiveness in a fair value hedge relationship in limited circumstances. Generally use of a hypothetical derivative will not result in the same outcome as if a different approach was used to determine the change in value of the hedged item.

Floating leg reset frequency

In fair value hedge relationship of a fixed rate liability hedged for interest rate risk, using a hypothetical derivative will not result in the same outcome as if a different approach was used, unless the floating leg of a hypothetical interest rate swap resets daily. Such swaps are rarely used in practice. In our opinion the hypothetical derivative method should be allowed to be used utilising a reset frequency in line with that used for risk management purposes, such as a 90 day reset.

Currency basis

Another example is hedging a liability denominated in a currency other than an entity's functional currency for interest rate and currency risk using a cross currency swap. The risk that the relationship between two currencies may move other than due to changes in interest rates in the two countries is referred to as currency basis risk. Currency basis risk exists in the valuation of the hedging instrument (i.e. the cross currency swap) however is not present in the hedged item (i.e. the foreign currency denominated liability). Under both IAS 39 and the Exposure Draft if a floating rate foreign currency liability is swapped to a fixed rate functional currency exposure, the impact of currency basis is deferred in other comprehensive income. However if a fixed rate foreign currency liability is swapped to a floating rate functional currency exposure, the impact of currency basis is reflected in profit or loss as hedge ineffectiveness. We recommend the IASB address this difference in accounting outcome by allowing this component of a cross currency swap fair value change to be deferred in other comprehensive income for fair value hedge relationships.

b) Requirement for a hedged forecast transaction to be highly probable in a cash flow hedge relationship

Cash flow hedge accounting of a forecast transaction requires the forecast transaction to be highly probable. This may not align with an entity's risk management strategy, which may include hedging of probable (and not highly probable) forecast transactions. In line with the IASB's indicated desire to represent the effects of an entity's risk management activities, hedge accounting should be able to be applied to forecast transactions that do not satisfy the highly probable criterion provided entering into such hedges is part of the entity's risk management strategy and the forecast transaction is probable.

An example is a probable acquisition of an entity where the purchase price is hedged for foreign currency risk. The risk management strategy may be to enter into a forward foreign currency contract to lock in an exchange rate when the acquisition is probable, although not highly probable. In our opinion the entity should be able to designate this as a cash flow hedge in line with its risk management strategy.

INSTRUMENTS THAT QUALIFY FOR DESIGNATION AS HEDGING INSTRUMENTS

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?

Yes.

DERIVATIVES THAT QUALIFY FOR DESIGNATION AS HEDGED ITEMS

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?

Yes.

DESIGNATION OF RISK COMPONENTS AS HEDGED ITEMS

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?

Yes, we agree with this proposal. In addition, we believe that credit risk is a component that can be identified and measured reliably. (Refer to question 15 for further discussion).

DESIGNATION OF A LAYER COMPONENT OF THE NOMINAL AMOUNT

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.

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 activities. 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

Question 6 – Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting?

Yes. We agree with the proposal to remove the 80 to 125 per cent test for assessing and measuring effectiveness. We also agree with the proposal to permit qualitative effectiveness assessment. We support the elimination of the retrospective effectiveness test and welcome the assessment of hedge effectiveness based on the risk management strategy.

However, we are concerned about the use of the term 'no bias' in the objective of hedge effectiveness testing. If there is a requirement to ensure that no bias exists on each assessment date, this would be a higher hurdle than achieving the 80 to 125 per cent required by IAS 39 and we would not support this outcome. We believe that this is not how the Exposure Draft is intended and recommend rewording the reference to 'no bias' to avoid confusion.

REBALANCING OF A HEDGING RELATIONSHIP

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?

We are generally supportive of the proposal to permit rebalancing of hedge relationships, although we have certain concerns about how the rebalancing provisions could be interpreted based on the currently wording of the Exposure Draft. Hedging is generally performed within certain tolerances. In our view, rebalancing for accounting should only be necessary when proactive risk management activity is required. We believe that this is the intent of the proposals but with the current wording of the Exposure Draft we see a risk that the rebalancing requirement could be applied too strictly in practice.

An example would be a cross currency swap designated as a fair value hedge of interest and foreign exchange risk on foreign currency denominated liability. In such a hedge, unavoidable ineffectiveness will arise due to currency basis risk. It would be inappropriate to require rebalancing as the unavoidable ineffectiveness will reverse over the term of the hedge. We believe that the intent of the Exposure Draft is that no rebalancing is required in such a scenario, but welcome confirmation.

Question 7(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?

Yes, we agree that if an entity wanted to rebalance in anticipation that the hedge effectiveness assessment might fail in the future, it should be permitted to do so.

DISCONTINUING HEDGE ACCOUNTING

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)?

Yes, we agree that hedge accounting should be discontinued prospectively when the hedge relationship no longer meets the qualifying criteria.

We do not agree that an entity should not be permitted to discontinue hedge accounting for a hedge relationship that still meets the risk management objective and strategy, and that continues to meet the qualifying criteria. An entity should have the flexibility to decide whether to discontinue hedge accounting or not in certain circumstances. (Refer to question 8(b) for further discussion).

Question 8(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?

We do not agree that an entity should not be permitted to discontinue hedge accounting for a hedge relationship that still meets the risk management objective and strategy, and that continues to meet the qualifying criteria. An entity should have the flexibility to decide whether to discontinue hedge accounting or not in certain circumstances. In particular, where it is not possible to designate hedges in line with actual risk management strategy, we believe it will be desirable to terminate hedges without any change in the overall designated risk management strategy, as more appropriate hedge designations become available elsewhere within the portfolio, or the exposure resulting from the portfolio changes.

An example of a situation where an entity may de-designate even though the risk management strategy is still being met is where an entity acquires another entity under a business combination. Although the acquiree previously applied hedge accounting, despite the fact that the acquiree's strategy remains unchanged after the business combination, upon acquisition the Group may decide that it is not material enough for the Group to bring the acquiree's hedge relationships into its existing systems, given the costs and operational difficulties associated with this. In this case the Group would prefer to discontinue the hedge relationships at the subsidiary level.

ACCOUNTING FOR FAIR VALUE HEDGES

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?

No. The Exposure Draft proposes a two-step approach for fair value hedges of recognising the gain or loss on the hedging instrument and the hedged item in other comprehensive income and then transferring the ineffective portion to profit or loss. The outcome of the proposed two-step approach is exactly the same as recognising the gain or loss on the hedging instrument and the hedged item directly in profit or loss. In our opinion because the proposed two-step approach does not provide more useful information to users, the system costs that would be incurred to implement the proposal cannot be justified.

Question 9(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?

No. In our opinion the gain or loss on the hedged asset or liability attributable to the hedged risk is best presented as an adjustment to the carrying amount of the hedged asset or liability and disclosed in the notes to the financial statements.

We disagree with the proposed presentation of fair value hedging adjustments as separate line items on the statement of financial position for the following reasons:

- In our opinion the statement of financial position is a primary financial statement that should provide a user an overview of an entity's assets and liabilities. We believe that multiple additional lines on the statement of financial position may distract from the statement of financial position providing such an overview.
- Paragraph 54 of IAS 1 *Presentation of Financial Statements* requires separate lines to be presented on the statement of financial position where items are sufficiently different in nature or function to warrant separate presentation. In many cases the fair value hedging adjustment will not result in the hedged asset or liability having a significantly different carrying amount compared to if the asset or liability had been measured at amortised cost. For example, the carrying amount of fixed rate debt hedged for interest rate risk, regardless of whether hedge accounting is applied, will be dominated by the debt principal.
- We believe that the proposed presentation has the potential to be misleading as it does not reflect that there is a single hedged item.
- In our opinion users have adequate information to understand the measurement basis of assets and liabilities without the need for more than one line item on the face of the statement of financial position. Information available for users includes a breakdown of the amount on the face of the statement of financial position (per our recommended approach) and disclosure of accounting policies. Disclosure of the carrying amount of the financial instrument categories under IFRS 7 *Financial Instruments: Disclosures* (IFRS 7) paragraph 8 can also be clarified as how to fulfil this disclosure requirement for financial instruments in fair value hedge relationships.

Question 9(c) - Do you agree that linked presentation should not be allowed for fair value hedges? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

Yes. We agree that disclosures about hedging are a better alternative to provide information about the relationship between hedged items and hedging instruments than linked presentation.

ACCOUNTING FOR THE TIME VALUE OF OPTIONS FOR CASH FLOW AND FAIR VALUE HEDGES

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)?

Yes. In our opinion this aligns with the general requirements for cash flow hedge accounting which avoids additional complexity.

In our opinion the explanation of a transaction related hedged item and a time period related hedged item in paragraph B67 could be clearer or include additional examples. For example, if we enter into swaption to hedge interest rate risk for the period of a highly probable forecast variable rate debt issuance, our reading of the Exposure Draft is that this is a transaction related hedged item. The forecast variable rate debt issuance is the transaction to which the option relates and initial measurement of the debt is at amortised cost including transaction costs. A basis adjustment of the amount accumulated in other comprehensive income to the measurement on initial recognition of the liability is not allowed as the debt is a financial item. Our reading of the Exposure Draft is that the amount in equity should be reclassified to the profit or loss as a reclassification adjustment when interest expense on the debt is recognised. This is regardless of whether the swaption is exercised. This requires tracking of the hedging gain or loss after the hedging relationship has ended and matching the gain or loss to the period(s) in which the debt affects profit or loss as opposed to being part of the effective interest rate calculation on the debt.

Question 10(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?

Yes. In our opinion a rational basis is wider than a straight-line basis, allowing management appropriate flexibility to determine a pattern of transfer to profit or loss.

Question 10(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)?

Yes. The proposals require the use of option pricing capability where the critical terms of an option do not perfectly match the hedged item. We have such capabilities, however expect that some entities will not. Nonetheless we agree with the proposals as such entities have

the choice to source such capability, not apply hedge accounting or designate an option in its entirety in a hedge relationship.

HEDGES OF A GROUP OF ITEMS

Question 11 – Do you agree with the criteria for the eligibility of groups of items as a hedged item?

We find the proposed criteria for eligibility of a group of items as a hedged item unclear and request the IASB review the wording to ensure it is interpreted consistently.

Parts of the Exposure Draft that suggest that designation of gross positions that give rise to the net position is an election to be made on a hedge relationship by relationship basis include:

- The reference in paragraphs 34, B70 and BC161 to a group of items (including a group of items that constitute a net position) being an *eligible* hedged item, suggesting they have the option to designate in this manner.
- The reference in paragraph B73 to *when* a group of items that constitute a net position is designated as a hedge item and the reference in paragraph BC178 to *an entity that applies net position hedge accounting*, implying the individual items in such a group need not be designated in such a manner.

Parts of the Exposure Draft that suggest that designation of gross positions that give rise to the net position is mandatory include:

- The statement in paragraph B70 that whether an entity hedges in this manner [of gross positions that give rise to a net position] is a matter of fact (not only of assertion or documentation).
- The statement in paragraph B73 that an entity *shall* designate gross positions that give rise to the net position so that the entity is able to comply with the requirements for the accounting for qualifying hedges.
- The statement in paragraph BC178 that an entity could not designate a merely abstract net position (i.e. without specifying the items that form the gross position from which the net position arises) as the hedged item.
- The IASB's observation in paragraph BC160 that the restrictions in IAS 39 that prevent an entity that hedges on a gross or net basis from presenting its activities in a manner that is consistent with its risk management practice do not give risk to useful information.

Based on the IASB's outreach activities in Australia (during which comments were made to the effect that items that qualify for hedge accounting under IAS 39 should continue to be eligible under the Exposure Draft), and the Exposure Draft as it stands, we interpret that under the Exposure Draft when we have a group of partially offsetting items and we hedge some or all of a risk from the net position, designation of the gross positions that give rise to the net position is allowed if we elect to designate a hedge relationship in this manner, however it is not mandatory. We would be unlikely to take up this election.

By way of example, a bank may manage the net exposure from fixed rate interest exposures (such as from residential mortgages (assets) and term deposits (liabilities)) within allowable tolerances to manage the net interest margin. The risk from the net fixed interest exposure is managed by time buckets using derivatives to maintain the net exposure within allowable tolerances. Under IAS 39 the derivatives used to reduce or widen the net fixed interest exposure can be designated in a cash flow hedge of unrelated variable rate assets or liabilities.

This matter is significant for the banking industry whose hedging activities include managing the net margin between interest rates earned on assets and those incurred on liabilities. Under IAS 39 the gross positions that form part of the economics behind the use of hedging instruments are not reflected in the documented hedge relationship. Significant work would be required to alter hedge documentation and effectiveness testing if it was mandatory to designate gross positions that give rise to the net position. Consequently we do not support such a change.

In relation to the hedging of groups of items, the IASB decided not to address open portfolio hedge accounting as part of this Exposure Draft. If open portfolio hedge accounting requirements are finalised after the general hedge accounting requirements (i.e. after the second quarter of 2011), we request that this time difference be reflected in the effective date of the open portfolio hedge accounting requirements so as to not disadvantage the banking industry.

PRESENTATION

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?

No. Whilst we acknowledge the IASB's desire to avoid the grossing up of net gains or losses on a single hedging instrument into offsetting gross amounts and recognising them in different line items, we are concerned that the proposals may result in a loss of comparability.

Further to our response to question 11, from our reading of the Exposure Draft we have concluded that designation of gross positions that give rise to a net position is allowed (i.e. that it is voluntary rather than mandatory). Following from this conclusion, entities with the same exposure and risk management activities may designate a hedge relationship in a different manner (i.e. as a net position hedge or as a hedge of a single gross hedged item) which will result in a different presentation on the face of this statement of financial performance.

While we are not suggesting that net position hedging should be mandatory, we note that the proposed presentation may be confusing to users with some entities including the effective portion of the hedging instrument in the measurement of the hedged item, and others reflecting it in a separate line item.

DISCLOSURES

Question 13(a) - Do you agree with the proposed disclosure requirements?

Paragraphs IN8 and BC183 of the Exposure Draft state that the proposed disclosure requirements will be included in IFRS 7 which implies they are in addition to the existing disclosure requirements. In our response however we have assumed that the proposed disclosures are to replace those already contained in paragraphs 22 to 24 of IFRS 7. We have the following comments in relation to the proposed disclosure requirements:

- Paragraph 40(a) of the Exposure Draft states that "hedge accounting disclosures shall provide information about an entity's risk management strategy and how it is applied to manage risk". In our opinion, it could be clearer that disclosures are only required where hedge accounting is applied, for example by rewording paragraph 40(a) to say that

“hedge accounting disclosures shall provide information about an entity’s risk management strategy for each category of risk exposure that it decides to hedge and for which hedge accounting is applied”. There are already disclosure requirements in respect of the objectives, policies and processes for managing risks in paragraph 33(b) of IFRS 7.

- We do not expect that the proposed quantitative disclosures in paragraphs 45 and 46 will be useful to users, and propose that these be removed. Paragraphs 45 and 46 require for each category of risk exposure, disclosure of quantitative information to enable users to evaluate:
 - the types of risk exposures being managed,
 - the extent to which each risk type of risk exposure is hedged, and
 - the effect of the hedging strategy on each type of risk exposure.

If an entity had a risk management strategy to swap foreign currency funding to the functional currency, when they swap fixed rate foreign currency denominated debt to floating rate functional currency debt the cross currency swap used would be designated in a fair value hedge of interest rate and currency risk. When they swap floating rate foreign currency denominated debt to floating rate functional currency debt, hedge accounting would not be applied to the cross currency swap as there is some natural offset in the profit or loss from the change in fair value of the swap and translation of the debt to the closing exchange rate. If this were to be presented in a quantitative form the entity may disclose:

- the risk exposure, being the functional currency equivalent of assets and liabilities subject to foreign exchange risk, including all the foreign currency debt
- the extent to which each type of risk exposure is hedged, being the notional of the swaps designated in hedge relationships
- the effect of the hedging strategy, being the residual foreign currency exposure not covered by a hedge relationship.

From this example, we believe that the prescriptive nature of the disclosure requirements would distort from presenting balanced risk management information as it focuses on hedge accounting rather than risk mitigation.

In our opinion, a user already has information about risk mitigation as the existing sensitivity to market risk disclosure requirements in IFRS 7 provide information about the sensitivity to market risk considering both the underlying exposures and hedging positions (regardless of whether hedge accounting is applied).

- Paragraph 41 of the Exposure Draft requires the hedge accounting disclosures to be presented in a single note or a separate section of the financial statements. In the absence of this disclosure requirement, we envisage that disclosure requirements would be presented across various notes to the financial statements including the hedging derivatives note, reserves note, financial risk management note and statement of comprehensive income. Consequently we recommend that the requirement to include all the hedge accounting disclosure requirements in a single place (being a single note or a separate section) is removed, allowing management to present the prescribed disclosures in the manner they see as useful for users.

Question 13(b) - What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

There are no additional disclosures we believe would provide useful information.

ACCOUNTING ALTERNATIVES TO HEDGE ACCOUNTING

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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?

Yes. We have no objection to the proposed approach however note that as a financial institution we are unlikely to be impacted by this issue.

Accounting for credit risk using credit derivatives

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?

No. We believe that an alternative accounting treatment to account for hedges of credit risk would not add unnecessary complexity.

Our reading of the Exposure Draft is that, similar to under IAS 39, there is nothing that specifically prevents the changes in cash flows or fair value of an item attributable to credit risk being a hedged item, provided that the credit risk component is separately identifiable and reliably measurable. Our opinion is contradictory to the discussion in the section on hedging credit risk using credit derivatives in the Basis of Conclusions that accompanies the Exposure Draft. In our opinion, credit risk can be separately identified and reliably measured in the majority of cases. As a bank a key part of our business is pricing credit risk, and under our reading of the Exposure Draft the onus would be on us to demonstrate that we are able to isolate and measure the credit component of a financial item. Where we have elected to fair value portfolios of loan assets we analyse our pricing as part of determining fair value. This analysis includes breaking down elements of the spread between the risk free rate and the total price into pricing for credit risk, liquidity risk, funding risk and any other components.

We believe that our circumstances are similar to those described in paragraph B15(b) where an entity may hedge the crude oil component of a forecast jet fuel purchase and not the refining margin component of forecast purchase. In such cases the onus will be on the entity to be able to support that the crude oil component is separately identifiable and reliably measurable, such as by accounting for all the elements that make up the cost of the jet fuel. Further, an entity looking to hedge account a component of a jet fuel purchase is the consumer of the commodity, whereas in general a supplier would have a better understanding of components that make up a price. As a bank we are a supplier of credit, and hence we would be in a better position to be able to explain the elements of the total lending charge.

The IASB has also requested constituents to consider whether an alternative accounting treatment relating to applying the fair value option other than on initial recognition of a financial instrument would add unnecessary complexity. We do not believe that this is the case. An alternative accounting treatment may be less burdensome to implement than hedge accounting in some circumstances, similar to the way that the fair value option is sometimes used as an alternative to fair value hedge accounting.

Question 15(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?

In our opinion alternative 3 is the most appropriate alternative to develop further for the following reasons:

- Alternative 3 includes the ability to elect the fair value option subsequent to initial recognition, in line with credit risk management activities whereby hedging instruments may be entered into after initial recognition of a financial instrument.
- We do not believe that an accounting election to subsequently apply the fair value option to manage an accounting mismatch should result in the measurement change adjustment being recognised immediately in profit or loss. We believe that this has the potential to deter entities from electing the fair value option, especially where the fair value has moved below the carrying amount of a financial asset.

In further developing alternative 3, we recommend that the IASB consider our observations as follows:

- In response to the presentation implications outlined in paragraph BC242, in our opinion including the unamortised measurement charge adjustment in the carrying amount of the exposure and disclosing the amount in the notes to the financial statements is most appropriate. This is in line with our response to question 9(b) on the gain or loss on the hedged item in a fair value hedge relationship.
- Paragraph BC240(a)(i) suggests amortisation of the measurement change adjustment over the life of the instrument, however does not specify whether this is the expected life or contractual life. We would expect that this is expected life.
- As the difference between 'amortised cost less impairment' and 'fair value' at the time of making the fair value option election is the measurement change adjustment, we are unclear how the circumstance described in paragraph BC240(a)(ii) (i.e. that the measurement change adjustment plus the fair value is greater than the carrying amount if the loan had been continued to be measured at amortised cost) could eventuate without further background information or an example.
- Amortisation of a measurement change adjustment in respect of a loan commitment is suggested to commence at the earlier of discontinuation of fair value through profit or loss accounting and recognition of a provision in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37). When the loan commitment is being accounted for using fair value through profit or loss accounting, tracking of whether a provision would have been required under IAS 37 appears onerous. In addition, the discussion on alternative 3 does not address how to account for when a loan commitment is drawn (i.e. initial recognition of the loan) if the measurement change adjustment has not been fully amortised at that time.
- We do not believe that the reconciliation of changes suggested in paragraph BC244 is warranted.

EFFECTIVE DATE AND TRANSITION

Question 16 – Do you agree with the proposed transition requirements?

The proposals in the Exposure Draft do not significantly impact the hedge accounting we currently apply under IAS 39, provided that our conclusion is appropriate that designation of gross positions that give rise to a net position is allowed if we choose to designate a hedge relationship in this matter (refer to our response to question 11). We do await the open portfolio hedge accounting proposals so we can consider the impact and transitional requirements.

Nonetheless we expect that some of our customers may wish to designate derivatives in a hedge relationship under the provisions in the Exposure Draft. The proposed prospective transitional provisions do not easily cater for relationships that qualify for hedge accounting under the proposals in the Exposure Draft unless they also qualify under IAS 39. For example, a derivative financial instrument that perfectly offsets the hedged item and qualifies for hedge accounting under the Exposure Draft and not under IAS 39 is likely to have a fair value other than zero at the transition date. Additional work will be required to define the hypothetical derivative and assess hedge ineffectiveness if the derivative is designated in a cash flow hedge relationship, despite the fact that the derivative perfectly offsets the hedged item over the life of the derivative. We recommend that an option be included for entities to apply the revised hedge accounting requirements retrospectively in line with the IASB's indicated desire to simplify hedge accounting. In our opinion, such an election will need to be provided on a relationship by relationship basis, as hedge accounting is applied on this basis.