Finance and Treasury Association

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FINANCE & TREASURY ASSOCIATION

Tuesday 11th December 2012

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

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

Dear Mr Hoogervorst,

IFRS 9 – Draft of Chapter 6, Hedge Accounting

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

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

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

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

The hedge accounting objective

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

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

Technical inconsistencies of the basis risk treatment

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

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

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

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

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

The efficiency of global capital markets

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

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

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

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

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

Yours sincerely

Yours sincerely,

Paul Travers FFTP	David Michell CFTP (Snr)
President	CEO
Finance and Treasury Association	Finance and Treasury Association

About FTA

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

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