TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

International Accounting Standards Board
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Dear Sir/Madam

Comments on Draft of Chapter 6 Hedge Accounting of IFRS 9

The Association of Corporate Treasurers (ACT) is a professional body for those working in corporate treasury, risk and corporate finance. Our members are typically responsible for economically hedging financial exposures that arise in their business. As a result they are also heavily involved in the hedge accounting for these derivatives if they decide to hedge account. The ACT would like to provide comment on the International Accounting Standard Board's (IASB's) Review Draft of IFRS 9 Chapter 6 Hedge Accounting ("RD") and specifically on a flaw that we believe has arisen subsequent to publication of the exposure draft. This letter focuses on that specific issue being the exclusion of currency basis risk in valuing the hypothetical derivative as outlined in paragraph RD.B6.5.5 Measurement of hedge ineffectiveness.

The current version of IAS 39 does not specifically exclude currency basis risk from the value of a hypothetical derivative nor did the exposure draft propose this exclusion for us to comment on.

The issue is particularly pertinent where corporates raise foreign currency debt and swap it into their functional currency using e.g. fixed-fixed cross currency swaps. The current accepted practice when accounting for such cash flow hedges where the critical terms of the hypothetical derivative (the model of hedge risk) and the derivative (the actual swap hedge) match in amounts, timing, and currency, the hedge is often treated as 100% effective and hence no significant hedge ineffectiveness is booked through the profit and loss account.

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Paragraph RD.B6.5.5 states that “a ‘hypothetical derivative’ is not a method in its own right but a mathematical expedient that can only be used to calculate the value of the hedge item. Consequently, a ‘hypothetical derivative’ cannot be used to include features in the value of the hedge item that only exist in the hedging instrument (but not in the hedged item).” “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 flow, 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”.

Whilst the above is based on a seemingly sound principle, we think it is inconsistent with the spirit of the RD - one of the stated objectives of which is to align hedge accounting more closely with the risk management activities. The principle of measuring hedge ineffectiveness by comparing the value of the actual derivative transacted (that may be an imperfect hedge) to the hypothetical derivative that models only the hedged risk is sound. However, due to the way e.g. currency and interest rate markets operate, the RD already provided two important exemptions from such principle – one on treatment of aligned time value of options and the other on treatment of the forward points. In our view currency basis is another such market structure driven factor that warrants a similar exemption. Currency basis is a counterparty-independent market phenomenon that would affect all market participants entering into cross currency swaps. It does not make sense to present the impact of currency basis as hedge ineffectiveness, suggesting that part of the derivative is unrelated to the hedge risk, when it is not possible to enter into a cross currency swap that is not affected by such an inherent market factor. We note that the IASB used similar arguments when they were discussing providing hedge accounting treatment for aligned time value of options. We also recognise that some may argue that there are many situations when the way a market functions will result in hedges being imperfect and hence basis risk should always give rise to ineffectiveness e.g. hedging jet fuel with crude oil futures. We would counter-argue that in these situations the basis risk can be managed or reduced by the structure of the hedge however this is not possible for currency basis risk.

Calculating the currency basis spread will add an additional unnecessary expense to hedge accounting and we question what use accounting for this through profit and loss would be to users of the financial statements. It does not express how effectively the hedge has been constructed.

In summary currency basis risk cannot be avoided. It is the cost or premium for undertaking what is a perfectly economically effective hedge. We therefore ask the IASB to consider adding the third exemption for an aligned currency basis before the RD is finalised and eliminate this unnecessary complexity.

Yours sincerely

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