

***AIFRS* Derivatives**

Hedging Impacts - Illustrative Examples

Recognition of Derivative Hedges under AASB139

Derivative Impact

	Book Equity	Tier 1 Capital
1 Ineffective Hedges	-132	-132
2 Cashflow Hedging	+161	0
3 MTM Long term bonds & Associated ANZ credit spread	-21	0
<hr/> Total <hr/>	+8	-132

2. Cash Flow Hedges

- Cash flow hedging occurs when a derivative is designated as hedging the variability in cashflows arising from an underlying transaction, or highly probable future transaction.
- AIFRS rules require all swaps to be carried on-balance sheet at their fair value. For cash flow hedges, the “effective” portion of the hedge is charged directly to a reserve in shareholders equity, and the “ineffective” portion to P&L

Example: Floating Rate Liability

- ANZ raises a floating rate deposit, with the current floating rate being 4.5%.
- ANZ executes a receive floating (4.5%), pay fixed (5.0%) interest rate derivative for 2 years to hedge the variable coupon on the deposit.

Year 1

- After taking into account the derivative, net interest expense is charged with 5.0%
- Fixed rates move from 5.0% to 5.75%, resulting in a MTM gain of \$50 on the interest rate derivative
 - Dr Derivative \$50
 - Cr Cash Flow Reserve \$50

Year 2

- Net interest expense is the same a year 1 as the interest rate derivative has hedged the cost back to 5.0%.
- Derivative matures, revaluation at year 1 reverses.
 - Dr Cash Flow Reserve \$50
 - Cr Derivative \$50

- **As APRA have stated in their draft prudential standards that any cash flow reserve in shareholders funds will not be permitted to be included as Tier 1 capital, the positive revaluation gain at year 1 (\$50) is not included in Tier 1 capital.**

3. MTM Long Term Bond & Associated ANZ Credit Spread

- Sometimes hedges that are highly effective in an economic sense may not comply with the technical requirements of the accounting standards. If the hedge does not meet the accounting requirements definition of “effective” the MTM of the hedge and the underlying instrument must be booked through P&L.

Example: Long term fixed rate \$500 bond hedged by an interest rate derivative

- ANZ issues a long term bond paying 5.0% but designates the bond as a fair value liability.
- ANZ executes a receive fixed (5.0%), pay floating (4.5%) interest rate derivative.

Year 1

- After taking into account the derivative, net interest expense is charged with 4.5%.
- Fixed interest rates move to 5.75% - fair value impact \$50
- At the same time ANZ’s credit spread widens by 10bps – fair value impact \$5

➤ Accounting for bond	Dr Bond	\$55	
	Cr P&L (\$50+\$5)		\$55
➤ Accounting for derivative	Dr P&L	\$50	
	Cr Derivative Liability		\$50

- **The result being that retained earnings has been impacted by the fair value of the change in ANZ credit spread (\$5). However, APRA have stated in their draft prudential standards that the impact of a MTM credit spread of an ADI will not be permitted to be included in the ADI’s Tier 1 capital.**

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