9 March 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

AOSSG Islamic Finance Working Group comments on
IASB Exposure Draft ED/2010/13 *Hedge Accounting*

The Asian-Oceanian Standard-Setters Group ("AOSSG") is pleased to provide comments from its Islamic Finance Working Group to IASB ED/2010/13 *Hedge Accounting*.

Introduction

1 The AOSSG's Islamic Finance Working Group ("AOSSG IF WG") was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events. The AOSSG IF WG comprises staff from the standard-setters of Australia, China, Dubai, Korea, Malaysia, Pakistan, and Saudi Arabia.

2 The working group had mainly discussed IASB ED/2010/13 in the context of Islamic hedging instruments. The comments are additional to the AOSSG Financial Instruments Working Group's comments on IASB ED/2010/13 dated 9 March 2011, and focus only on issues that are specific to Islamic finance. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and none of those members have expressed significant disagreements.

Hedging & Islamic finance

3 With the prolific growth and increasing sophistication of the Islamic finance industry, there has been a corresponding demand for effective risk management and Shariah compliant means of hedging. Although 'conventional' entities may freely avail themselves of a host of instruments for hedging, there has been some apprehension about doing so within the Islamic finance industry.

4 Contemporary Sharia scholars recognise that there is a legitimate need to manage risk, but many are somewhat circumspect with regards to 'exotic' financial instruments and derivatives because their use could easily descend to speculative profit-seeking – a prohibited activity which entails *gharar* (excessive, unacceptable uncertainty), *maisir* (an element of gambling) and *riba* (illegitimate, usurious gain). Some Shariah scholars opine that the settling of net positions without delivery of, or payment for, an underlying asset could also be in contravention of Shariah law on trade. Thus, traditionally, Islamically-inclined entities had relied on strategies using economic or natural hedges.

Profit rate swaps

5 Nevertheless, developments in Islamic finance have seen the rise in some countries of the 'profit rate swap'. Its use is very much similar to that of an interest rate swap; indeed some may say the difference is only in terminology. However, we would like to point out that its structuring is also different. A profit rate swap makes use of a two-leg 'reciprocal *murabahah*[1]' of a reference commodity. For example, *A* has variable rate obligations, and fixed income. In the first leg, *A* would promise to sell a reference commodity to *B* at a notional principal, and *B* would promise to sell back the commodity to *A* at notional principal plus a fixed profit. In the second leg, *B* would promise to sell a reference commodity to *A* at notional principal, and *A* would promise to sell back the commodity at notional principal plus a floating rate return (i.e. separate individual contracts would subsequently be entered into, at differing prices). Hence, *A* hedges its floating rate obligations. The profit rate swap achieves very much the same objectives as an interest rate swap, in that the sales and repurchases of a reference commodity are meant to manage the cash flow risks related *A*'s variable rate obligations; while its use of an underlying sale contract for a reference commodity is intended to keep it in line with Shariah principles.

6 The Working Group is not entirely clear on whether this type of transaction would be eligible for hedge accounting under the proposals because, as it is currently drafted, the hedged item is a 'reference commodity item' and it is not directly linked to the actual hedge transaction. However, perhaps such transactions should be eligible if they are intended to hedge risk consistent with the entity's risk management strategies.

Future of Islamic derivatives

7 It should be highlighted that the profit rate swap is not universally accepted because some Shariah scholars, particularly in the Gulf jurisdictions, object to resale of the commodity to the party from whom it was originally bought. In jurisdictions where the profit rate swap is deemed acceptable, it has paved the way for exploration into other Islamic derivatives. For example, an Islamic cross-currency swap has been

[1] Murabahah (alternatively, 'murabaha', 'morabaha') is simply a sale at a mark-up. However, in Islamic finance it is often used in conjunction with other contracts and arrangements to achieve financing.

developed, also based on *murabaha*h. There is also discussion on developing structures based on other trade contracts. In March 2010, the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) introduced a standardised master agreement for privately negotiated arrangements. With the forecasted proliferation of Islamic derivatives in future, regulators and Shariah scholars are drafting guidelines to ensure that these products are used exclusively for hedging.

***Comments on IASB Exposure Draft ED/2010/13* Hedge Accounting**

8 The proposals in this ED could potentially be significant to Islamic finance given the inroads made with regards to derivatives and hedging in the industry. However, as derivatives and hedging are relatively new areas in Islamic finance, the issues we have identified are limited and may not be exhaustive. The AOSSG IF WG hopes to conduct further study on the matter, and will inform the IASB of any new findings. The remainder of this letter comprise our responses to questions that are relevant to Islamic finance in ED/2010/13's invitation to comment.

Objective of hedge accounting

9 We agree with the proposed objective of hedge accounting. The objective of the ED to represent the effect of an entity's risk management activities in the financial statements would provide useful information that may not otherwise have been made available to users. Additionally, reflecting the effects of hedging primarily through the statement of comprehensive income assists in clarifying that these transactions are not meant to be income-generating activities of the entity, which is congruent with Shariah views on not using financial instruments and derivatives for speculative trading purposes.

Eligibility of a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss for designation as a hedging instrument

10 We 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. Indeed, we would like the IASB to consider allowing other assets and liabilities as hedging instruments as well, given that they may be involved in an entity's risk management strategy. Some Shariah-compliant hedging strategies may make use of non-derivative financial instruments, especially since many common derivative instruments are not allowed under Shariah principles. Thus, allowing non-derivative instruments could potentially open up hedge accounting to Islamic financial institutions. Therefore, it is appropriate that such items may be recognised as hedging instruments.

Designation as a hedged item an aggregated exposure that is a combination of another exposure and a derivative

11 We understand that under the proposal, an entity is permitted - but not required - to designate as a hedged item an aggregated exposure that is a combination of another

exposure and a derivative. Nevertheless, we are not clear at this point whether Shariah scholars would allow designating as a hedged item an aggregated exposure where one of its components is a derivative; the derivative may need to be considered separately. Thus, an entity under the auspices of a Shariah board may need to seek its advice before electing to use such a designation, despite being allowed to do so under the proposal.

Hedge effectiveness requirements to qualify for hedge accounting

12 We agree with the hedged effectiveness requirements proposed by the exposure draft. The Shariah board of an Islamic financial institution would often require evidence that a hedging transaction is what it purports to be before allowing it to take place. Thus, we expect that the criterion for hedge effectiveness to qualify for hedge accounting would not be in conflict with criteria placed by an Islamic financial institution's Shariah board. Additionally, we welcome the elimination of the '80-125%' effectiveness requirement. As mentioned, there are not many hedging tools available to Islamic entities, and an entity may well have to utilise instruments that, though intended for hedging, may fall short of the previous effectiveness requirement.

Discontinuing hedge accounting for a hedging relationship that still meets the risk management objective and strategy

13 We 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. As mentioned in earlier paragraphs, contemporary Islamic scholars only allow the use of certain derivative items for hedging purposes. Discontinuing hedge accounting for a hedging relationship that fails the hedge effectiveness assessment, but which is still intended by management to be hedging in nature, may erroneously signal to users that the entity is now engaged in a prohibited transaction.

Accounting for value hedges

14 We agree that for a fair value hedge, the gain or loss on the hedging instrument and hedged item should be recognised in other comprehensive income. However, transferring the ineffective portion to profit and loss may confuse users as profit and loss is associated with items which are income in nature. It may create the impression that the entity has used a derivative for speculative trading, which is prohibited by Shariah scholars. To prevent any perception issues, the ineffective portions of the hedging instrument and hedged item would need to be segregated from other profit and loss items for users to more clearly understand the economic effects of the hedging relationships, without overstepping the Shariah guidelines. Some working group members are of the opinion that this could satisfactorily be dealt with by applying paragraph 85 of IAS 1, which is believed to be broad enough to address the classification of ineffective hedges.

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

15 This provision could potentially be useful for Islamic hedging arrangements as we expect most would be based on some form of trade contract, whereby the Islamic financial institution contractually takes delivery of the goods with one contract, and then offsets its exposure with a parallel contract. The contracts could be settled net in cash, using the principle of *muqasah*[2]. In these cases, the trade-based contracts may fall under the normal use scope exception. Allowing entities to elect derivative accounting in normal use circumstances could open up hedge accounting to more Shariah-compliant arrangements.

Conclusion

The use of exotic financial instruments and derivatives in Islamic finance for hedging is in its infancy, and the AOSSG Islamic Finance Working Group will closely monitor its development. We plan to convey to the IASB any findings we may make, and would be honoured to assist the IASB in considering the related accounting issues.

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,

Mohammad Faiz Azmi
Leader of the AOSSG Islamic Finance Working Group

[2] Muqasah means settling through a contra transaction, or off-setting.