Notes to the financial statements
for the financial year ended 31 March 2012
continued

Note 40
Derivative financial instruments

Objectives of holding and issuing derivative financial instruments

The Consolidated Entity is an active price maker in derivatives on interest rates, foreign exchange, commodities and equities. Its objective is to earn profits from the price making spread and from managing the residual exposures on hedged positions. Proprietary position taking is a small part of the Consolidated Entity's trading activities. Risks on derivatives are managed together with all other trading positions in the same market. All trading positions, including derivatives, are marked to fair value daily.

The Consolidated Entity also uses derivatives to hedge banking operations and for asset/liability management. Certain derivative transactions may qualify as cash flow, fair value or net investment in foreign operations hedges, if they meet the appropriate strict hedge criteria outlined in note 1(xi)–Summary of significant accounting policies:

Cash flow hedges: The Consolidated Entity is exposed to volatility in future interest cash flows arising from floating rate issued debt used to fund fixed rate asset positions. The aggregate principal balances and interest cash flows across these portfolios form the basis for identifying the non–trading interest rate risk of the Consolidated Entity, which is hedged with interest rate swaps and cross currency swaps.

At 31 March 2012, the fair value of outstanding derivatives held by the Consolidated Entity and designated as cash flow hedges was $51 million negative value (2011: $174 million negative value).

During the year the Consolidated Entity recognised $4 million gains (2011: $nil) in the income statement due to hedge ineffectiveness on cash flow hedges.

Fair value hedges: The Consolidated Entity's fair value hedges consist of:

– interest rate swaps used to hedge against changes in the fair value of fixed rate assets and liabilities as a result of movements in benchmark interest rates; and
– foreign exchange forward contracts used to hedge against changes in the fair value of foreign denominated equity instruments as a result of movements in market foreign exchange rates.

As at 31 March 2012, the fair value of outstanding derivatives held by the Consolidated Entity and designated as fair value hedges was $395 million positive value (2011: $486 million positive value).

During the year fair value losses on the hedging instruments of $91 million have been recognised (2011: $385 million gains), offset by $88 million (2011: $375 million losses) of gains on the hedged item.

Net investment in foreign operations hedges: The Consolidated Entity has applied net investment hedging for foreign exchange risk arising from its non–core foreign operations.

At 31 March 2012, the fair value of outstanding derivatives held by the Consolidated Entity and designated as net investment in foreign operations hedges was $14 million negative value (2011: $69 million positive value). During the year the Consolidated Entity recognised $2 million gains (2011: $nil) in the income statement due to hedge ineffectiveness on net investment hedges.

The types of contracts which the Consolidated Entity trades and uses for hedging purposes are detailed below:

Futures: Futures contracts provide the holder with the obligation to buy a specified financial instrument or commodity at a fixed price and fixed date in the future. Contracts may be closed early via cash settlement. Futures contracts are exchange traded.

Forwards and forward rate agreements: Forward contracts, which resemble futures contracts, are an agreement between two parties that a financial instrument or commodity will be traded at a fixed price and fixed date in the future. A forward rate agreement provides for two parties to exchange interest rate differentials based on an underlying principal amount at a fixed date in the future.

Swaps: Swap transactions provide for two parties to swap a series of cash flows in relation to an underlying principal amount, usually to exchange a fixed interest rate for a floating interest rate. Cross–currency swaps provide a tool for two parties to manage risk arising from movements in exchange rates.

Options: Option contracts provide the holder the right to buy or sell financial instruments or commodities at a fixed price over an agreed period or on a fixed date. The contract does not oblige the holder to buy or sell, however the writer must perform if the holder exercises the rights pertaining to the option.