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28 November 2014
Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Hans,

IASB Discussion Paper DP/2014/1
Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

The Australian Accounting Standards Board is pleased to submit its comments on the Discussion Paper (DP) *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* to the International Accounting Standards Board. In formulating its views, the AASB sought and considered the views of its Australian constituents, through both holding Roundtables and publishing an Invitation to Comment (ITC 31). The comment letters received are published on the AASB's website.

The AASB's most significant comments on the DP are noted in this letter for your consideration, and expanded on further in the attached pages, together with responses to the other specific questions.

The stated objective of the DP is as follows:

> *The objective of this project is to develop an approach to better reflect entities' dynamic risk management activities in their financial statements and to enhance the usefulness of the financial information to help users of financial statements to better understand such activities. Operational feasibility has also been one of the considerations that has been evaluated when exploring an accounting approach for dynamic risk management.*

The AASB acknowledges that financial institutions have operational difficulties in hedge accounting for open portfolios and that this is largely a consequence of applying the current hedge accounting requirements to dynamically managed portfolios. The IASB's objective in issuing this DP was to work on that issue. However, the AASB considers that the IASB has shifted the scope of the project from the operational difficulties of hedge accounting for open portfolios by financial institutions, to accounting for dynamic risk management.

The AASB's view is that an objective of accounting for dynamic risk management significantly broadens the scope of the project and opens up some fundamental conceptual accounting questions. The AASB also notes that the IASB's rationale for broadening the scope to risk management activities more generally has not been clearly articulated.

It appears that the DP has combined two objectives: a standards level project on macro hedge accounting and a research project on accounting for dynamic risk management activities. In order to address these separate objectives, the AASB recommends that the IASB formally separates these as two distinct projects:

1. a Standards-level project on targeting improvements to hedge accounting of interest rate risk of open portfolios as a first priority; and

2. a Research project on the topic of accounting for risk management activities, perhaps as part of its on-going work on the *Conceptual Framework*.

A consideration of the fundamental concepts explored in the DP (eg. behavioralisation, the equity model book and pipeline transactions) could have a substantive impact on the recognition and measurement bases adopted in IFRS. In the AASB's view, such conceptual matters would be better dealt with in the IASB's research programme. Furthermore, the AASB recommends that, if the IASB continues to research accounting for risk management, it should consider a range of approaches, rather than just the portfolio revaluation approach (PRA).

However, in considering the DP, we have identified the following areas which we consider could potentially lead to improvements to the existing hedge accounting of interest rate risk of open portfolios:

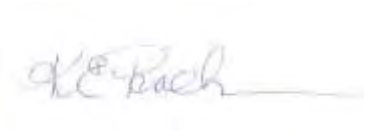
- permitting hedge accounting of an interest rate risk component of core demand deposits (refer to our response to question 9);
- improving disclosure about proxy hedging (refer to our response to question 1); and
- improving disclosures of risk management activities (refer to our response to question 1).

The AASB notes that the hedge accounting requirements issued in IFRS 9 *Financial Instruments* in December 2013 have yet to be implemented in practice. The AASB recommends that, before committing significant resources to a research project, the IASB considers whether further improvements are actually needed, given that some of the challenges posed by the IAS 39 *Financial Instruments: Recognition and Measurement* hedge accounting requirements may have already been sufficiently addressed by IFRS 9, particularly for non-financial institutions.

Any decision by the IASB to proceed to a standard-setting project and/or research project arising out of the DP should be made in the context of its periodic agenda consultation, so that competing priorities can be properly considered.

If you have queries regarding any matters in this submission, please contact Sue Lightfoot (slightfoot@aasb.gov.au).

Yours sincerely



Kris Peach
Chair

Specific AASB comments on IASB Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*

Specific Questions for Comment

1 The AASB provides the following comments on the IASB's specific questions set out in the Discussion Paper.

Q1	**Need for an accounting approach for dynamic risk management**
Do you think that there is a need for a specific accounting approach to represent dynamic risk management in entities' financial statements? Why or why not?	

2 The AASB is not convinced that a specific accounting approach to represent broad dynamic risk management in entities' financial statements is urgently needed.

3 The AASB acknowledges that the hedge accounting requirements in IAS 39 are highly restrictive and do not allow entities, in all cases, to easily reflect the underlying economic interactions between particular transactions. This is particularly so in the case of open portfolios and derivatives designed to manage risks in those portfolios, which do not readily fit into the micro hedge accounting models in IAS 39.

4 However, feedback from financial institution constituents in Australia has not indicated significant concerns about the accounting outcomes from current IAS 39 requirements, in the sense that the profit or loss volatility from accounting for risk management activities is acceptably close to a risk management view. Although the current operational burden is significant, in the main the costs of implementing systems to apply hedge accounting have been incurred and their maintenance is 'business as usual'.

5 Notwithstanding the above, the AASB has concerns about the extent of proxy hedging used in practice (ie. designations of hedging relationships that do not exactly represent an entity's actual risk management). In principle, the AASB supports removing the need for proxy hedging; however, careful consideration would need to be given to the relative costs to preparers in changing systems and processes versus the benefits to users of improved information.

6 A more cost effective way to improve information for users may be to require more detail concerning the hedge designations and cases where proxy hedging is employed, if this is material to an entity's results. The AASB encourages the IASB to also consider its work on its Principles of Disclosure project in deliberating on what modifications to existing disclosure requirements would improve information for users, subject to appropriate cost/benefit considerations.

7 Constituents have raised a concern that the implementation guidance in paragraphs IG F.6.1 to F.6.3 in relation to macro cash flow hedge accounting has not been carried forward to IFRS 9. Although it is stated in paragraphs BC 93-95 of IFRS 9 that this did not mean the IASB had rejected the guidance, it raises a

question of the IASB's intention concerning this guidance and whether future changes to macro cash flow hedge accounting will be made.

8 Although the AASB does not consider that there is an urgent need to represent dynamic risk management in entities' financial statements, the AASB supports the IASB in exploring more broadly the aspects of risk management (dynamic or otherwise) that should be incorporated into financial reporting. The AASB recommends that the IASB undertakes further research on this topic but with reference to the qualitative characteristics of financial statements in the *Framework*. The AASB's view is that this research would be best considered in the IASB's current work on revising the *Framework* as the extent to which accounting standards should include requirements about risk management is, in part, an issue about the scope of financial reporting. Such research should be a separate project from the hedge accounting project.

9 The AASB notes that IASB members have acknowledged that the approach outlined in the DP, the PRA, represents a radically new approach. The AASB encourages the IASB to also explore whether alternative accounting approaches could achieve the objective of improving the reporting of dynamic risk management activities (and perhaps risk management more generally).

10 The AASB also recommends that the IASB considers the existing reporting for regulatory monitoring in different jurisdictions. For example in Australia the local banking regulator, the Australian Prudential Regulation Authority (APRA) requires a capital charge for interest rate risk in the banking book calculated under APS 117[1] *Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)*. This applies to those banks applying the Advanced Approach in the Basel III framework who must also make public disclosure in accordance with APS 330[2] *Public Disclosure*. The AASB acknowledges the different objectives of financial reporting and regulatory reporting and recommends that the IASB considers whether disclosure of such information is necessary for financial reporting purposes, or whether disclosure to regulatory bodies is sufficient.

Q2 Current difficulties in representing dynamic risk management in entities' financial statements

(a) Do you think that this DP has correctly identified the main issues that entities currently face when applying the current hedge accounting requirements to dynamic risk management? Why or why not? If not, what additional issues would the IASB need to consider when developing an accounting approach for dynamic risk management?

(b) Do you think that the PRA would address the issues identified? Why or why not?

11 The AASB agrees that the DP has correctly identified the main issues.

1 http://www.apra.gov.au/adi/PrudentialFramework/Documents/Basel-III-Prudential-Standard-APS-117-(January-2013).pdf

2 http://www.apra.gov.au/adi/PrudentialFramework/Documents/APS-330-June-2013.pdf

12 However, the AASB does not consider that the PRA addresses the issues identified. In its Supplementary Paper to AASB's Submission on the IASB's Discussion Paper DP/2013/1 *A Review of the Conceptual Framework for Financial Reporting*, the AASB noted in paragraph S221 the following:

The AASB considers that, conceptually:

remeasuring recognised assets and liabilities on a consistent basis (with full remeasurement of each asset and liability) would faithfully represent the economic events affecting those assets and liabilities each period; and

instead of applying hedge accounting, an entity should disclose by way of note the relationships between items, including relationships between unrecognised and recognised elements.

13 Notwithstanding the above, which the AASB acknowledges is 'aspirational', the AASB notes that the issues the DP seeks to address predominantly arise from:

(a) the use of a mixed measurement model (including the requirement to account for derivatives at fair value through profit or loss) which gives rise to the need for hedge accounting;

(b) identification of the unit of account in accounting for open portfolios; and

(c) the requirement to account for financial instruments based on their contractual terms, rather than their expected behaviour.

(a) Use of a mixed measurement model

14 In the PRA, although derivatives are required to be measured at full fair value, the other items in scope are only remeasured for the 'managed risk'. The PRA, therefore, retains a mixed measurement approach. In its September 2014 Board meeting, the IASB tentatively decided to retain a mixed measurement model in the *Framework*.

15 Assets and liabilities are usually measured in full, rather than selecting only certain components to remeasure. It is not clear why 'management' of a particular risk would trigger its recognition and measurement whereas other risks would not be recognised. Risk management activities are very broad: they may be active or passive and an entity may seek to increase risk rather than reduce risk. Risk is considered by many to be multidimensional and focussing on particular components may not provide a full depiction of an entity's exposure.

16 Furthermore, the remeasurement of items within scope of the PRA appears to conflict with some of the decisions made by the IASB in finalising IFRS 9. For example, financial assets with 'basic' features that an entity is holding for collection of contractual cash flows would meet the criteria in IFRS 9 to be at measured at amortised cost. In contrast, such financial assets would be remeasured for the managed risk if in scope of the PRA.

17 The AASB encourages the IASB to further clarify the conceptual rationale for a mixed measurement model, including its application to derivatives. However, the

AASB notes that it supports the IASB's decision to retain the requirement that derivatives are measured at fair value.

18 The AASB considers that a significant amount of research would be necessary before it could be determined that remeasurement of components by managed risk is the optimal basis for an accounting model and that any additional benefits of this approach would outweigh the additional costs.

19 The DP considers extending application of the PRA to items beyond financial instruments. Further challenges exist when considering remeasurement based on risk management for non-financial items, since risk may exist across a number of processes in an entity's operations. For example, exposure to commodity price risk in the extractives industries ranges from exploration, development of unextracted reserves, extraction, through production to sale.

20 A further concern arises when considering remeasurement of a broader range of items. Many financial instruments may be highly reliably measured using quoted prices (ie. 'level 1' as defined in IFRS 13 *Fair Value Measurement*), or using inputs that are directly or indirectly observable (ie. 'level 2'). However, many non-financial items can often only be fair valued by reference to unobservable inputs (ie. a 'level 3' approach). An accounting model which combines remeasurement of items of different input levels may be at risk of being misleading unless sufficient disaggregation and/or disclosure is provided to explain the nature of the remeasurement. Some may be of the view that remeasurement of 'level 3' items is less useful than other measurement approaches required by existing standards (for example, lower of cost and net realisable value) and that disclosure would be more appropriate.

(b) Application of the unit of account

21 In the *Conceptual Framework* DP/2013/1 the IASB's preliminary view was that the unit of account will normally be decided when it develops or revises particular Standards and, in selecting a unit of account, it should consider the qualitative characteristics of useful information. In its redeliberations in June 2014 the IASB tentatively decided that:

(a) determining the unit of account is a Standards-level decision;

(b) the *Conceptual Framework* should describe possible units of account; and

(c) the *Conceptual Framework* should include a list of factors to consider when determining the unit of account but should not give a priority ranking of the factors.

22 The AASB's view, as set out in paragraph A7 of its Submission on DP/2013/1 is that the 'unit of account' issue would need standards-level guidance, but that guidance should be developed from concepts.

23 The discussion in the *Accounting for Dynamic Risk Management* DP/2014/1 does not explicitly consider the unit of account issue. The AASB encourages the IASB to further develop its thinking on the topic as it considers that unit of account is particularly relevant to open portfolios.

(c) Accounting for financial instruments based on their contractual terms, rather than their expected behaviour

24 Comments concerning accounting on an expected behaviour basis rather than a contractual basis are given in response to questions 4, 5, 6 and 9 below.

Q3 Dynamic risk management

Do you think that the description of dynamic risk management in paragraphs 2.1.1–2.1.2 is accurate and complete? Why or why not? If not, what changes do you suggest, and why?

25 In the context of interest rate risk management, feedback from Australian constituents from financial institutions indicates that the description in the DP, at a high level, is appropriate. In particular, the feedback acknowledged that risk management in financial institutions is dynamic and there are substantial challenges in accounting for open portfolios. However, at a more detailed level, each entity approaches risk management according to its own objectives and depending on its own particular circumstances.

26 The AASB also notes that although the DP does not attempt to describe dynamic risk management activities for other than interest rate risk, nor for non-financial institutions, this is consistent with the IASB's objective of addressing operational difficulties of accounting for open portfolios by financial institutions.

27 In respect of the broader question of whether the DP accurately describes dynamic risk management, the AASB considers that a more relevant question to consider is the extent to which risk management activities should be reflected in accounting. The AASB notes that paragraph 4.1.2 of IFRS 9 concerning classification of financial assets refers to the entity's business model for managing the financial assets. As noted in paragraph 1.22 of the DP, the IASB rejected the notion that dynamic risk management is a distinct business model. Instead the IASB considered an approach is needed that is specifically targeted towards the assets and liabilities that are managed dynamically for risk management purposes. The AASB encourages the IASB to more fully explore the rationale for this, taking into account the objective of financial reporting and its work on the *Framework*.

Q4(a) Pipeline transactions

Do you think that pipeline transactions should be included in the PRA if they are considered by an entity as part of its dynamic risk management? Why or why not? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the *Conceptual Framework for Financial Reporting (the Conceptual Framework*).

28 The AASB does not support recognition of items that do not meet the definition of assets or liabilities according to the *Framework*. Pipeline transactions as described in the DP do not appear to meet the definition of assets or liabilities; therefore, alternative means of providing information about these economic phenomena, such as disclosure, would be preferable.

Q4(b) Equity Model Book

Do you think that EMB should be included in the PRA if it is considered by an entity as part of its dynamic risk management? Why or why not? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the *Conceptual Framework*.

29 Australian banking constituents indicated that they do have equity model books. As noted in paragraph A1.12 of the DP, the revaluation adjustment for EMB (being a targeted base return to equity holders) arises from items that do not satisfy the definition of assets or liabilities under the *Conceptual Framework* as it is. For this reason, the AASB does not support requiring or permitting the recognition of amounts relating to the EMB.

Q4(c) Behaviouralisation

For the purposes of applying the PRA, should the cash flows be based on a behaviouralised rather than on a contractual basis (for example, after considering prepayment expectations), when the risk is managed on a behaviouralised basis? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the *Conceptual Framework*

30 The AASB would support the IASB in considering how to improve accounting for items whose behaviour may differ from their contractual terms if this were part of a broader exercise to consider current value measurement of liabilities. Although introducing forecast behaviour into measurement increases the need for management judgement, current value measurement bases more generally also require judgement. Any such exercise should be conducted within the conceptual framework project, not on a piecemeal basis and as an adjunct to that project.

Q5 Prepayment risk

When risk management instruments with optionality are used to manage prepayment risk as part of dynamic risk management, how do you think the PRA should consider this dynamic risk management activity? Please explain your reasons.

31 IFRS 9 permits options to be designated in hedge accounting relationships of one-sided risks. If the objective of the PRA is to account for risk mitigation, one-sided risk mitigation should be reflected in remeasuring the risk mitigated items for one-sided risk only. However as an objective of the PRA is to reduce operational complexity; remeasuring for one-sided managed risk in a portfolio may not achieve this.

32 Conceptually, the AASB prefers that the portfolio is remeasured for the managed risk both up and down as this reflects the actual change in value due to the risk exposure, independent of the nature of the instruments used for risk mitigation.

Q6 Recognition of changes in customer behaviour

Do you think that the impact of changes in past assumptions of customer behaviour captured in the cash flow profile of behaviouralised portfolios should be recognised in profit or loss through the application of the PRA when and to the extent they occur? Why or why not?

33 The AASB agrees that the impact of changes in past assumptions of customer behaviour captured in the cash flow profile of behaviouralised portfolios should be recognised in profit or loss through the application of the PRA when and to the extent they occur. This is because the change in estimate is a current period change that should be reflected immediately.

Q7 Bottom layers and proportions of managed exposures

If a bottom layer or a proportion approach is taken for dynamic risk management purposes, do you think that it should be permitted or required within the PRA? Why or why not? If yes, how would you suggest overcoming the conceptual and operational difficulties identified? Please explain your reasons.

34 Using a bottom layer approach and/or proportions of managed exposures would seem to significantly increase the complexity of the PRA. However if the PRA scope is based on risk mitigation only, there would be a need to determine which part of the exposure should be remeasured. The bottom layer approach could be used as a method to stratify a portfolio into components with different probabilities of repayment. However, the selection of the bottom layer may be difficult to determine and comparability between entities would be difficult to maintain. Additional guidance would need to be provided to help ensure that bottom layer accounting was consistent between portfolios and entities.

Q8 Risk limits

Do you think that risk limits should be reflected in the application of the PRA? Why or why not?

35 The AASB does not support the use of risk limits in accounting. The tolerance or appetite of an entity for risk does not appear to be relevant in determining the appropriate representation of the underlying economic transactions in a given period.

Q9 Core demand deposits

(a) Do you think that core demand deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA if that is how an entity would consider them for dynamic risk management purposes? Why or why not?

(b) Do you think that guidance would be necessary for entities to determine the behaviouralised profile of core demand deposits? Why or why not?

36 The AASB would only support consideration of accounting for core demand deposits on a fully behaviouralised basis if it were part of a wider exercise to consider current value measurement of liabilities. The AASB notes that application of behaviouralisation to core demand deposits would involve a fundamental shift of thinking about measurement, and would need to include consideration of the implications of overriding paragraph 47 of IFRS 13 which requires the fair value of a financial liability with a demand feature (eg. a demand deposit) to be no less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

37 However, the AASB considers that permitting the designation of the interest rate risk component of core demand deposits as an eligible hedged risk could be considered in the context of IFRS 9 hedge accounting. If components of core demand deposits were eligible for designation as hedged items, the same restrictions applicable to other hedged components should apply, including the requirement in paragraph 6.3.7 of IFRS 9 that the risk component needs to be separately identifiable and reliably measurable.

38 If hedge accounting of core demand deposits were permitted, some guidance may be useful for entities that do not already have systems and processes in place to measure the component; however, as practice already exists any guidance should consider the merits of existing methodologies which achieve the IASB's aim.

Q10 Sub-benchmark rate managed risk instruments

(a) Do you think that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if it is consistent with an entity's dynamic risk management approach (ie Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (ie Approaches 1 and 2 in Section 3.10) for calculating the revaluation adjustment for sub-benchmark instruments provide an appropriate reflection of the risk attached to sub-benchmark instruments? Why or why not?

(b) If sub-benchmark variable interest rate financial instruments have an embedded floor that is not included in dynamic risk management because it remains with the business unit, do you think that it is appropriate not to reflect the floor within the managed portfolio? Why or why not?

39 If the objective of the PRA is to reflect risk management, to the extent possible within the bounds of the *Framework*, instruments should be accounted for on a risk

management basis. Therefore, if the basis of accounting is risk management, an embedded floor which is not 'risk managed' should not be included in the PRA.

40 However, as noted above, the AASB considers that further research is necessary before it could be established whether, and to what extent, it would be desirable for accounting to be based on risk management activities.

Q11 Revaluation of the managed exposures

(a) Do you think that the revaluation calculations outlined in this Section provide a faithful representation of dynamic risk management? Why or why not?

(b) When the dynamic risk management objective is to manage net interest income with respect to the funding curve of a bank, do you think that it is appropriate for the managed risk to be the funding rate? Why or why not? If not, what changes do you suggest, and why?

41 The AASB agrees that the revaluation calculations in the DP are consistent with revaluation of the managed risk only.

42 The AASB's view is that the benchmark rate is the appropriate rate to use to determine the managed risk. This would be consistent with paragraph 6.3.7(a) of IFRS 9 which requires that any hedged risk component is 'separately identifiable and reliably measurable'. The funding rate may be a suitable practical expedient in some circumstances.

Q12 Transfer pricing transactions

(a) Do you think that transfer pricing transactions would provide a good representation of the managed risk in the managed portfolio for the purposes of applying the PRA? To what extent do you think that the risk transferred to ALM via transfer pricing is representative of the risk that exists in the managed portfolio (see paragraphs 4.2.23–4.2.24)?

(b) If the managed risk is a funding rate and is represented via transfer pricing transactions, which of the approaches discussed in paragraph 4.2.21 do you think provides the most faithful representation of dynamic risk management? If you consider none of the approaches to be appropriate, what alternatives do you suggest? In your answer please consider both representational faithfulness and operational feasibility.

(c) Do you think restrictions are required on the eligibility of the indexes and spreads that can be used in transfer pricing as a basis for applying the PRA? Why or why not? If not, what changes do you recommend, and why?

(d) If transfer pricing were to be used as a practical expedient, how would you resolve the issues identified in paragraphs 4.3.1–4.3.4 concerning ongoing linkage?

43 Based on the feedback from constituents, in the context of the PRA, using an internal transfer price to identify a managed risk might have merit as a starting

point. However, although internal pricing may be based on a core risk free curve, it may then be adjusted (for example for long term funding, incentives or disincentives) and the adjustments may not be consistent between entities.

44 To remove the effect of entity specific adjustments to transfer prices, restrictions would likely be necessary in order to adequately represent the managed risk. Without restrictions there is potential for inadvertent distortion of results as well as manipulation of earnings.

45 Outside of banking, the use of internal pricing is not common. Therefore alternative approaches may need to be developed to identify managed risks for other scenarios.

Q13 Selection of the funding index

(a) Do you think that it is acceptable to identify a single funding index for all managed portfolios if funding is based on more than one funding index? Why or why not? If yes, please explain the circumstances under which this would be appropriate.

(b) Do you think that criteria for selecting a suitable funding index or indexes are necessary? Why or why not? If yes, what would those criteria be, and why?

Q14 Pricing index

(a) Please provide one or more example(s) of dynamic risk management undertaken for portfolios with respect to a pricing index.

(b) How is the pricing index determined for these portfolios? Do you think that this pricing index would be an appropriate basis for applying the PRA if used in dynamic risk management? Why or why not? If not, what criteria should be required? Please explain your reasons.

(c) Do you think that the application of the PRA would provide useful information about these dynamic risk management activities when the pricing index is used in dynamic risk management? Why or why not?

46 In the context of the PRA, the funding index or pricing index used should be consistent with risk management. In many cases we expect that would be a benchmark rate. We envisage that it may not be appropriate to identify a single funding index as the managed risk for all managed portfolios if funding is based on more than one funding index.

47 To ensure comparability and consistency of approach between entities we expect that additional criteria and guidance would be necessary.

Q15 Scope

(a) Do you think that the PRA should be applied to all managed portfolios included in an entity's dynamic risk management (ie a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (ie a scope focused on risk mitigation)?

Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

(b) Please provide comments on the usefulness of the information that would result from the application of the PRA under each scope alternative. Do you think that a combination of the PRA limited to risk mitigation and the hedge accounting requirements in IFRS 9 would provide a faithful representation of dynamic risk management? Why or why not?

(c) Please provide comments on the operational feasibility of applying the PRA for each of the scope alternatives. In the case of a scope focused on risk mitigation, how could the need for frequent changes to the identified hedged sub-portfolio and/or proportion be accommodated?

(d) Would the answers provided in questions (a)–(c) change when considering risks other than interest rate risk (for example, commodity price risk, FX risk)? If yes, how would those answers change, and why? If not, why not?

48 Refer to the response to question 1.

Q16 Mandatory or optional application of the PRA

(a) Do you think that the application of the PRA should be mandatory if the scope of application of the PRA were focused on dynamic risk management? Why or why not?

(b) Do you think that the application of the PRA should be mandatory if the scope of the application of the PRA were focused on risk mitigation? Why or why not?

49 The AASB's preference is that the IASB should prioritise targeting improvements to the existing hedge accounting of interest rate risk of open portfolios. The scope should therefore be based on risk mitigation and application should be elective, consistent with IAS 39 / IFRS 9 hedge accounting.

50 The AASB's view is that further research, perhaps in the context of the *Framework*, would be needed before pursuing a risk management scope. If the objective were to portray risk management activities comprehensively, the scope should be broader and should include items subject to the risk management activities as defined. The IASB would therefore need to clearly define the boundaries and how an entity would determine the criteria for inclusion or exclusion. Consideration would also need to be given to how an approach based on a risk management scope would interact with other accounting standards.

51 One of the concerns around accounting for financial instruments is the 'patchwork' of different accounting approaches. Introducing the PRA based on either a risk mitigation or risk management scope, alongside the existing requirements, would further add to this patchwork. The IASB should carefully consider the benefit of introducing yet another approach, in addition to the existing classification categories of financial instruments, the hedge accounting overlay and the choice to apply the fair value option.

Q17 Other eligibility criteria

(a) Do you think that if the scope of the application of the PRA were focused on dynamic risk management, then no additional criterion would be required to qualify for applying the PRA? Why or why not?

(i) Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.

(ii) If the application of the PRA were optional, but with a focus on dynamic risk management, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

(b) Do you think that if the scope of the application of the PRA were to be focused on risk mitigation, additional eligibility criteria would be needed regarding what is considered as risk mitigation through hedging under dynamic risk management? Why or why not? If your answer is yes, please explain what eligibility criteria you would suggest and, why.

(i) Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.

(ii) If the application of the PRA were optional, but with a focus on risk mitigation, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

52 The AASB recommends that, if the IASB proceeds with the PRA, additional criteria be included for items to qualify for its application. That would be the case regardless of whether the PRA were based on a risk management or a risk mitigation scope and also whether or not it would be mandatory.

53 The AASB's view is that if the PRA was based on a risk mitigation scope, the additional criteria might be similar to existing hedge accounting requirements. It might include, for example, designation and documentation concerning identification of the designated items, identification of the managed risk (how it is determined and measured), and how the entity will assess whether the risk mitigation objective is achieved. Criteria would also be required to specify which items are eligible for inclusion in scope and how the accounting would apply, including on entry and exit from the PRA scope.

54 The AASB's view is that further research would be necessary before the IASB could determine what criteria would be required for application of the PRA on a risk management based scope.

Q18 Presentation alternatives

(a) Which presentation alternative would you prefer in the statement of financial position, and why?

(b) Which presentation alternative would you prefer in the statement of comprehensive income, and why?

(c) Please provide details of any alternative presentation in the statement of financial position and/or in the statement of comprehensive income that you think would result in a better representation of dynamic risk management activities. Please explain why you prefer this presentation taking into consideration the usefulness of the information and operational feasibility.

55 The DP sets out the following presentation alternatives:

Statement of financial position:

(a) line-by-line gross up;

(b) separate lines for aggregate adjustments to assets and liabilities; and

(c) single net line item.

Statement of comprehensive income

(a) actual net interest presentation; and

(b) stable net interest income presentation.

56 The AASB considers that further research into the PRA is necessary before secondary questions such as presentation and disclosure can be fully considered.

57 However, as a preliminary view, the AASB prefers a line-by-line gross up in the statement of financial position and the actual net interest presentation in the statement of comprehensive income. Line-by-line gross up would provide greater transparency of the accounting adjustments made to items on the balance sheet; however, the benefit of this would likely be significantly greater than aggregate or single (net) line reporting. The AASB cannot see a conceptual basis for permitting reporting of a stable net interest income and strongly prefers a presentation of the actual net interest.

Q19 Presentation of internal derivatives

(a) If an entity uses internal derivatives as part of its dynamic risk management, the DP considers whether they should be eligible for inclusion in the application of the PRA. This would lead to a gross presentation of internal derivatives in the statement of comprehensive income. Do you think that a gross presentation enhances the usefulness of information provided on an entity's dynamic risk management and trading activities? Why or why not?

(b) Do you think that the described treatment of internal derivatives enhances the operational feasibility of the PRA? Why or why not?

(c)	Do you think that additional conditions should be required in order for internal derivatives to be included in the application of the PRA? If yes, which ones, and why?

58 The AASB does not support presentation of internal transactions which eliminate on consolidation because they would not, in concept, be revenues, expenses, assets and liabilities of the entity. In addition, a grossed up presentation seems likely to confuse users and detract from the presentation in financial reporting of the entity as a whole.

Q20 Disclosures

(a) Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views.

(b) If you think that an identified theme would not provide useful information, please identify that theme and explain why.

(c) What additional disclosures, if any, do you think would result in useful information about an entity's dynamic risk management? Please explain why you think these disclosures would be useful.

59 The AASB considers it is premature to determine the appropriate disclosures before determining the relevant recognition and measurement approach. However, if the PRA were to be applied as described in the DP the four themes appear reasonable.

Q21 Scope of disclosures

(a) Do you think that the scope of the disclosures should be the same as the scope of the application of the PRA? Why or why not?

(b) If you do not think that the scope of the disclosures should be the same as the scope of the application of the PRA, what do you think would be an appropriate scope for the disclosures, and why?

60 At a minimum the scope of the disclosures should be the scope of the PRA, but the IASB should give consideration to requiring information about the entity's risks as a whole, not just activities subject to dynamic risk management.

61 The AASB encourages the IASB to be mindful of the work in its Principles of Disclosure project when developing new disclosure requirements.

Q22 Date of inclusion of exposures in a managed portfolio

Do you think that the PRA should allow for the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract? Why or why not?

(a) If yes, under which circumstances do you think it would be appropriate, and why?

(b) How would you propose to account for any non-zero Day 1 revaluations? Please explain your reasons and comment on any operational implications.

Q23 Removal of exposures from a managed portfolio

(a) Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?

(b) Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from a managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?

(c) If exposures are removed from a managed portfolio prior to maturity, how would you propose to account for the recognised revaluation adjustment, and why? Please explain your reasons, including commenting on the usefulness of information provided to users of financial statements.

62 In the context of the PRA, if the objective of the approach is to reflect risk management then inclusion and/or exclusion of items would be expected to follow the risk management activities.

63 However, to the extent that a portfolio is within scope of the PRA, the AASB's view is that exposures should generally be included in the PRA when an entity first becomes party to a contract and as a general principle, the AASB thinks that exposures should remain in the PRA until derecognition.

64 However, consideration could be given to either prohibiting removal, similar to the fair value option, or restricting removal of exposures in a similar manner to discontinuing hedge accounting in paragraph B6.5.23 (a) of IFRS 9 [if the exposure still meets the risk management objective on the basis of which it qualified for hedge accounting (ie. the entity still pursues that risk management objective)].

65 The AASB thinks that revaluations should be prospective only; therefore, day-one revaluations should not arise.

66 If exposures are removed from the PRA, the valuation adjustment could be amortised over the instrument's remaining term. There is likely to be significant tracking needed if instruments are permitted to be removed.

Q24 Dynamic risk management of foreign currency instruments

(a) Do you think that it is possible to apply the PRA to the dynamic risk management of FX risk in conjunction with interest rate risk that is being dynamically managed?

(b) Please provide an overview of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not.

67 If the IASB wishes to make a radical change to the accounting for foreign exchange, the interaction of any new approach with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and existing hedge accounting requirements would need to be

considered. For example, considerations might include application of the functional currency approach, accounting for net investments in foreign operations (and hedging of those investments). Although it is a relatively old standard, the AASB does not see the need for the IASB to revisit IAS 21, but supports the IASB in considering the topic as part of its research program.

Q25 Application of the PRA to other risks

(a) Should the PRA be available for dynamic risk management other than banks' dynamic interest rate risk management? Why or why not? If yes, for which additional fact patterns do you think it would be appropriate? Please explain your fact patterns.

(b) For each fact pattern in (a), please explain whether and how the PRA could be applied and whether it would provide useful information about dynamic risk management in entities' financial statements.

68 Conceptually, the AASB considers that the nature of the risk should not be the determinant of an accounting treatment. However, the implications of basing accounting on risk management activities are yet to be fully researched. Although we support the IASB in developing its thinking for a cohesive accounting approach based on dynamic risk management, we consider that research of this nature would be more appropriately tackled at the conceptual framework level. This is because a number of issues that may surface are pervasive to financial reporting, such as the objective of financial reporting, the scope of financial reporting, unit of account and selection of measurement bases.

69 Therefore, although the AASB supports the IASB in thinking broadly about accounting for risks and risk management activities, we encourage the IASB to undertake research into additional fact patterns, beyond interest rate risk management in a banking context, before reaching any conclusions. The AASB thinks that fact patterns from industries such as insurance, energy and extractives could be explored in this regard, given the prevalence of risk management of portfolios in the insurance industry and commodity-price risk management in the energy and extractives industries.

Q26 PRA through OCI

Do you think that an approach incorporating the use of OCI in the manner described in paragraphs 9.1–9.8 should be considered? Why or why not? If you think the use of OCI should be incorporated in the PRA, how could the conceptual and practical difficulties identified with this alternative approach be overcome?

70 The AASB does not support the IASB increasing the use of OCI until further progress is made in the *Framework* project concerning the basis for using OCI. However, the AASB would support the IASB in exploring opportunities to improve the existing cash flow hedge accounting model in IFRS 9 for open portfolios.

71 As stated in paragraph S213 of its Supplementary Paper to its Submission on DP/2013/1 the AASB considers that, rather than adopting a binary classification of

economic ('comprehensive') income, the IASB should develop principles for a multi-faceted disaggregation of economic income that facilitates classifying items of economic income (supported by disclosures) according to their different implications for predicting the amount, timing, uncertainty and velocity of future cash flows. In making these predictions, users need information about the volume, direction, pace of change, variability and predictability of changes in the entity's economic resources and claims on the entity's economic resources. In this regard, the distinction between profit or loss and OCI, if made at all, should be a matter of sub-classification of items recognised once (and only once) in the statement of comprehensive income.