Angus Thomson
Acting Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

via email: standard@aasb.gov.au

22 October 2014

Dear Angus

Re: Invitation to Comment on IASB DP/2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*

I am enclosing a copy of PricewatehouseCoopers' response to the International Accounting Standards Board's Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (ITC 31).

PwC very much appreciated the opportunity to participate in the AASB's Round Tables on this topic. They helped both us and our key banking and other clients understand, consider and develop a point of view on the myriad of issues raised in DP and enabled us to contribute to our global submission.

The attached letter reflects the views of the PricewaterhouseCoopers (PwC) network of firms and as such includes our own comments on the matters raised. PwC refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

I would welcome the opportunity to discuss our firm's views at your convenience. Please contact me on (02) 8266 4664 if you would like to discuss our comments further.

Yours sincerely,

Paul Brunner
Partner
PricewaterhouseCoopers

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International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

17 October 2014

Dear Sir/Madam

Discussion Paper: Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging (the 'Discussion Paper')

We are responding to your invitation to comment on the Discussion Paper on behalf of PricewaterhouseCoopers. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of those firms who commented on the Discussion Paper. 'PricewaterhouseCoopers' refer to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We support the Board's effort to address the accounting for risk management of open portfolios. We welcome the Discussion Paper, since it is a positive step forward in identifying some of the challenging issues in the accounting for risk management of open portfolios and we support the development of an accounting model to address these issues. Entities currently face significant challenges trying to accommodate these types of risk management activities in the existing hedge accounting requirements under IAS 39 and IFRS 9.

However, we do not support an accounting model with a scope focused on Dynamic Risk Management as explored in the Discussion Paper. We believe that approach would result in the revaluation of all net open risk positions, regardless of the extent to which derivative instruments have been used to mitigate the managed risk. This goes far beyond the objective of hedge accounting, that is, to minimise the accounting mismatch in the income statement between the risk management instruments and the measurement of the managed portfolios. We also believe that an accounting approach that potentially reports significant volatility in the income statement due to unhedged positions will not provide more relevant financial information to users of financial statements.

We support an accounting model for hedges of open portfolios that has all of the following characteristics:

- It is based on a scope focused on risk mitigation through hedging. We support the revaluation of the assets and liabilities only to the extent they are hedged, including for example, partial term hedges.
- It is applied on an optional basis, similar to the general hedge accounting model. We do not support a mandatory application of the portfolio revaluation approach. We believe entities should be allowed to weigh the costs and benefits of the application of this accounting model.
- It allows designation of risk exposures of open portfolios on a net basis if that is consistent with the entity's risk management strategy and objectives.

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- It allows designation of layer components, for example bottom layers, if that is consistent with the entity's risk management strategy and objectives.
- It appropriately reflects ineffectiveness arising from risk mitigation through hedging.
- It expands the risk exposures qualifying for hedges of open portfolios (as compared to IAS 39 and IFRS 9) to include risk exposures measured on a behaviouralised basis (such as core demand deposits, prepayable items and pipeline transactions).

We believe that an accounting model with all the above characteristics would better reflect an entity's risk management strategy and objectives while still being consistent with the Conceptual Framework for Financial Reporting under IFRS.

We believe that a revaluation approach applied to the risk management of open portfolios addresses some of the dynamic risk management strategies commonly applied by banks, for example, for banks hedging the interest rate risk exposure of the fair value of their assets and liabilities. However, the portfolio revaluation approach as proposed in the Discussion Paper does not address other risk management approaches, for example, those focused on reducing the sensitivity of a bank's net interest margin to interest rate movements. Therefore, we encourage the Board to consider exploring other accounting models to address these alternative risk management approaches of open portfolios, including for example, expanding the current cash flow hedge accounting model to enable hedges of net positions for risks other than foreign currency risk.

We also support an accounting model for the risk management of open portfolios as discussed above for risks other than interest rate risk. Examples of other industries that may benefit are power, utility, commodity transformation industries and insurers, the latter if the new insurance contract standard does not address all accounting mismatches. We encourage the Board to continue to research how such a model could apply outside of the banking sector.

Developing a solution to reflect the various ways in which entities manage their interest rate risk (and other risk exposures) is clearly challenging. We encourage the Board to ensure that the model proposed in the next due process document considers holistically all the issues raised, to ensure it results in a conceptually valid and internally consistent accounting model.

Our responses to the Board's questions are included in the Appendix to this letter.

If you have any questions on this letter, please contact Paul Fitzsimon, PwC Global Chief Accountant (+1 416 869 2322) or Gail Tucker (+44 117 923 4230).

Yours sincerely,

PricewaterhouseCoopers

PricewaterhouseCoopers

Appendix

Section 1—Background and introduction to the portfolio revaluation approach (PRA)

Question 1—Need for an accounting approach for dynamic risk management (DRM)

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?

We believe that there is a need for an accounting solution that better reflects risk management strategies applied by entities. The current accounting policy choice to apply hedge accounting either in IFRS 9 or IAS 39 is not sustainable in the long run, and we therefore support finding a solution through this project. However, we do not believe that such a solution should be focused on Dynamic Risk Management as explored in the Discussion Paper, but should instead be focused on Risk Mitigation for the reasons further explained in our response to question 15.

Entities currently find it difficult to apply hedge accounting to their dynamic hedging strategies of open portfolios. As a result, some entities have developed accounting approaches to accommodate their dynamic risk management activities, for example 'proxy hedges'. Proxy hedging generally introduces a significant level of operational complexity, for example, treating open portfolios as a series of closed portfolios and therefore, introduces the need for significant processes and systems to frequently de-designate and re-designate hedge relationships. Often, these processes and systems are developed for accounting purposes only.

In addition some entities may not have sufficient qualifying hedged items (for example, floating rate assets), to be able to designate proxy hedges under the general hedge accounting requirements. Hence they may not use hedge accounting at all, which results in a further disconnect between risk management and accounting.

These difficulties have resulted in a carved-out version of IAS 39 in the European Union (the 'EU'). In our view, this is a sub-optimal solution, and it is a solution designed primarily for hedges of interest rate risk (and not for other risks). In addition, it is not available to entities outside the EU. Although these challenges are not limited to entities in the EU, but they are applicable to all entities that manage their risk exposures on open portfolios.

We note that some entities outside of the banking industry, for example, in the power, utilities and insurance industries, also undertake dynamic risk management activities and face similar issues in producing accounting results which are consistent with their risk management activities.

Question 2—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?

We believe the Board has appropriately identified in the Discussion Paper the issues that are most common to financial institutions dynamically managing the interest rate risk exposure of the fair value of their assets and liabilities, which results in a fair value hedge accounting approach. However, we note that other risk management approaches exist, for example, those focused on reducing the sensitivity of a bank's net interest margin to interest rate movements. While the current cash flow hedge accounting model may be used for some of these exposures, management undertakes its risk management activities based on a dynamic analysis of the net open risk position. Accordingly, it would make sense for the Board to consider exploring further accounting models to address these alternative risk management approaches. These could include for example, expanding current cash flow hedge accounting to enable hedges of net positions for risks other than foreign currency risk.

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

We believe the Portfolio Revaluation Approach ("PRA") addresses most of the issues arising from risk managing the net exposure to interest rate risk of the fair value of their assets and liabilities. However, as explained in 2(a) above, we do not believe the accounting approach proposed in the Discussion Paper fully addresses the issues faced by entities that apply alternative approaches to risk management, for example, the risk management of the sensitivity of the net interest margin to interest rate movements.

Section 2—Overview

Question 3—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?

We agree with the Board that the characteristics described in the Discussion Paper, in paragraphs 2.1.1 – 2.1.2. are contained in some risk management approaches, for example, a risk management strategy for the interest rate risk of the fair value of their assets and liabilities. However, we believe that the Board needs to continue its work in identifying features of other dynamic risk management strategies, including a risk management strategy to reduce the sensitivity to interest rate risk of the net interest margin and the risk management strategies for other risk exposures that are applied by entities in other industries, for example, insurers and entities in the power and utility industries.

Section 3—The managed portfolio

Question 4—Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

(a) 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*).

We believe that pipeline transactions should be included in the scope of accounting for hedges of open portfolios if that is consistent with the entity's risk management strategy. Pipeline transactions are very common in the banking sector (as well as other industries) and entities honour these commitments, given the reputational damage that would arise from not doing so.

However, we note that pipeline transactions differ amongst entities and territories; therefore, we believe the Board should consider developing a principle on the use of behaviouralisation (see further comments on question 4(c)), which would address when pipeline transactions can be included. For example, the Board could look at the principle developed in IFRS 9 on impairment of revolving credit facilities, where it acknowledged that credit risk may exist beyond the contractual term when an entity does not have the practical ability to withdraw the commitment before a loss event occurs and therefore, cannot limit its exposure to credit losses to the contractual period.

Equity Model Book ('EMB')

(b) 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*.

We do not believe that EMB should be included in the PRA. Equity does not meet the definition of an asset or a liability under the Conceptual Framework for Financial Reporting. The PRA is based on a fair value approach of the managed risk, and therefore we do not support the revaluation of such an item that is neither an asset nor a liability for accounting purposes.

However, in alternative risk management approaches (see further comments in question 2(a)), for example where banks are hedging to reduce the sensitivity to interest rate risk of the net interest margin, an entity may be able to include as part of the managed portfolio the financial assets that are funded by equity. This may include both the financial assets recognised on the balance sheet and those the entity may issue in the future that give an exposure to interest rate risk.

Behaviouralisation

(c) 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*.

We believe that the PRA should be applied to behaviouralised (rather than contractual) cash flows. These provide a better representation of an entity's risk exposures. For example, it is well recognised that in practice not all demand deposits will be repaid at the demand date even when a higher interest rate could be obtained by the depositor reinvesting the cash flows in a different instrument. The use of behaviouralised cash flows would enable entities to better align accounting with the risk exposures they expect to actually experience, and thus enable them to provide more useful and transparent information for users of financial statements.

We believe the use of behaviouralisation is consistent with existing accounting requirements for determining the amortised cost of a financial instrument in IAS 39 and IFRS 9, where an entity is required to estimate the future cash flows through the expected life of the financial instrument. It is also consistent with the existing guidance in IAS 39 on fair value hedge accounting for portfolio hedges of interest rate risk and also with the guidance in IFRS 9 on impairment of revolving credit facilities.

However, entities will need to have sufficient evidence to support the assumptions used and therefore a principle on the use of behaviouralisation should be developed. However, when developing such principle the Board should take into consideration that customer behaviour varies depending on facts and circumstances, for example, by territory. We believe such a principle would be applicable to pre-payable items, pipeline transactions (see question 4(a)) and core demand deposits (see question 9).

While we suggest that disclosures should be addressed at a future stage in the project (see questions 20 and 21), we believe that disclosures on the use of behaviouralisation will be key to enable users of financial statements to understand the entity's risk exposures and to enhance comparability amongst entities.

Question 5—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.

We believe the accounting for hedges of open portfolios of pre-payable items using risk management instruments with optionality (i.e. derivative option contracts) should be consistent with the entity's risk management strategy and objectives. For example, this could be either by using behaviouralised cash flows or by building the optionality within the underlying managed portfolio. We believe either accounting approach should be allowed if it is consistent with the entity's risk management strategy.

However, we acknowledge that the latter approach (that is, building the optionality within the managed portfolio) is complex. The Board should investigate further whether such an approach could be made to be operational.

Question 6—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?

We believe that the impact of changes in past assumptions of customer behaviour should be recognised in the statement of comprehensive income when the change in expectations arise, but only to the extent that such changes affect the layer or proportion designated in accordance with the risk management strategy and objectives.

While we suggest that disclosures should be addressed at a future stage in the project (see questions 20 and 21), we believe it is important that changes in past assumptions are clearly disclosed in the notes

of the financial statements, so users can understand the changes, the basis for those changes, and their corresponding effect in the entity's financial statements.

Question 7—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.

As previously noted, we support an accounting model that better reflects an entity's risk management strategy provided the model is consistent with the Conceptual Framework for Financial Reporting under IFRS. As a result, we believe that the designation of bottom layers and proportions within the PRA model should be permitted if that is consistent with the entity's risk management strategy and objectives. This would be consistent with existing guidance in IFRS 9.6.6.3. We do not believe that the use of bottom layers or proportions should be required if they are not used for risk management purposes.

The more common strategy for banks in managing the interest rate risk from prepayable portfolios is to use a bottom layer approach. Therefore, to better represent interest rate risk management, we believe bottom layers should be accommodated in the accounting for hedges of open portfolios. Unless prepayment occurs within the hedged bottom layer, there should not be volatility arising in the statement of comprehensive income from changes in prepayment risk within the PRA model.

We acknowledge that the application of both bottom layers and proportions introduces an additional layer of complexity to the PRA model which will require tracking mechanisms. We encourage the Board to continue investigating how such tracking mechanisms might operate in practice. Allowing entities to decide whether to use the accounting for hedges of open portfolios in the PRA by making it optional (instead of mandatory), as noted in question 16, would allow them to assess whether the benefits of a PRA model will outweigh the additional costs in developing the systems and tracking mechanisms needed.

Question 8—Risk limits

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

As previously noted, we support the application of the PRA with a scope focused on Risk Mitigation (see further comments in our response to question 15).

We do not support the use of risk limits in the application of the PRA as explored by the Board in the Discussion Paper, where no ineffectiveness arises as long as the net open risk position is within the risk limits set by management. In that context, the wider the risk limits are (reflecting an entity's greater risk tolerance), the less volatility the profit or loss would show. We believe that would not result in transparent financial information for the users of financial statements.

Question 9—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?

Core demand deposits give rise to interest rate risk exposures and are included by banks in their risk management approaches. We believe they should be eligible for inclusion in the managed portfolio under the Portfolio Revaluation Approach on a behaviouralised basis. We believe this would reflect more faithfully the economic reality of an entity's exposure to interest rate risk and it is therefore, relevant information for the users of the financial statements.

The inclusion of core demand deposits in the managed portfolio is important for all banks, but it is even more relevant for those banks whose balance sheets comprise predominantly loan portfolios and core demand deposits; that is, they do not have additional balance sheet items to be used for proxy hedge designation.

Allowing core demand deposits on a behaviouralised basis would reduce the need for both the EU carve out and proxy hedge accounting.

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

As noted in our response to question 4(c), entities will need to have sufficient evidence to support the assumptions used, and therefore we believe the Board should develop an accounting principle on the use of behaviouralised (instead of contractual) cash flows. We also believe that when developing such principle, the Board should take into consideration that customer behaviour varies depending on facts and circumstances of the entity and the economic environment in which it operates, for example, by territory.

Question 10—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 (i.e. Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (i.e. 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?

We believe that sub-benchmark instruments (i.e. instruments priced at a floating interest rate based on a benchmark index less a margin) should be included within the managed portfolio as benchmark instruments only if such benchmark rate is contractually specified and if that designation is consistent with the entity's risk management strategy. For such instruments we support approach 'three' of the Discussion Paper when measuring the fair value attributable to the interest rate risk, that is, the behaviouralised cash-flows of the instruments (see questions 4(c) and 9) are based on the corresponding benchmark rate and the discount rate is also based on the benchmark rate.

Whilst we support the consideration of fixed rate sub-benchmark instruments on a behaviouralised basis, we acknowledge that the inclusion of a benchmark component on a fixed rate (or zero rate) financial instrument that pays less than benchmark is not conceptually justified under the current fair value hedge model under IFRS, as it imputes cash flows that are not part of the contractual terms of the instrument.

However, we understand that the interest rate risk management strategy of many banks is to hedge the sensitivity to net interest rate risk, and therefore they include sub-benchmark fixed rate (or zero rate) instruments within the managed portfolio as if they were benchmark financial instruments. We encourage the Board to take this into consideration when exploring further this accounting model, as well as other accounting models that address alternative risk management strategies (see our response to question 2(a)).

(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?

For floating sub-benchmark instruments whose overall interest cannot become negative (because of an embedded floor), we agree with the Board that if such instruments are hedged using a swap whose floating rate is not floored at the fixed margin such a hedge presents some ineffectiveness that should be captured. This is because the floor applies to the overall interest rate and it is not conceptually sound to separate the spread margin from the benchmark that is hedged. Therefore, such sub-benchmark interest rate instruments contain an embedded floor that should be included in the measurement of the hedged item.

Section 4—Revaluing the managed portfolio

Question 11—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?

We believe that the revaluation calculations provide a faithful representation of certain types of dynamic risk management, such as hedges of the exposure to interest rate risk of the fair value of an entity's assets and liabilities. However, we believe that the revaluation calculations do not provide a faithful representation of other dynamic risk management strategies, such as hedging the sensitivity of the net interest margin to interest rate risk.

(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?

We support the use of benchmark rates, such as LIBOR or a swap rate, if these represent the interest rate risk exposure in the managed portfolio. We also believe that in certain circumstances the funding curves could be appropriate if such funding rate reflects the risks that exist in the managed portfolio (and not other factors, such as profit margins), for example, when managing the interest rate risk in

financial liabilities. We believe those funding curves should be subject to some safeguards on the observability of the inputs used for their calculation.

We recognise that the methods of calculating benchmark rates in the current economic environment are undergoing change, and so the Board should continue to monitor these developments.

Question 12—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)?

We do not support the use of transfer pricing transactions for the purpose of determining the revaluation adjustments for accounting for hedges of open portfolios. Transfer pricing transactions are entity specific, are used as a management tool and so may include additional effects on the managed interest rate risk (for example, profit margins charged within business units). As a result, they will not necessarily be a faithful representation of the managed interest rate risk.

(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.

As explained in our response to question 12(a) above, we do not support the use of transfer pricing transactions for the purposes of accounting for hedges of open portfolios.

(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?

As explained in our response to question 12(a) above, we do not support the use of transfer pricing transactions for the purposes of accounting for hedges of open portfolios.

(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?

As explained in our response to question 12(a) above, we do not support the use of transfer pricing transactions for the purposes of accounting for hedges of open portfolios.

Question 13—Selection of 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.

We believe that accounting for hedges of open portfolios should follow the entity's risk management strategy and objectives. In practice, an entity may have different types of portfolios or sub-portfolios and each of these may be subject to different funding indexes or benchmark interest rates. We support the use of more than one benchmark rate or funding index (as noted in question 11(b)) if they represent the interest rate risk to which an entity is exposed in the managed portfolio.

(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?

As explained in our response to question 11(b), we support the use of benchmark interest rates, such as LIBOR or a swap rate if they represent the managed risk. If a funding rate is used, we believe some safeguards are necessary regarding the observability of the inputs used for its calculation and that the chosen index represents the actual interest rate risk that exists in the managed portfolio (and not other factors such as profit margins).

Question 14—Pricing index

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

A pricing index is generally comprised of different components, the interest rate risk being only one component. As a result, we do not support the use of a pricing index for calculating the revaluation adjustments for the purpose of accounting for hedges of open portfolios, since we believe that pricing indexes would not be a faithful representation of the managed interest rate risk.

(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.

As explained in our response to question 14(a) above, we do not support the use of a pricing index for calculating the revaluation adjustments for the purposes of accounting for hedges of open portfolios.

(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?

As explained in our response to question 14(a) above, we do not support the use of a pricing index for calculating the revaluation adjustments in accounting for hedges of open portfolios.

Section 5—Scope

Question 15—Scope

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

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mitigation through hedging (i.e. 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?

As noted in our covering letter we believe an accounting solution should be more closely aligned with how banks manage their interest rate risk, while still being consistent with the conceptual Framework for Financial Reporting under IFRS. However, we do not support an accounting model with a scope focused on Dynamic Risk Management as explored in the Discussion Paper. A scope based on Dynamic Risk Management would result in the revaluation of all net open risk positions, regardless of the extent to which derivative instruments have been used to mitigate the managed risk. This goes far beyond the objective of hedge accounting that is to minimise the accounting mismatch in the income statement between the fair value measurement of the risk management instruments (derivatives) and the measurement of the managed portfolios, and it would give rise to significant volatility in profit or loss. We believe that an approach that potentially reports significant volatility in the income statement due to unhedged positions will not provide more relevant financial information to users of financial statements. Such an approach would be contrary to the conclusion in IFRS 9 that the amortised cost measurement of basic loans, which are held to collect and have cash flows that are solely payments of principal and interest, results in more decision useful information.

We support an accounting model with a scope based on a Risk Mitigation Approach. Under this approach, the PRA is applied to the designated managed risk exposures to the extent they are hedged. The designation would be based for example, on specific portfolios, proportions or bottom layer components if such designation is consistent with the entity's risk management strategy and objectives. This accounting model would better represent the results of an entity's risk management activities, including any ineffectiveness, and therefore, provide relevant and transparent information for users of financial statements.

(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?

We believe that applying PRA with a scope focused on Dynamic Risk Management (that is, to all managed portfolios even if unhedged), would result in financial statements suggesting that a single approach has been undertaken for risk management purposes. However, this is rarely the case in practice and therefore, the financial information would portray neither the entity's business model, nor the results of the entity's risk mitigation activities. An accounting model with a scope focused on Risk Mitigation would better represent the results of an entity's risk management activities and therefore provide relevant and transparent information for users of financial statements.

We believe that a combination of the current accounting guidance in IFRS 9 and the new accounting for hedges of open portfolios would provide an entity with the necessary accounting alternatives to reflect its risk management strategies and objectives. For example, an entity could apply (1) the PRA model (with the characteristics noted in our covering letter and the other responses included in this document) for open portfolios whose interest rate risk is dynamically managed on a fair value basis, and (2) the general hedge accounting under IFRS 9 for hedges of individual items and/or hedges of 'closed' portfolios. However, we believe the standard should be clear how the PRA interacts with the general hedging model in IFRS 9 and when an entity can choose to use to apply the PRA.

These accounting alternatives, accompanied by appropriate disclosures, will provide the users of financial statements with the relevant information needed to understand how an entity manages its risk exposures.

(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?

As noted in question 15(a) above, we do not support the application of an accounting model with a scope focused on Dynamic Risk Management. An entity's approach to risk management may range from complex strategies (involving a combination of derivatives addressing several different risks that is continually adjusted for changing market conditions) to simple strategies where investments are financed with liabilities of similar durations. We believe it would not be possible to provide a clear enough definition of Dynamic Risk Management to achieve a consistent application of the PRA amongst banks given the breadth of actions that may be taken to manage net risk exposures.

We believe that the objective of the PRA should be consistent with the objective of IFRS 9 hedge accounting, that is, to better represent in the financial statements the effect of an entity's risk management activities. As a result, as noted in 15(a), we believe that the designation of the risk exposures used for accounting purposes should be consistent with those used for risk management purposes.

However, once an entity designates, for example a sub-portfolio and/or a proportion of an open portfolio for risk management purposes, then some tracking mechanisms will be necessary. We believe that such tracking mechanisms could be complex and will vary depending on the entity's specific facts and circumstances. We encourage the Board to continue to investigate how such tracking mechanisms might operate in practice.

(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?

All our responses to questions (a) – (c) would be consistent for the application of accounting for hedges of open portfolios for risks other than interest rate risk. We believe that the accounting principle should be broadly available for accounting for hedges of open portfolios of other risks and for entities in industries other than the banking industry.

Question 16—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?

As noted in our covering letter, we do not believe that any hedge accounting solution, whether it has a scope with a focus on Dynamic Disk Management or Risk Mitigation, should be mandatory. As noted

in question 15(c), Dynamic Risk Management is not clearly defined in the Discussion Paper. Therefore, we do not believe entities should be required to designate a net open position based on Dynamic Risk Management, as a result of a mandatory application of the PRA. This is consistent with the optional application of general hedge accounting under IAS 39 and IFRS 9. This will enable entities to conclude whether the benefits of adopting hedge accounting outweigh the additional costs that might be involved.

As noted in our response to question 15, we believe that a combination of the current accounting guidance in IFRS 9 and the new accounting for hedges of open portfolios would provide an entity with the necessary accounting alternatives to reflect its risk management strategies and objectives. However, we believe the standard should be clear how the PRA interacts with the general hedging model in IFRS 9 and when an entity can chose to apply the PRA.

Question 17—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.

As noted in our responses to the questions above, we do not support the application of accounting for hedges of open portfolios with a scope focused on Dynamic Risk Management (that is, with the revaluation of risk exposures even when not mitigated through risk management activities).

(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.

As noted in our response to question 16, we do not support a mandatory application of accounting for hedges of open portfolios. We support the application of the accounting for hedges of open portfolios on an optional basis.

We believe the accounting for hedges of open portfolios should be based on an entity's risk management strategy and objectives. That would be consistent with the existing IFRS 9 accounting requirements. We do not believe additional eligibility criteria should be required, other than requiring the accounting to follow the risk management strategy and objectives; that an economic relationship should exist; and, to be subject to the safeguards or constraints explained in our responses to the other questions in this document (for example, requiring a funding index based on observable inputs and the guidance for what pipeline transactions may be included in the managed portfolio).

Section 6—Presentation and disclosures

Question 18—Presentation alternatives

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

We support the 'single' net line item presentation, that is, the net revaluation adjustment for all exposures subject to accounting for hedges of open portfolios presented in a single line item in the statement of financial position. We believe that this approach provides information to enable users to more easily understand the accumulated net effect arising from the application of accounting for hedges of open portfolios. In addition, since the entity's risk management is performed on a net basis, any allocation of the revaluation effect to the different assets and liabilities would be arbitrary. Applying the aggregate adjustment approach does not appear to provide significant additional information that users would find meaningful.

We believe that a single net line item presentation results in sufficiently transparent financial information and is consistent with the entity's dynamic risk management strategy.

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

We support the actual net interest income presentation. Requiring interest accruals from risk management instruments to be presented as part of net interest income provides relevant information about how the accounting of hedges for open portfolios has altered the actual net interest income in the period. We believe this approach provides the necessary information to understand the financial information before and after the effect of accounting for hedges of open portfolios by presenting the actual interest revenue and expenses separately from the results of the risk mitigation activities.

(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.

We have not identified any further alternative presentations.

Question 19—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?

As previously noted, we support an accounting model that better reflects risk management strategy and objectives while still being consistent with the Conceptual Framework for Financial Reporting under IFRS. Therefore, we believe that the application and presentation of the effects on the accounting for hedges of open portfolios should not contradict the consolidation principles in IFRS.

As a result, we do not support the application of an accounting approach that leads to a gross presentation of internal derivatives in the statement of comprehensive income. We believe that entities can distinguish their risk management activities and trading activities as part of their segment information in the notes to the financial statements.

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

As commented in 19(a) above, we do not support the grossing up of internal derivatives in the statement of comprehensive income.

(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?

As commented in 19(a) above, we do not support the grossing up of internal derivatives in the statement of comprehensive income.

Question 20—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.

We believe that disclosures are a key element for any approach for accounting for hedges of open portfolios and we agree with the Board that each of the four disclosure themes will provide useful and relevant information for users of the financial statements.

We also believe that the Board should develop accounting principles regarding disclosures, as opposed to detailed disclosure requirements. This would be consistent with the Board's current disclosure initiative (in particular, as part of the Board's planned review of IFRS 7). However, we believe disclosures should be addressed at a future stage, once the details of the accounting model are finalised.

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

We believe that all of the four identified disclosure themes would provide useful information. However, as noted in 20(a) we believe the Board should address the disclosures at a future stage, once the details on the accounting model are finalised.

(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.

We believe that all of the disclosure themes identified by the Board are relevant for users of financial statements. As the Board identifies detailed disclosure requirements, it should continue to consult with preparers and users, to ensure that the proposed disclosures provide the appropriate level of information, taking into consideration that some disclosures may be commercially sensitive.

Question 21—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?

As explained in our response to question 15, we do not support the application of PRA on a Dynamic Risk Management basis.

In supporting a Risk Mitigation approach, we recognise that additional disclosures may be warranted to provide transparency to the risks not mitigated through hedging. This may mean disclosing some residual interest rate sensitivity for the DRM activity, but this is not the same as disclosing the gain or loss in the period on the intentionally unhedged position. We do not believe that it would be appropriate in terms of cost/benefit to require the introduction of the full PRA model (that is, the revaluation of all risk exposures, even if unhedged) just for disclosure purposes.

However, as noted in question 20, we believe disclosures should be addressed at a future stage, once the accounting model has been finalised.

(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?

We believe disclosures may need to be provided in different categories and that this should be part of the further outreach with preparers and users.

<u>Section 7—Other considerations</u>

Question 22—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?

We support the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract if that is consistent with the entity's risk management strategy and objectives. As explained in our responses to the questions above, we do not believe that the trigger for the inclusion of exposures in the managed portfolio is necessarily the existence of a contract. We believe all exposures should be included in the scope of application of this accounting model at the time an entity decides to mitigate the managed risk in a net open position. This decision may be taken by an entity at points in time other than inception of the risk exposures.

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

We believe it is still very early in the process to comment on the details for the accounting of non-zero Day 1 revaluations. We believe this question should be addressed at a future stage of the process once the accounting model is further developed. When addressing this accounting, the Board should take into consideration how it would interact with the tracking issues noted in our response to question 15(c).

Question 23—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?

We believe that similar to the IFRS 9 requirements, an entity should not de-designate, and thereby discontinue the application of accounting for hedges of open portfolios, if it still meets the entity's risk management objective.

As a result, we believe that similar to IFRS 9, exposures included within a managed portfolio should remain until derecognition or until the entity's risk management objective changes.

(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?

Refer to our response to question 23(a) above.

(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.

We believe it is still very early in the process to comment on the details for the accounting of the recognised revaluation adjustment. We believe this question should be addressed at a future stage of the process once the accounting model is further developed. When addressing this accounting, the Board should take into consideration how it would interact with the tracking issues noted in our response to question 15(c).

Question 24—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?

We believe it is possible for entities to risk manage their foreign currency risk in conjunction with interest rate risk on their open portfolios. We therefore believe that it should be possible to apply the PRA to open portfolio that manage their risk on this basis.

(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.

As discussed in the section 7.3 of the Discussion Paper, there are multiple approaches entities can follow for purposes of risk management of their foreign currency risk in conjunction with their interest rate risk on their open portfolios. As a result, we believe that the accounting for hedges of open portfolios should reflect the entity's risk management strategy and objective, and therefore more than one accounting approach should be allowed.

We would like to highlight that this situation is not only applicable to hedges of foreign currency and interest rate risk, but to hedges of other risks as well. We encourage the Board to continue its work for developing accounting principles for risk management of open portfolios for more than one risk (for example, interest rate risk and insurance risk, or foreign currency and commodity price risk).

<u>Section 8—Application of the PRA to other risks</u>

Question 25—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.

As noted in our response to question 15(d), we believe that the accounting for hedges of open portfolios should be available for hedges of other than interest rate risk and for entities in industries other than the banking industry. Examples of industries that may benefit from accounting for hedges of open portfolios are the power and utility industries, as well as entities in the commodities transformation business. In addition, an accounting model for hedges of open portfolios may be of interest to insurers if the new insurance contract accounting standard does not address all accounting mismatches.

We encourage the Board to continue to research how such a model could apply outside of the banking sector.

(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.

We believe that applying the PRA to other industries that manage their risks on a dynamic basis might provide a better reflection of their dynamic risk management activities and therefore would result in

more relevant financial information. In particular this may be true of the commodity transformation industries which often apply a risk management strategy that is a fair value hedging strategy on a portfolio basis. In such cases, a PRA approach could be an appropriate way of reflecting the substance of their risk management strategies. However, given the limitations of current hedge accounting, it is unclear what other hedging strategies might develop if entities outside of the banking industry were given an accounting model for hedges of open portfolios. We believe detailed outreach and further work needs to be undertaken by the Board with interested parties in these industries to understand the needs and challenges these entities would face when applying such an accounting model. For example, it is possible that unlike banks (which mainly hedge financial instruments), these other industries could be managing the risks associated with non-financial items (like, commodity inventories or reserves in the ground) which may present different challenges to those presented in the Discussion Paper.

<u>Section 9—Alternative approach—PRA through other comprehensive income</u>

Question 26—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?

As previously noted, we support an accounting approach that better reflects an entity's risk management strategy and objectives while still being consistent with the Conceptual Framework for Financial Reporting under IFRS. We do not believe the PRA, which is based on a fair value approach, should be accounted for in OCI. We agree with the conceptual issues raised by the Board in the Discussion Paper, for example, the fact that such accounting would be inconsistent with the assumption applied by the Board in developing the PRA, that is, that all risk management instruments (derivatives) would be measured at fair value through profit or loss.

However, as noted in our response to question 2(a), we encourage the Board to consider exploring further accounting models for hedges of open portfolios to address other risk management approaches, for example, those focused on reducing the sensitivity of a bank's net interest margin to interest rate movements. Further work would necessary to assess whether such alternative accounting models could be accounted for in OCI.

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Hans Hoogervorst
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17 October 2014

Dear Mr Hoogervorst

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

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's ('the IASB's') Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* ('the discussion paper').

We support the IASB's development of an approach to account for dynamic risk management activities. We acknowledge that dynamic risk management activities are complex and commend the work done by the IASB to understand and clearly present in its discussion paper how banks dynamically manage interest rate risk and also to consider more broadly how the accounting for such activities in a variety of industries could be improved. We are supportive of an accounting approach that better reflects in the financial statements an entity's economic activity including its execution of its risk management activity as we believe this would provide useful information to users of financial statements.

However, we do not support the Portfolio Revaluation Approach (PRA) detailed in the discussion paper. The PRA endeavours to be an all-encompassing measurement approach for items subject to dynamic risk management. While we commend the IASB for developing an approach that starts in understanding the risk management activities, we do not believe the solution is an alternative measurement approach for risk management activities that should be pursued. We are concerned that such an approach has conflicts with accounting principles in the conceptual framework, will require risk management activities to be defined in order to determine what is in or out of the revaluation model, and the approach fails to build on the classification, measurement and general hedge accounting concepts already established in IFRS 9 *Financial Instruments*.

The discussion paper requests views on whether the project should extend to entities other than banks hedging interest rate risk. As noted in our responses to the IASB on phase two of Insurance Contracts in 2010 and 2013 we believe a portfolio hedging solution should be explored for insurers as it is common for insurers to use derivatives to hedge interest rate risk on their duration mismatch between their non-derivative financial assets and insurance liabilities. Given the measurement of insurance contracts is due

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to be finalised next year we recommend that the Board consider whether such hedging strategies will lead to accounting mismatches that can minimised with a portfolio hedge accounting solution that includes insurance contracts as hedged items. Further, as the development of the PRA is a solution to a structural interest rate hedge in banks, we would favour outreach to non-financial entities on whether their portfolio hedging strategies share similar characteristics to financial entities.

Our preference is to develop an approach like IFRS 9 that aims to mitigate the accounting mismatches that can arise from an entity executing its risk management objective due to the mixed measurement and recognition approach in IFRSs. Such an approach is voluntary, builds on the thinking used in IFRS 9, does not seek to define risk management nor to remeasure all assets, liabilities and future transactions that are subject to risk management.

We acknowledge that the IASB already has a hedge accounting based solution to portfolio hedges of interest rate risk in IAS 39 but note that this approach has not been universally applied because of the prohibitions in hedging certain items and applying the model to an open and dynamic portfolio. This has led to complexity in application without providing information that is necessarily easily understandable. Our preference therefore would be for the IASB to focus on specific issues, as already identified in the discussion paper, which, if overcome, could be built on top of approaches already contained in IFRSs, so as to give preparers a hedge accounting approach that is more compelling than the current one in IFRSs.

Areas the IASB should explore in developing our preferred approach are:

- the eligibility of core deposits as hedged items;
- valuing assets, liabilities and firm commitments hedged for interest rate risk on a basis of behaviouralised, rather than contractual, cash flows;
- hedging the 'bottom layer' of a portfolio of prepayable loans; and
- the designation of LIBOR when the yield on the instrument is sub-LIBOR.

Firstly, core deposits are a significant part of banks' exposures hedged for interest rate risk and therefore for a macro hedge model to be accepted and applied it will need to accommodate such exposures. We acknowledge there will be challenges in objectively identifying and measuring core demand deposits. However, we think it would be worthwhile for the Board to explore how such challenges could be overcome. We note that the value ascribed to purchases of core deposits in practice is not equal to the demand amount given the 'stickiness' of these deposits. Permitting such liabilities to be remeasured for changes in interest rates in a macro hedge model would be a significant step towards developing a portfolio hedge accounting model that would be operational, reflective of banks' risk management activities and consistent with accounting principles and the conceptual framework.

Secondly, we believe that valuing assets, liabilities and firm commitments hedged for interest rate risk based on behaviouralised, rather than contractual, cash flows (for example, after considering prepayment expectations) is another essential feature of a portfolio hedge accounting model if it is to be accepted and applied. We note that for phase two of Insurance Contracts the IASB has adopted an approach based on probability weighed values of deposit components in insurance contracts and the use of behavioural assumptions in projecting cash flows rather than relying solely on contractual cash flows. Without such a behaviouralised approach, a portfolio hedge accounting model would not take account of the portfolio effects and enhanced predictability of grouping assets, liabilities and firm commitments together and hedging them as a single portfolio or unit for risk management purposes.

We consider that valuing groups of assets, liabilities and firm commitments, taking into account any offsetting effects and portfolio behaviours, can be consistent with established accounting principles. For

example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* includes requirements to measure large populations of items by weighting all possible outcomes by their associated probabilities (i.e. based on expected values). Also IFRS 13 *Fair Value Measurement* includes an exception for valuing portfolios of items with certain offsetting risk positions as a single unit for valuation purposes provided specific conditions are met.

Given these precedents, we believe the Board should consider how a portfolio valuation approach that includes core deposits as well as consideration of behaviour can be accepted within the confines of the conceptual framework.

Thirdly, when hedging a portfolio, we believe that the Board should consider further how it may be appropriate to identify the hedged item as the bottom layer of a portfolio. We note that identifying a bottom layer of a single item is already permitted in the IFRS 9 general hedge accounting model, and if it were possible to view a portfolio as a unit for hedge accounting purposes, this would permit the bottom layer for a portfolio of prepayable items to be designated as a hedged item.

Fourthly, reconsideration should be given as to how an instrument that has a yield that is sub-LIBOR can be hedged for LIBOR for accounting purposes. Given the historically low central bank interest rate environment and the nature of savings products offered it is common that financial liabilities have a yield less than sub-LIBOR, yet for risk management purposes they form part of a portfolio that is hedged for LIBOR (or another suitable benchmark interest rate risk).

Overall, an approach that combines existing thinking in IFRS 9 with the ability to behaviouralise cash flows on a portfolio basis (including core deposits) and allowing bottom layers to be designated has the potential to be more relevant than the existing portfolio fair value hedge accounting model in IAS 39. This would be less complex than a more wide ranging measurement alternative for risk management activities as envisioned by the PRA and have the potential for applicability to other industries, such as for insurers.

Our detailed responses to the questions in the invitation to comment are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole at +44 (0) 20 7007 0884 or Andrew Spooner at +44 (0) 20 7007 0204.

Yours sincerely

Veronica Poole
Global IFRS Leader

Question 1—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?

We believe that where an entity uses financial instruments for risk management purposes, and the application of the classification and measurement requirements of IFRS 9 gives rise to accounting mismatches, hedge accounting should be available (subject to meeting certain eligibility criteria) to address this mismatch and provide useful information for users. We appreciate that hedge accounting becomes more complex to apply when risks are hedged on an open, dynamic, portfolio basis and agree that a portfolio hedging model is required to address this. However, we do not believe that the portfolio hedging model should aim to represent dynamic risk management in entities' financial statements by revaluing all financial assets and liabilities for interest rate risk.

We believe a more appropriate approach would be to develop a portfolio hedging model that builds on concepts already established in the general hedge accounting approach in IFRS 9. The model should take into account the characteristics of portfolio hedging from an economic perspective to ensure a more meaningful presentation of risk management activities. Such an approach should aim to minimise conflicts with the Conceptual Framework. In our response to the remaining questions we outline those aspects of the PRA that we believe are, or could be developed to be, consistent with the Conceptual Framework and appropriately used in a portfolio hedging model that aims to minimise accounting mismatches rather than one that focussing exclusively on accounting for risk management.

Question 2—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?*

We agree the IASB has identified the key issues faced by financial institutions in applying hedge accounting for dynamic risk management activities.

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

The PRA represents a significant change to the accounting of certain financial instruments that are part of dynamic risk management activities. Although we believe that such a model may address some of the issues entities currently face when applying the current hedge accounting requirements, it would raise other more fundamental issues which we discuss further in our response to the questions below. One particular issue we have with the PRA is the disconnection of risk management and accounting volatility through hedging. In our view, simply focusing on risk management could effectively override the general classification and measurement requirements in IFRS 9. This could result in misleading performance reporting since portfolios of assets held to collect contractual cash flows would be revalued for interest rate risk. Therefore, focusing on risk management alone appears insufficient without taking into account the effects from dynamic risk management on accounting, more precisely on accounting volatility. As most hedging instruments are measured at fair value through profit or

loss, whereas the hedged items are usually not, this creates accounting volatility where positions are economically hedged. To align accounting volatility with economic volatility from hedged positions when dynamic risk management takes place should be a key objective in developing the new requirements. This would provide users of financial statements better information on the economic position of an entity without having the conceptual shortcomings of the PRA or its features, as discussed below.

Another observation is that application of the PRA would conflict with the Conceptual Framework in many instances as noted in our responses below. The Board will need to consider carefully for each case in turn whether such exceptions are appropriate.

Hence, overall, we do not consider the PRA a viable solution to the issues that entities currently face when applying the current hedge accounting requirements.

Question 3—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?

We believe the description in paragraphs 2.1.1 – 2.1.2 captures some of the key characteristics of dynamic risk management but note that dynamic risk management across different entities and industries can be diverse. We believe this would be sufficient as a high-level description of dynamic risk management rather than as a qualifying criterion for portfolio hedge accounting which should be avoided given the difficulties in defining it for all entities and industries.

Question 4—Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

(a) *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).*

We agree that pipeline transactions are often part of entities' dynamic risk management of interest rate risk and hence will be considered in their gap analysis of net interest rate risk position. Furthermore, we recognise that there may be potential to consider some limited pipeline transactions to have value that could be recognised in the statement of financial position whilst complying with the Conceptual Framework (where for example they represent a constructive obligation which under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* can give rise to the recognition of a provision).

However, in many cases pipeline transactions will represent forecast transactions with a higher degree of uncertainty where recognising any assets or liabilities in respect of them in the statement of financial position would be inconsistent with basic accounting principles such as the definition of assets and liabilities in the Conceptual Framework. To resolve this, as an alternative to the PRA, we believe a portfolio hedging model should allow all exposures managed for interest rate risk (including any pipeline transactions) to be included in the

determination of the net risk position, but only permit the recognition of revaluation adjustments on items where the recognition of the adjustment is consistent with the Conceptual Framework (i.e. only recognising adjustments that meet the definition of an asset or liability, for example in respect of pipeline transactions that represent constructive obligations in accordance with IAS 37, or in respect of core demand deposits, see response to Question 9). Under this alternative, the revaluation adjustment would only apply in respect of the hedged net position. Therefore, as noted in our response to Question 9 we believe that the IASB should prioritise developing a model where core demand deposits can be included as this would, in many cases, ensure there are sufficient eligible exposures to revalue in respect of the net position hedged. This would in turn reduce the need to recognise valuation adjustments in respect of pipeline transactions.

Exposures that make up the determination of the net position for which hedge accounting is applied to, including pipeline transactions, should be subject to disclosure that helps explain the objective of risk management, how it was executed, and how the execution of the risk management objective is presented in the financial statements.

EMB

(b) 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.

If the objective of the model is to represent entities' dynamic risk management in the financial statements then it is difficult to see why the equity model book that forms part of that risk management should not be included and remeasured for changes in interest rates. However, we are concerned that if the EMB is included as part of a revaluation model, leading to revaluation adjustments recognised in profit or loss with cumulative changes recognised as assets or liabilities, this would be inconsistent with the Conceptual Framework. This is another reason why we do not support the objective of representing entities' dynamic risk management in the financial statements.

As noted in our response to Question 3(a), we would support a portfolio hedging model that allows the equity model book to be included in determining the net risk position, provided revaluation adjustments are only recognised in respect of exposures where adjustments meet the definition of an asset or liability (thus excluding the equity model book from this). To supplement this approach, disclosures could be used to communicate the effect of the entity's risk management in respect of the equity model book.

In developing a portfolio hedge accounting model that permits revaluation of core demand deposits the need to allow the equity model book to be revalued would be diminished since there would be a significant increase in the availability of financial liabilities to revalue for interest rate risk to match the net hedged position. Therefore, although both EMB and core demand deposits can be a source of funding, an accounting mismatch resulting from hedging the EMB could be reduced by designating a proxy hedge of core demand deposits which would not violate the fundamental principle in IFRS that equity is not subject to remeasurement. Hence we are not supportive of the IASB recognising revaluation adjustments in respect of the equity model book.

Behaviouralisation

(c) *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.*

We believe a portfolio hedge accounting approach should take account of portfolio characteristics and are supportive of a model based on behaviouralised contractual cash flows (and constructive obligations in respect of pipeline transactions) where this is consistent with existing IFRSs as discussed below. Valuing assets, liabilities and firm commitments hedged for interest rate risk based on behaviouralised, rather than contractual, cash flows (for example, after considering prepayment expectations) is an essential feature of any portfolio hedge accounting model. Without such an approach, a portfolio hedge accounting model would not take account of the portfolio effects, economics and enhanced predictability of grouping assets, liabilities and firm commitments together and hedging them as a single unit on a portfolio basis.

We believe that valuing groups of assets, liabilities and firm commitments, taking into account any offsetting effects and portfolio behaviours is consistent with established accounting principles. For example:

- IFRS 9 allows the effective interest rate method to be applied on a portfolio basis as it is presumed that the cash flows of a group of similar financial instruments can be estimated reliably.
- IAS 37 includes requirements to measure large populations of items by weighting all possible outcomes by their associated probabilities (i.e. based on expected values).
- IFRS 13 includes an exception for valuing portfolios of items with certain offsetting risk positions as a single unit of valuation provided specific conditions are met.

Hence we believe that a behaviouralised approach can be developed that is acceptable and consistent with existing accounting principles.

Question 5—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.

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

Within a hedge accounting model, where entities use financial instruments with optionality for hedging purposes, we believe they should be treated like any other hedging instrument under the IFRS 9 hedge accounting model. Whether the valuation of such options could be used as a proxy measure of the hedged exposure for changes in interest rate risk would depend on the specific terms of the options relatives to the risk they were hedging.

Deloitte

Question 6—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?

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

In the context of a hedge accounting approach we understand that changes in behavioural assumptions may affect the valuation of certain hedged exposures that are revalued for interest rate risk. Where this is the case we believe such changes should be recognised in profit or loss in the hedged period when the changes in assumptions occur. Where the effect of changes in assumptions is material, disclosures should give further information about the reason and impact of the change in assumptions. Not to recognise the effect of changes in assumptions in profit or loss in such cases will give rise to additional complexity in the application of any portfolio hedge accounting model.

It should be noted that not all changes in behavioural assumptions will have an effect on the hedged exposure, for example where only the bottom layer of a portfolio is revalued and the changes in behavioural assumptions of the overall portfolio do not change the cash flows of the bottom layer.

Question 7—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.

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

As noted in our response to Question 4, we believe it is appropriate to model the hedged portfolio based on expected, behaviouralised cash flows which takes account of the portfolio effect of grouping together similar items. As an extension of this principle, we believe that it is appropriate to develop a model that can identify the hedged item as the bottom layer of a portfolio. We note that identifying a bottom layer of a single item, or certain groups of items, is already permitted in the IFRS 9 general hedge accounting model, and if we are to view a portfolio as a unit for hedge accounting purposes, we believe a bottom layer should also be permitted for a portfolio of prepayable items. We understand that designating a bottom layer of a portfolio of prepayable items could lead to no hedge ineffectiveness from lower/higher than expected prepayments, provided the designated bottom layer cash flows are still forecast to occur. However, we believe this is consistent with the risk management approach for such items and is consistent with the valuation of a bottom layer of a portfolio which behaves differently to a proportional amount.

We recognise that there will be further factors to consider in developing a bottom layer approach. For example, consideration of whether to only permit a bottom layer of a static

portfolio (which could be advantageous in terms of tracking but would break with the basic idea of dynamic risk management to some extent) or a dynamic portfolio and whether to define the portfolio based solely on notional amounts or whether to also consider the quantum of the interest rate paid/received on the underlying items.

Question 8—Risk limits

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

As noted in our response to Question 1, we believe that the IASB should pursue a portfolio hedge accounting model rather than a broader portfolio valuation approach for all risk management activities. This would have the additional benefit of accommodating risk limits, since an entity could only apply hedge accounting to the extent that it has hedged the risk. However, an important difference to the concept of risk limits as presented in paragraph 3.8.3 of the DP is that there would be volatility to the extent that the hedge is ineffective, whereas under the risk limits concept in the DP, there would be none, even if the hedge does not perfectly offset.

Question 9—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?*

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

Core demand deposits are a significant part of banks' exposures hedged for interest rate risk and not recognising the change in value of such deposits due to changes in interest rates can give rise to an accounting mismatch which we believe should be addressed through hedge accounting.

In particular, risk management of core demand deposits is usually based on expected behaviour and using bottom layer approaches. This is in contrast to the general accounting requirements that restrict the unit of account and the measurement of demand deposits to their contractual features rather than their expected behaviour. A way to better align accounting with risk management and also reducing accounting mismatches could be focusing on a portfolio of core demand deposits as a unit of account. This could apply in circumstances where risk management is also based on the portfolio (similar to the requirements already in place under IFRS 13.49), which then overcomes the restriction in IFRS 13.47 given the different unit of account.

We acknowledge there can be challenges in objectively identifying and measuring core demand deposits, however, we do not think these would be too difficult to overcome given the difference between the value of core demand deposits and the demandable amount is already reflected in the accounting in certain circumstances, for example in business combination accounting where core deposit intangibles are recognised on acquisition. Furthermore, the cash flow profile of core demand deposits is also recognised by regulators in

the assessment of interest rate and liquidity risk at banks.

Allowing such liabilities to be remeasured for changes in interest rates would be a significant step towards developing a portfolio hedge accounting model that would be more operational and reflective of banks' risk management activities that the portfolio fair value hedge accounting approach currently in IAS 39.

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

To promote consistency we believe it will be essential for guiding principles to be provided on the factors that should be taken into account when behaviouralising core demand deposits.

Given the significance and subjectivity of the behavioural assumptions for valuing core demand deposits, we believe sufficient disclosures should accompany the model to explain the assumptions used and explain any changes in assumptions applied.

Question 10—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 (i.e. Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (i.e. 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?*

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

We believe that sub-benchmark instruments should be eligible hedged items in a portfolio hedge accounting model if they are hedged for changes in the benchmark interest rates. In particular we note that this is necessary in order for demand deposits to be eligible hedged items since in many cases such deposits have very low or nil interest rates which are often lower than the benchmark rate.

Where fixed rate sub-benchmark instruments are designated as the hedged item, we believe the discount rate used to value the hedged item for changes in interest rates should be the benchmark rate and the numerator should be the hedged expected cash flows identified and designated from the overall portfolio.

(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?*

Variable rate exposures with an embedded floor would be included as part of a portfolio cash flow hedge and hence give rise to hedge ineffectiveness to the extent that an embedded floor impacts the variability of the designated hedged cash flows and the same (but offsetting) effect is not present in the hedging instrument (i.e. the hedging instrument is a vanilla swap with no equivalent embedded floor). In such a cash flow hedge, we do not believe the

embedded floor should be fair valued for interest rate risk unless it is hedged as part of a fair value hedge.

Question 11—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?*

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

In developing a portfolio hedge accounting model, we believe the IASB should retain the principle that the designated hedged risk must be 'separately identifiable and reliably measurable' and subject to risk management in order to be eligible for hedge accounting. Hence, we believe in practice the identified hedged cash flows and the hedged risk will typically be based on a funding benchmark interest (i.e. 3-month LIBOR in the analysis presented in section 4.1 of the DP).

(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?*

As noted in response to Question 11(a), we believe the hedged risk should be "separately identifiable and reliably measurable" and subject to risk management in order to be eligible.

Question 12—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)?*

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

As noted in response to Question 11(a), we believe the managed risk should only be eligible as the designated hedged risk if it is 'separately identifiable and reliably measurable'. Hence, transfer pricing transactions will not necessarily be relevant in determining the hedged risk for hedge accounting purposes. Where the rate used in transfer pricing transactions is equivalent to the designated hedged risk (which must be 'separately identifiable and reliably measurable' and subject to risk management), such transactions (as a proxy to external hedged transaction) may represent a useful way to identify and measure the hedged item.

(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.*

As noted in our response to Question 11(a), we believe the designated cash flows and the discount rate applied should be based on the hedged risk which must be 'separately identifiable and reliably measurable'. Based on this, we would accept the 'market funding index' approach (assuming that market funding index is separately identifiable and reliably measurable and subject to risk management).

(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?*

Yes, as noted in our response to Question 11(a) we believe the hedged risk should be 'separately identifiable and reliably measurable' in order for it to be an eligible hedged risk.

(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?

As noted in our response to Question 12(a), we believe the use of transfer pricing would be limited to certain situations, which in turn would avoid the issues identified in paragraphs 4.3.1 – 4.3.4 of the DP.

Question 13—Selection of 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.*

As noted in response to Questions 11 and 12, we believe the hedged risk can be any rate provided it is 'separately identifiable and reliably measurable' and is subject to risk management. This could result in the hedged risk being a single rate for all hedged items even where actual funding is based on more than one index.

(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?*

As noted in response to Questions 11 and 12, we believe the hedged risk can be any rate provided it is 'separately identifiable and reliably measurable'.

Question 14—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?*

We have not fully considered examples of different pricing indexes that may be dynamically

managed since we believe those entities that dynamically manage interest rate risk based on a pricing index will be best placed to comment here. However, as noted in response to Question 11(a), we believe the hedged risk should be "separately identifiable and reliably measurable" and subject to risk management in order to be eligible. Therefore, dynamically managing interest rate risk with respect to a pricing index alone would not be sufficient to permit revaluation of the hedged exposure using the pricing index as the discount rate.

Question 15—Scope

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

As noted in our response to Question 1, we do not support the PRA as described in the DP and instead prefer the development of a hedge accounting model that caters for accounting mismatches arising from risk management activities. A hedge accounting approach that includes the ability to behaviouralise cash flows on a portfolio basis and allowing bottom layers to be designated would reduce the operational complexities experienced under the existing portfolio fair value hedge accounting model in IAS 39 that are exacerbated through the ineligibility of demand deposits and restrictions from applying a bottom layer approach. We acknowledge that operational challenges will remain but consider these are commensurate with a portfolio hedge accounting approach that portrays complex portfolio risk management activities in the financial statements.

(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?*

As noted in our response to Question 1, we do not believe that the objective should be to represent dynamic risk management in the financial statements. The PRA as described in the DP can result in items (or open exposures) that are purposely not risk reduced through risk management activities that under the classification requirements of IFRS would by default be measured at amortised cost be revalued through profit or loss leading to income volatility. We question the usefulness of this and therefore our preference is to develop a portfolio hedge accounting model that respond to accounting mismatches arising the execution of risk management activities. We believe that developing a portfolio hedge accounting model where (portfolios of) core demand deposits are eligible, bottom layers of portfolios may be designated and the hedged cash flows of portfolios can be based on expected (or 'behaviouralised') cash flows would represent a significant improvement on the current hedge accounting requirements and provide more useful information about an entity's performance. As noted above, where exposures are not eligible to be revalued for accounting purposes (e.g. EMB), they may still be included by an entity to determine the net risk position of which some or all is hedge accounted.

(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?*

Since we do not support the PRA, for the reasons highlighted in our response to the questions above, we have not commented on the operational feasibility of applying the PRA for the various scope alternatives presented in the DP.

(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?

For consideration of application to other risks, please see response to Question 25 below.

Question 16—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?*

We do not support the PRA and would not support mandatory application.

(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?*

Consistent with application of hedge accounting under the general hedge accounting model, we do not believe that a portfolio hedge accounting model should be mandatory because (1) it represents an exception to the default accounting requirements in IFRS 9 and (2) it would not be operationally feasible to enforce hedge accounting through defining what risk management is.

Question 17—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.*

Since we do not support the PRA focused on dynamic risk management we have not considered further any qualifying criteria that would be necessary.

(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.

Under a portfolio risk mitigation hedge accounting model we would expect eligibility criteria consistent with that required under the IFRS 9 general hedge accounting model except for tailored concessions relating specifically to portfolio hedge accounting. For example, we would expect hedge accounting to be permitted only if the hedge is formally designated and if an economic relationship exists (rather than the 80 – 125% effectiveness threshold). Specific for portfolio hedging for interest rate risk, and as noted in our responses to the other questions, we would expect the model to include (portfolios of) core demand deposits, sub-LIBOR exposures and behaviouralised cash flows.

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

We do not support a mandatory model and have therefore not considered how the eligibility criteria might be different under a mandatory model.

(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.

We believe that any accounting alternative to address the accounting mismatches arising from executing risk management activities, like hedge accounting, should be an exception to the IFRS 9 classification and measurement model and voluntary to apply. Consistent with our comments on ED/2010/13 IFRS 9 Hedge Accounting we believe that ceasing to apply hedge accounting should also be a free choice. This will be particularly important for a portfolio hedging model given the dynamic nature of the hedging activity where the hedged items and hedging instruments will change frequently.

Question 18—Presentation alternatives

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

In the context of a portfolio hedge accounting approach, we would prefer the presentation in the statement of financial position to be consistent with the current requirements for portfolio fair value hedge accounting in IAS 39. That is separate lines for aggregate adjustments to assets and liabilities. We believe that this alternative is operationally simpler than adjusting on a line by line basis and consistent with existing accounting principles since the IAS 32 *Financial Instruments: Presentation* criteria for offsetting the aggregate asset and aggregate liability would not be met.

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

In the context of a hedge accounting approach we believe that the actual net interest income

presentation would be the most relevant presentation in the statement of comprehensive income. However, where the hedged item is not a net position (for example where the hedged item is solely a portfolio of demand deposits), we believe the interest from the hedging instruments should be presented in the same line as the interest from the hedged item rather than in a separate line as presented in paragraph 6.1.17 of the DP. We believe the separate line presentation of interest from the hedging instruments is only appropriate if the hedged item is a net position. This presentation is consistent with the presentation of amounts reclassified from the cash flow hedge reserve for cash flow hedges under IFRS 9. That is, the reclassified amounts are presented in the same line as the hedged item unless it is designated as a hedge of a net position in which case the reclassified amounts are presented in a separate line.

(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.

We have not considered any other alternatives.

Question 19—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?

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

We do not believe that internal derivatives should represent eligible hedged items or eligible hedging instruments in a portfolio hedge accounting model as we do not believe that the resulting gross presentation in the statement of comprehensive income, arising solely from internal transactions, is appropriate.

Furthermore, in practice, the formalities and controls around internal derivatives can vary significantly which could introduce significant challenges in practice and could hinder comparability amongst reporters.

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

Since we do not support the risk management PRA approach, we have not considered whether the treatment of internal derivatives would enhance its operational feasibility.

We do not believe that a portfolio hedge accounting model needs to accommodate internal derivatives in order to be operable.

(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?*

We do not support the recognition and measurement of internal derivatives in the consolidated financial statements.

Question 20—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.*

Given that we do not support the PRA as proposed in the DP and the early stage of its development we have not considered the disclosure requirements in detail. However, if the IASB were to develop a portfolio hedge accounting model that builds on the concepts already in IFRS that includes core demand deposits, behaviouralised cash flows and bottom layers, we would support disclosures that help users understand the significant judgements and assumptions applied and an analysis of the impact of hedge accounting on the financial statements.

Furthermore, to make the financial reporting more useful for users, disclosures will play a key role for bridging the gap between risk management activities and recognition and measurement in the primary financial statements. However, in developing appropriate disclosures, we recommend a full evaluation of current disclosure requirements and other disclosure related initiatives by the IASB and others (e.g. FASB, EDTF, etc.).

Question 21—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?

Please see our response to Question 20 for our initial views on disclosures.

Question 22—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.*

We believe the approach to inclusion of exposures in a portfolio hedge accounting model should be consistent with the current requirements in IAS 39. That is, items can generally be included at any time typically from the point they become contractual (or, in respect of pipeline transactions, become constructive obligations).

Question 23—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.*

Consistent with our response to Question 17 and 22, we believe that under a portfolio hedge accounting model, hedged items can be removed (i.e. de-designated) voluntarily with the resulting adjustment accounted for in the same was as under the current portfolio fair value hedge accounting model in IAS 39.

Question 24—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.*

Since we do not support the PRA we have not considered its extension to dynamic risk management of foreign currency instruments. However, in the context of portfolio hedge accounting, we do not see why such a model should not permit the inclusion of foreign currency risk if both interest rate and foreign currency risk are hedged together (for example with cross-currency interest rate swaps). In this context, we believe the Board should reconsider the requirements from IFRS 9.6.5.16. This is because basis spreads, without a similar or identical special accounting treatment, would give rise to ineffectiveness.

Question 25—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.

For the reasons outlined in response to Question 1 (and responses to other questions), we do not support the PRA approach and hence do not support it for other non-bank dynamic risk management.

We believe the Board should consider more broadly a portfolio hedge accounting approach to interest rate risk, not just for banks. As noted in our responses on phase two of Insurance Contracts in 2010 and 2013 we believe a portfolio hedging solution should be explored for insurers as it is common for insurers to use derivatives to hedge interest rate risk on their duration mismatch between their non-derivative financial assets and insurance liabilities. Given the measurement of insurance contracts is due to be finalised next year we recommend that the Board consider whether such hedging strategies will lead to accounting mismatches that can minimised with a portfolio hedge accounting solution that includes insurance contracts as hedged items. Further, as the development of the PRA is a solution to a structural interest rate hedge in banks, we would favour outreach to non-financial entities on whether their portfolio hedging strategies share similar characteristics to financial entities.

Question 26—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?

We do not support the PRA through OCI approach and therefore do not think this should be pursued.

ITC31 sub 8

The Institute of Public Accountants

Submission Re: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging (DP/2014/1)

31 October 2014

Partnership beyond numbers

IPA INSTITUTE OF PUBLIC ACCOUNTANTS

31 October 2014

International Accounting Standards Board
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The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
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Dear Sir/Madam

Re: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging (DP/2014/1)

Thank you for the opportunity to comment on the Discussion Paper DP/2014/1 'Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging'. While the IPA acknowledges the current options for hedge accounting for interest rate risk in the banking book are sub-optimal, the IPA does not support the Portfolio Revaluation Approach (PRA) proposed in the Discussion Paper (DP).

For the reasons set out in the DP the existing accounting options available under IFRS 9 'Financial Instruments'/IAS 39 'Financial Instruments: Recognition and Measurement' do not faithfully reflect the manner in which banks' manage their net interest exposures. The current portfolio hedging requirements are operationally difficult to implement and require a series of "closed portfolios" rather than the open portfolios used in banks' management of their net interest disclosure. As a result, cash flow hedges designated to variable rate mortgages are used to achieve hedge accounting under current rules. While such "work-arounds" have ensured minimal profit and loss volatility, they are not a true representation of the actual risk management process for managing interest rate risk in the banking book.

The IPA does not support the PRA proposed for the following reasons.

1. Management of interest rate risk in the banking book is effectively the management of the bank's net interest cash flows and as such a model based on fair value revaluations does not reflect the substance of the risk management activities and, therefore, is subject to some the same criticisms applicable to the current requirements;
2. The model effectively requires the recognition on the balance sheet as a fair value "increment" the net future cash flows arising from assets and liabilities held at amortised cost; we do not believe that there is basis for such accounting under the Framework
3. While we agree with a number concepts underpinning the proposal, some are inconsistent with the Framework, including:
    a. The inclusion of the Equity Model Book (EMB) as part of the managed portfolio;
    b. The treatment of core demand deposits; and
    c. Sub-benchmark managed risk instruments.
4. We are concerned with the ease of operationalising the proposals, including the use of transfer pricing as a practical expedient; and

5. The DP attempts to reflect in financial statement risk management activities, and we are of the view that the current Framework is inconsistent with such an objective. On a more fundamental basis, whether the existing financial statements are the appropriate format for the recognition and measurement of risk management activities (even on a limited basis as contemplated by the DP); and
6. The IPA is concerned with the proposal to extent to concepts on the DP to areas outside interest rate risk in the banking book, where there currently have been no demonstrated concerns in relation to the existing hedging options.

The IPA believes the revaluation model is not appropriate to reflect the substance of risk management of interest rate risk in the banking book and recommend the IASB consider a cash hedging based model.

Finally, the IPA believes the IASB should consider a broad risk management disclosure framework including qualitative and quantitative disclosures applicable to all entities, not just those that adopt hedge accounting.

Our detailed comments and responses to the questions in the Discussion Paper are set out in Appendix A.

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 24,000 members nationally, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investment Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA) on issues affecting the profession and industry.

If you would like to discuss our comments, please contact me or our technical adviser Stephen La Greca, GAAP Consulting, (0417 451 315, or stephenlagreca@aol.com).

Yours faithfully

Vicki Stylianou
Executive General Manager Public Affairs

APPENDIX A

Question 1 – 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?

IPA response

While the IPA believes there is a need to address the failure of the current hedging rules to appropriately cater for the manner in which financial institutions manage the interest rate in their banking books, we do not believe the proposed dynamic risk management (DRM) approach is an appropriate manner to do so.

The IPA does not believe a method based on the recognition of future net interest margins as a balance sheet item is consistent with the Framework. Further, we have reservations that a number of concepts used in the dynamic risk management are also not consistent with the current purpose of financial reporting.

Financial reporting is currently not based on the recognition and measurement of the various business risk of entity and while there is a case for the disclosure and quantification of such risks, the IPA believes such objective would be better served by disclosure in the notes rather than the recognition of balance sheet items. Therefore, we believe the IASB needs to focus on cash flow hedging model that reflects the hedging of net interest income flows rather than a revaluation model.

Question 2 – Current difficulties in representing dynamic risk management in entitles financial statement

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?

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

IPA response

The IPA agrees the DP has identified the main issues with the interest rate risk management under current hedge accounting rules. However, the DP does not make the case of the need and appropriateness or otherwise of dynamic risk management in relation to hedging of other net risk exposures. As mentioned is our response to question 1, the IPA does not believe the DRM approach based on a PRA is appropriate.

Question 3 – 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?

IPA response

The IPA agrees that the DP describes many of the characteristics of management of interest rate risk in the banking book. However, it is unclear whether these characteristics of other risk dynamically managed by banks or in other industry sectors.

Question 4 – Pipeline transactions, EMB and behaviouralisation

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).

EMB

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.

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.

IPA response

The IPA has reservations in relation to the inclusion of pipeline transactions. However, we believe that as long as the pipeline transactions are considered highly probable they should be included as hedged items.

The IPA acknowledges that EMB can be used as part of management of interest rates. However, under a revaluation model where some of the items being hedged are equity instruments there are issues with consistency with the Framework that need to be addressed. The other issue is whether the inclusion of EMB interest rate management should be limited to equity instruments with “preferential coupons” (i.e. hybrid tier 1 equity) or all equity.

The inclusion of behavioural considerations of core deposits is integral to the management of interest rate in the banking book. Any accounting model attempting to apply hedge accounting to these risk management activities needs to acknowledge the behavioural characteristics of items comprising the net exposure. The IPA does not see the behavioural characteristics as inconsistent with the Framework as they simply represent a methodology of estimating the forecast cash flow.

Question 5 – 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.

IPA response

The IPA supports the view that any model of hedge accounting of risk management of interest rate in the banking book should include those instruments that are used to manage prepayment risk. The management of prepayment risk in the banking book is an integral part of managing interest rate risk in the banking book.

Question 6 – 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?

IPA response

Material changes in customer behaviour should be reflected in the expected cash flows to the extent such changes are material to the net cash flow exposure being hedged. Appropriate disclosures need to be made of both the underlying assumptions of customer behaviour and the basis and quantification of any changes.

Question 7 – 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? If yes, how would you suggest overcoming the conceptual and operational difficulties identified? Please explain your reasons.

IPA response

The IPA does not have a view on whether a bottom layer or proportional basis is superior with the PRA. However, we believe both methods have serious operational implementation issues.

Question 8 – Risk limits

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

IPA response

Risk appetite and consequential risk management policies should not be mandated by accounting standards; this is the purview of boards and prudential regulators. Therefore, the IPA does not support the imposition of risk limits for the application of the PRA. The IPA would support general qualitative and quantitative disclosures on risk appetite and risk limits and the relationship with risk management in general and the application of such limits to the PRA.

Question 9 – Core demand deposits

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?

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

IPA response

The IPA believes there is no doubt the inclusion of core demand deposits is integral to the management of interest rate in the banking book and therefore needs to be included in any accounting approach purporting to portray the hedging activities in relation to interest rate management. We believe appropriate quantitative and qualitative relating to core deposit behavioural assumption should be made.

Question 10 – Sub-benchmark rate managed risk instruments

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 (i.e. Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (i.e. 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?

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?

IPA response

The IPA supports Approach 3 ("Risk included in ALM") as it represents the activities undertaken to manage interest rate risk in the banking book. To the extent embedded floors are included in the net risk position being hedged they should be included.

Question 11 – Revaluation of the managed exposures

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

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?

IPA response

As previously noted the IPA does not support a PRA basis for the measurement of interest rate risk in the banking book. We reiterate our position that the management of interest rate risk in the banking book is the management of net interest cash flows and therefore a fair value model for hedge accounting is inappropriate. The IASB should be developing a cash flow hedging model for interest rate risk in the banking book.

Question 12 – Transfer pricing transactions

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)?

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.

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?

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?

IPA response

The IPA understands the need for operational expedients to implement the PRA as set-out in the DP. However, we are concerned with management bias in the measurement of the hedged position. We believe that internal transfer pricing systems are not normally subject to external audit and therefore additional audit costs will necessarily be incurred to establish the adequacy of the control environment of transfer pricing systems including the consideration of management bias.

If the funding rate is used a market funding index (excluding transfer pricing spreads) is the basis the IPA would support. If transfer pricing is to be used as a practical expedient theoretically there should be no restrictions on indexes and spreads otherwise system changes may be required to achieve compliance, diminishing the benefits of the use of transfer pricing. However, the IPA is concerned with management bias and the potential lack of external audit scrutiny.

Transfer pricing can only be considered a practical expedient, to the extent ongoing linkages are identified. If this is not the case or no longer is the case, the use of transfer pricing represents ongoing linkages to the hedged items then it is no longer appropriate.

Question 13 – Selection of funding index

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.

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?

IPA response

The IPA believes the selection of a funding index is the part of the entity's risk management process and should not be mandated by accounting standards. However, there should be adequate

documentation supporting the selection of a funding index explaining its relationship to risk management processes and transfer pricing objectives.

Question 14 – Pricing Index

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

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.

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?

IPA response

The IPA has no basis for comment.

Question 15 – Scope

Do you think that the PRA should be applied to all managed portfolios included in an entity's dynamic risk management (i.e. 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?

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?

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?

Would the answers provided in questions (a) – (c) change when considering risk 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?

IPA response

The IPA does not support the use of PRA to represent hedge accounting of interest rate risk in the banking book. As has previously stated, we consider the hedging of interest rate risk in the banking book as a hedge of future net interest cash flows and as such a cash flow hedge model would be the appropriate mechanism for such hedging activity.

Question 16 – Mandatory or optional application of the PRA

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?

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?

IPA response

The IPA believes preparers should be able to choose whether to adopt general hedging requirements or the proposed PRA method. A move to mandate a specific hedging approach would also require preparers to potentially incur additional operational costs, when they believe the alternative is a more faithful representation of the hedging relationship. However having made the choice to apply one method there should be no option to change.

Question 17 – Other eligibility criteria

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?

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

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.

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.

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

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.

IPA response

If the IASB proceeds with dynamic risk management PRA model, the IPA believes a preparer should demonstrate the following to use the method:

1. The exposure must be managed on a dynamic risk management basis;
2. The exposure is not already hedge accounted as a fair value or cash flow hedge under IFRS 9; and
3. Prospective effectiveness testing supports the economic effective of hedge relationship.

Question 18 – Presentation alternatives

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

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

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.

IPA response

As previously stated, the IPA does not support the use of revaluation model to represent hedging of interest rate risk in the banking book. Nonetheless, if is such a method was to be used a single line item representing the revalued net interest exposures would be most appropriate. The IPA prefers the representation of actual net interest income as it represents the contractual interest cash flows. However, we believe the current label on the net revaluation impact is uninformative and an alternative descriptor should be developed.

The IPA does not support the other alternative presented.

Question 19 – Presentation of internal derivatives

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?

Do you think that the described treatment of internal derivatives enhances the operation feasibility of the PRA? Why or why not?

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?

IPA response

The IPA does not see the benefit from the grossing-up of risk management exposures for use of internal derivatives. The IPA sees no operational benefit from the proposal as most preparers have already put in place processes to externalise exposures.

Question 20 – Disclosures

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.

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

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.

IPA response

The IPA in general supports the disclosures proposed. However, we would like to see an integrated risk identification and risk management framework, including existing disclosures. We agree with assessment at 6.3.11 disclosures by class are unlikely to be meaningful disclosures when risk is managed on a net basis.

Furthermore, we are also of the view that risk disclosures need to be made not just by entities adopting PRA hedge accounting but all entities regardless of whether they adopt hedge accounting (either fair value, cash flow or PRA hedging) or have uncovered positions.

Question 21 – Scope of disclosures

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?

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?

IPA response

As mentioned in response to question 20, the IPA believe there should be integrated risk reporting framework including the use of hedging instruments when applicable.

Question 22 – 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?

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

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

IPA response

As has been previously raised, the IPA does not support a revaluation model for risk managed on a dynamic basis. In the event a PRA methodology is adopted the IPA's view is that it is at the entity's option as how and when it decides to hedge exposures. Such decisions are integral to the concept of dynamic risk management.

To maintain consistency with current requirements in relation to day one valuations, such gains/losses should be recognised over the period of the hedge relationship. This would ensure no additional volatility arises on inclusion of an exposure in the PRA.

Question 23 – Removal of exposures from managed portfolio

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?

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?

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.

IPA response

The nature of dynamic risk management is such that exposures may be added and removed on a continuous basis. Therefore, it should be permitted to remove exposures prior to maturity to reflect changes in the underlying risk or the risk management strategy. The accounting for a resultant change in underlying risk position should result in an immediate impact on profit and loss. However where there has been a change in risk management strategy the issue becomes more problematic, if a similar treatment is proposed to the removal of underlying risk position, the possibility exists for the cessation of a hedge relationship as a result of management discretion gains may be recognised on an opportunistic basis.

Question 24 – Dynamic risk management of foreign currency

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?

Please provide an over view of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not.

IPA response

The IPA has no basis for comment at this time.

Question 25 – Application of the PRA to other risks

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.

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.

IPA response

Where a risk is managed on a net basis it is possible the PRA dynamic risk management in the DP may be applicable. The approach in the DP has been developed for exposures relating to interest rate risk in the banking book and guidance would need to be of more general basis.

The IPA does not support a revaluation model for what are effectively hedges of expected cash flows.

Question 26 – 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 be conceptual and practical difficulties identified with this alternative approach be overcome?

IPA response

The IPA does not believe the use of OCI is appropriate for fair value hedge accounting model. A fair value hedge model implicitly implies that movements in the hedged item are offset by movements in the hedge instrument; any differences between the fair value of the hedged item and hedge instrument reflects the ineffectiveness of the hedge. If one part of the transaction was to be reflected in OCI this relationship would be severed and hedge effectiveness would no longer be reflected in profit and loss.

If the IASB developed a cash flow hedge accounting model for the management interest rate risk in the banking book the use of OCI would be appropriate.

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