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

We are pleased to have the opportunity to comment on Discussion Paper 2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the DP).

National Australia Bank Limited is one of the four major Australian banks. Our operations are predominantly based in Australia, New Zealand and the United Kingdom. In our September 2013 full year results we reported net profit after tax of A$5.5 billion and total assets of approximately A$810 billion.

We strongly object to the introduction of the Portfolio Revaluation Approach (PRA) on a mandatory basis. Many entities have already developed hedge accounting solutions that work in practice, such as designating derivatives as hedging unrelated exposures. We do not want the use of the IFRS 9 *Financial Instruments* hedge accounting provisions to be prohibited if they are effective and efficient solutions.

We are indifferent if the International Accounting Standards Board (IASB) wish to further develop the PRA and allow its application on an optional basis. Our preference however is for the IASB to focus on improving the existing macro hedge accounting rules. If the IASB decides to proceed with the proposed PRA, we prefer an approach that does not revalue the unhedged exposure.

We have the following concerns with the proposals and mandatory application of the PRA:

<u>Profit or loss volatility resulting from the PRA</u>
We believe the PRA would lead to a disconnect between reported performance (including the revaluation of the unhedged exposure) and the underlying business model. Banks are in the business of collecting streams of net interest income cash flows, and manage their business in this manner, rather than on a present value basis.

We are concerned that any resulting profit or loss volatility could confuse or cause undue concern with users of financial statements, as a result of a lack of understanding of the PRA. This would be heightened in a period of increased market volatility.

As a result, we also fear that the PRA would negatively impact on risk management activities. In the most extreme case, it may result in a risk management function looking to perfectly hedge all exposures to avoid profit or loss volatility despite this not being the preferred business outcome. Whilst accounting is a reporting mechanism, the fact that accounting requirements can drive corporate behaviour is very real. An example is the decline in the use of options in light of the hedge accounting consequences under IAS 39 *Financial Instruments: Recognition and Measurement.*

The PRA is inconsistent with hedge accounting under IFRS 9

It is proposed that the PRA would be applied by entities that manage interest rate risk on a dynamic basis. We believe that the requirement to apply an accounting approach should be based on the existence of a risk, rather than the way in which it is managed.

The objective of hedge accounting is to describe when and how an entity overrides the general recognition and measurement requirements, and recognises effectiveness and/or ineffectiveness of a hedging relationship. We believe that macro hedge accounting should be aligned with IFRS 9 hedge accounting model principles as they apply to the same underlying risks. In our view, both hedge accounting models should provide a toolkit to mitigate profit or loss volatility arising from the use of the derivatives as hedging instruments.

We can foresee that the PRA would become a banking specific accounting standard, and believe that such an industry standard could confuse users of financial statements.

The PRA would not improve information provided to users of financial statements

Accounting standards already require a significant amount of disclosure about financial risk management; specifically part of the purpose of IFRS 7 *Financial Instruments: Disclosures* is to provide disclosures that enable users of financial statements to evaluate the nature and extent of risks arising from financial instruments, and how those risks are managed. Interest rate risk is generally managed using risk limits which effectively cap the potential unhedged exposure, and users have information on the effectiveness of managing this market risk such as through disclosure of Value at Risk estimating the potential loss from the unhedged exposure (as required by IFRS 7 paragraphs 40 and 41). As such the PRA has limited value, other than as a macro hedge accounting solution.

Further, revaluation of the unhedged exposure would not provide information on the effectiveness of a hedging activity, i.e. how successful was an entity in managing exposures within its risk management framework and limits.

The PRA would not fully reflect dynamic risk management activities

We understand that the IASB have intentionally not referred to the DP as a hedge accounting proposal, and instead are proposing a solution that reflects dynamic risk management activities in financial statements. The proposals are nonetheless a potential solution to the fact that derivatives are recognised on balance sheet at fair value, and the fact that the matching of hedged items and hedging instruments is overly onerous when the underlying hedging activity is dynamic.

We believe that dynamic risk management activities would not be fully reflected in financial statements under the PRA. Dynamic risk management activities are applied to multiple correlated financial risks and include market valuation and earnings based approaches and techniques, such as Value at Risk, Earnings at Risk, interest rate risk stress testing, repricing analysis, cash flow analysis and scenario analysis. A one-dimensional revaluation of the underlying exposures for interest rate risk would provide incomplete information on a limited aspect of the dynamic risk management.

Our preferred approach in developing a solution for macro hedging

We envisage that if the IASB pursues the PRA, it will take a significant period of time to finalise the proposals, and even longer if it is expanded to include risks other than interest rate risk. We believe that a more short-term solution is needed to address the limitations of the current accounting requirements.

We recommend changing the focus of the project to improve the current macro hedge accounting requirements to make them more operational. In particular we would welcome the extension of improvements made to general hedge accounting under IFRS 9 to macro hedge accounting. For example, the removal of arbitrary hedge effectiveness thresholds and the allowance of rebalancing without discontinuation of an existing hedge designation.

In addition, we would welcome the expansion of possible hedged items for macro hedge relationships, such as those contained in the DP, being the equity model book, pipeline transactions and core demand deposits on the basis that they form part of risk management activities.

The appendix to this letter outlines our responses to the specific questions in the DP which should be read in the context of the general comments raised above.

Should you have any queries regarding our comments, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at Marc.Smit@nab.com.au.

Yours sincerely

Stephen Gallagher

General Manager Group Finance

APPENDIX – Responses to Specific Questions

Section 1 *BACKGROUND AND INTRODUCTION TO THE PORTFOLIO REVALUATION APPROACH (PRA)*

Question 1 - Do you think that there is a need for a specific accounting approach to represent dynamic risk management in entities' financial statements?

We agree with the description of the limitations of the current accounting requirements contained in the Discussion Paper (DP). As a result of these limitations, in most circumstances entities have developed hedge accounting solutions that work in practice, such as designating derivatives as hedging unrelated exposures. This does reduce the faithful representation of risk management in financial statements, in particular on the face of the balance sheet and income statement.

In our view, improvements to accounting pronouncements are necessary to provide more relevant information to users of financial statements, including entities' own management. A specific accounting approach to represent dynamic risk management may not be the best way to achieve this. We understand that the International Accounting Standards Board (IASB) have intentionally not referred to the DP as a hedge accounting proposal, but we believe what is needed is a hedge accounting solution for open portfolios that allows the designation of hedged items that entities hedge in practice.

We are indifferent if the IASB wish to further develop the PRA and allow its application on an optional basis. We strongly object however to the introduction of the PRA on a mandatory basis. We do not want the use of the IFRS 9 *Financial Instruments* hedge accounting provisions to be prohibited if they are effective and efficient solutions.

We recommend changing the focus of the project to improve the current macro hedge accounting requirements to make them more operational. In particular we would welcome the extension of improvements made to general hedge accounting under IFRS 9 to macro hedge accounting. For example, the removal of arbitrary hedge effectiveness thresholds and the allowance of rebalancing without discontinuation of an existing hedge designation. In addition, we would welcome the expansion of possible hedged items for macro hedge relationships, such as those contained in the DP, being the equity model book, pipeline transactions and core demand deposits on the basis that they form part of risk management activities.

We envisage that if the IASB pursues the PRA, it will take a significant period of time to finalise the proposals, and even longer if it is expanded to include risks other than interest rate risk. We believe that a more short-term solution is needed to address the limitations of the current accounting requirements.

We have the following concerns with the PRA as a specific accounting approach to reflect dynamic risk management in entities' financial statements:

<u>Profit or loss volatility resulting from the PRA is of concern</u>
We believe the PRA would lead to a disconnect between reported performance (including the revaluation of the unhedged exposure) and the underlying business model. Banks are in the business of collecting streams of net interest income cash flows, and manage their business in this manner, rather than on a present value basis.

We are concerned that any resulting profit or loss volatility could confuse or cause undue concern with users of financial statements, as a result of a lack of understanding of the PRA. This would be heightened in a period of increased market volatility.

As a result, we also fear that the PRA would negatively impact on risk management activities. In the most extreme case, it may result in a risk management function looking to perfectly hedge all exposures to avoid profit or loss volatility despite this not being the preferred business outcome. Whilst accounting is a reporting mechanism, the fact that accounting requirements can drive corporate behaviour is very real. An example is the decline in the use of options in light of the hedge accounting consequences under IAS 39 *Financial Instruments: Recognition and Measurement.*

<u>The PRA is inconsistent with hedge accounting under IFRS 9</u>
It is proposed that the PRA would be applied by entities that manage interest rate risk on a dynamic basis. We believe that the requirement to apply an accounting approach should be based on the existence of a risk, rather than the way in which it is managed.

The objective of the hedge accounting is to describe when and how an entity overrides the general recognition and measurement requirements, and recognises effectiveness and/or ineffectiveness of a hedging relationship. We believe that macro hedge accounting should be aligned with IFRS 9 hedge accounting model principles as they apply to the same underlying risks. In our view, both hedge accounting models should provide a toolkit to mitigate profit or loss volatility arising from the use of derivatives as hedging instruments.

We can foresee that the PRA would become a banking specific accounting standard, and believe that such an industry standard could confuse users of financial statements.

<u>The PRA would not improve information provided to users of financial statements</u>
Accounting standards already require a significant amount of disclosure about financial risk management; specifically part of the purpose of IFRS 7 *Financial Instruments: Disclosures* is to provide disclosures that enable users of financial statements to evaluate the nature and extent of risks arising from financial instruments, and how those risks are managed. Interest rate risk is generally managed using risk limits which effectively cap the potential unhedged exposure, and users have information on the effectiveness of managing this market risk such as through disclosure of Value at Risk estimating the potential loss from the unhedged exposure (as required by IFRS 7 paragraphs 40 and 41). As such the PRA has limited value, other than as a macro hedge accounting solution.

Further, revaluation of the unhedged exposure would not provide information on the effectiveness of the hedging activity, i.e. how successful was an entity in managing exposures within its risk management framework and limits.

<u>The PRA would not fully represent dynamic risk management activities</u>
We believe that dynamic risk management activities would not be fully reflected in financial statements under the PRA. Dynamic risk management activities are applied to multiple correlated financial risks and include market valuation and earnings based approaches and techniques, such as Value at Risk, Earnings at Risk, interest rate risk stress testing, repricing analysis, cash flow analysis and scenario analysis. A one-dimensional revaluation of the underlying exposures for interest rate risk would provide incomplete information on a limited aspect of dynamic risk management.

Question 2a) - 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?

Question 2b) - Do you think that the PRA would address the issues identified?

Response 2a) - We agree that the DP has identified the main issues that entities face with macro hedge accounting, such as hedging of interest rate risk associated with the equity model book, pipeline transactions and core demand deposits.

Response 2b) - The PRA would address the issues identified, however we believe it would introduce other unfavourable consequences. In particular, we have concerns about the resulting profit or loss volatility, that would be counterintuitive to the general aim of the hedge accounting. We fear that the PRA may change risk management behaviour, as although accounting is a reporting mechanism, the fact that accounting requirements can drive corporate behaviour is very real. In addition we can foresee that the PRA would become a banking specific accounting standard, and believe that such an industry standard could confuse users of the financial statements. Refer to our response to Question 1 for further details of our concerns with the PRA.

Section 2 OVERVIEW

Question 3 - Do you think that the description of dynamic risk management in paragraphs 2.1.1 - 2.1.2 is accurate and complete?

Overall, we agree that the usual characteristics of dynamic risk management in paragraph 2.1.1 are appropriate. On a minor wording point, it may be better to replace the word "mature" with "are removed" in the sentence "open portfolios to which new exposures are frequently added and existing exposures mature", as the prepayment of an exposure in an open portfolio may not be considered to have reached maturity.

In respect of paragraph 2.1.2, we do not believe that dynamic risk management will necessary only manage risk arising from external exposures, as there may be inter-company and intra-company (i.e. across desk) exposures, on the basis that they are expected to be similar to an external exposure, or because different areas of a bank may have responsibility to manage different portfolios.

The IASB may wish to provide further guidance on what is concerned by "frequently" and "on a timely basis" to avoid misinterpretation and have more consistent application, especially as the accounting consequences from being within the scope of the PRA are significant.

Section 3 THE MANAGED PORTFOLIO

Question 4a) - 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?

Question 4b) - Do you think that equity model book (EMB) should be included in the PRA if it is considered by an entity as part of its dynamic risk management?

Question 4c) - For the purposes of applying the PRA, should the cash flows be based on a behaviouralised rather than on a contractual basis when the risk is managed on a behaviouralised basis?

Response 4a) - Yes, if pipeline transactions are part of an entity's dynamic risk management these should be included in the PRA. If expected exposures are not reflected in the PRA in the same way in which they are managed for risk purposes, the usefulness of the PRA will diminish.

We not do foresee including pipeline transactions in the PRA being any more operationally complex than for other exposures. Verification of the resulting amounts, such as by external auditors, will require more judgement as the auditors will need to rely to some extent on management's representations that derivatives have been entered into for hedging rather than speculative purposes. In addition, auditors will need to be mindful that accounting balances could potentially be manipulated by misrepresenting that derivatives were entered into related to pipeline transactions.

We recognise the conceptual challenge with revaluation of pipeline transactions for the managed risk, and consider the constructive obligation to current and future customers is the closest accounting rationale for the treatment. In our opinion, deviations from the Conceptual Framework can be tolerated based on the benefit from being able to apply the PRA to all derivatives entered into as part of dynamic interest rate risk management activities.

Response 4b) - Yes, if EMB is part of an entity's dynamic risk management it should be included in the PRA. It is common for banks in Australia to manage the return on their own equity in the way outlined in paragraph 3.3.1 of the DP, and hence this is an issue for us. If such derivatives are excluded from the PRA, they are likely to be included in general hedge accounting relationships, designated against unrelated exposures, which would reduce the usefulness of the PRA.

We not do foresee including EMB in the PRA being any more operationally complex than for other exposures. Verification of the resulting amounts, such as by external auditors, will require more judgement as the auditors will need to rely to some extent on management's representations that derivatives have been entered into for hedging rather than speculative purposes. In addition, auditors will need to be mindful that accounting balances could potentially be manipulated by misrepresenting that derivatives were entered into related to EMB.

We view EMB as more difficult to justify conceptually than pipeline transactions, however in our opinion, deviations from the Conceptual Framework can be tolerated based on the benefit from being able to apply the PRA to all derivatives entered into as part of dynamic interest rate risk management activities.

Response 4c) - Yes, if cash flows are based on behaviouralised basis in an entity's dynamic risk management these should be included in the PRA on the same basis. If cash flows are not reflected in the PRA in the same way in which they are managed for risk purposes, the usefulness of the PRA will diminish.

The PRA itself is operationally complex, and in our view reflecting cash flows on a behaviouralised basis would not significantly add to this complexity.

Under the PRA on a behaviouralised basis, future interest cash flows on demand deposits would be re-measured for interest rate risk, resulting in the deposit liability not being measured at the present value of the amount that is payable on demand. In our opinion, deviations from the Conceptual Framework can be tolerated based on the benefit from being able to apply the PRA to derivatives entered into as part of dynamic interest rate risk management activities in a manner that is consistent with the underlying rationale for entering into them.

Question 5 - 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?

In our opinion, this question highlights a significant flaw with the proposed PRA, in that it will not faithfully represent dynamic interest rate risk management in financial statements, as per its objective. On a portfolio basis the valuation of derivatives with optionality, and valuation of the underlying exposures for interest rate risk is going to result in profit or loss volatility. Whilst the theory behind the PRA is logical, we are concerned over issues such as this and operational complexity that would arose from its practical application.

Please refer to our response to question 1 where we have outlined our concerns over profit or loss volatility from the PRA, and our preference for the IASB to change the focus of the project to improve the current macro hedge accounting requirements to make them more operational.

Question 6 - 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?

Yes, we believe that the impact of changes in past assumptions of customer behaviour should be recognised in profit or loss through the application of the PRA when and to the extent they occur. We would expect the modelling of customer behaviour to require regular updating, which in turn will impact on dynamic interest rate risk management activities.

Question 7 - 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?

In cases where interest rate risk is managed in the way described in paragraph 3.7.1 of the DP, we believe that a bottom layer approach should be permitted within the PRA. This would reduce profit or loss volatility resulting from the PRA. As outlined in our response to question 1 we are concerned that profit or loss volatility from the PRA could confuse or cause undue concern with users of financial statements, especially in a period of increased market volatility. In addition, we also fear that profit or loss volatility from the PRA would negatively impact on risk management activities, as whilst accounting is a reporting mechanism, the fact that accounting requirements can drive corporate behaviour is very real.

The DP raises various difficulties with a bottom layer approach. The DP states in paragraph 3.7.2 that a bank cannot determine which exposures within the portfolio make up the bottom layer and which exposures do not. In practice a percentage of all exposures (for example, 60% of each exposure in the portfolio) could be considered to be the bottom layer, with this percentage increasing over time (for example, to 100%) based on the expected run-off profile of the exposure. This would require the bucketing of exposures based on say origination date, with this bucketing also potentially addressing the operational difficulty when there is a change in the level of the bottom level that is being managed.

Under a bottom layer approach, the PRA would not revalue the top layer for interest rate risk. The DP suggests that this a conceptual issue with the approach, however we are comfortable with such an approach as the benefit of reduced profit or loss volatility is significant.

Whilst the theory behind the PRA is logical, we are concerned over issues such as this and operational complexity that would arise from its practical application. Please refer to our response to question 1 where we have outlined our preference for the IASB to change the focus of the project to improve the current macro hedge accounting requirements to make them more operational.

Question 8 - Do you think that risk limits should be reflected in the application of the PRA?

No, we agree with the IASB that risk limits should not be reflected in the application of the PRA. Whilst we understand the conceptual concerns of the IASB in paragraph 3.8.4 of the DP, our main concern is practical application and increased complexity of a PRA that reflects risk limits. Risk limits may be multi-dimensional, for example the net open position may have dollar limits, as well as other limits such as the resulting Value at Risk, and may differ between short, medium and long term net open positions.

Question 9a) - 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?

Question 9b) - Do you think that guidance would be necessary for entities to determine the behaviouralised profile of core demand deposits?

Response 9a) - Yes, we think that core demand deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA if this is consistent with how they are treated for dynamic risk management purposes. If cash flows are not reflected in the PRA in the same way in which they are managed for risk purposes, the usefulness of the PRA will diminish.

Response 9b) - We do not think that guidance for entities to determine the behaviouralised profile of core demand deposits is necessary, as this would only be reflected in the PRA if the risk management function is already modelling cash flows on this basis. That said, guidance may be useful as core demand deposits would commonly be taken into account when interest rate risk is managed on a dynamic basis. Guidance may assist in improving consistency in financial statements between entities, and may also assist preparers as the PRA would require input from various parties within an entity, such as the risk function and valuation experts.

Question 10a) - 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)?

Questions 10b) - 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?

Response 10a) - Yes, we think that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if this is consistent with the dynamic risk management approach (i.e. Approach 3 in the DP). If cash flows are not reflected in the PRA in the same way in which they are managed for risk purposes, the usefulness of the PRA will diminish.

Response 10b) – Yes, 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, we think that it is appropriate not to reflect the floor within the managed portfolio. If transactions are reflected in the PRA in a different way from which they are managed for risk purposes, the usefulness of the PRA will diminish from an operational perspective.

If an embedded floor is reflected within the managed portfolio this would result in profit or loss volatility from recognising this on a fair value basis, rather than on an accruals basis over time.

Section 4 REVALUING THE MANAGED PORTFOLIO

Question 11a) - Do you think that the revaluation calculations outlined in this Section provide a faithful representation of dynamic risk management?

Question 11b) - 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?

Question 11a) - Yes.

Questions 11b) - Yes, if the dynamically managed risk is based on the funding curve, then this should be reflected in the PRA. If interest rates are reflected in the PRA in a different way from which they are managed for risk purposes, the usefulness of the PRA will diminish from an operational perspective.

Question 12a) - 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)?

Question 12b) - 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?

Question 12c) - 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?

Question 12d) - If transfer pricing were to be used as a practical expedient, how would you resolve the issues identified in paragraphs 4.3.1 to 4.3.4 concerning ongoing linkage?

Response 12a) - We have reservations about using transfer pricing rates and believe that they may not provide a good representation of the managed risk for the purposes of applying the PRA, although note this will differ from entity to entity depending on how the transfer pricing rate is determined. For example, as noted in paragraph 4.2.10 of the DP, transfer pricing rates may be adjusted to encourage particular behaviours in business units, and may not move in the same manner as benchmark interest rates.

Some entities may benefit from the practical expedient suggested in paragraph 4.2.24, being that use of the transfer pricing rate on the basis that it is deemed to be close enough to the risks in the managed exposure.

Response 12b) - The market funding index (excluding any other transfer pricing spreads) for both numerator and denominator (i.e. the top row of the table in paragraph 4.2.21 of the DP) would be the preferred approach from the alternatives outlined in DP.

The operational complexity that would arise from an approach that results in a Day 1 revaluation effect which would need to be recognised in profit or loss immediately or amortised in some way, is not considered a suitable approach.

Response 12c) - Rather than considering possible components of transfer pricing rates and determining which indexes and spreads should be eligible to be used in transfer pricing, we suggest the practical expedient in paragraph 4.2.24 is a better approach.

Response 12d) - We do not have a way to resolve the issues identified in paragraphs 4.3.1 to 4.3.4 of the DP, and as noted above, have reservations about using transfer pricing rates and believe that they may not provide a good representation of the managed risk for the purposes of applying the PRA.

Question 13a) - 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?

Question 13b) - Do you think that criteria for selecting a suitable funding index or indexes are necessary?

Response 13a) - It will depend on how related the funding indexes are, and also how interest rate risk is dynamically managed by the entity. For example, if there are long-term liabilities on one funding index, and short-term assets on another funding index, it may still be appropriate to have a single funding index if this is how the portfolio is dynamically managed. In another example, if a foreign subsidiary manages its portfolios based on a funding index relevant to the country in which it operates, rather than the country of its parent, in our opinion, it would be appropriate to have two funding indexes for the Group.

Response 13b) - Criteria or principles for selection of a suitable funding index or indexes would be useful, with the main principle being consistency with risk management activities.

Question 14a) - Please provide one or more example(s) of dynamic risk management undertaken for portfolios with respect to a pricing index.

Question 14b) - 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?

Question 14c) - 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?

Response 14a) - Not applicable as we do not use pricing indexes for dynamic risk management.

Response 14b) - Yes, we do think that a pricing index would be an appropriate basis for applying the PRA if used for the dynamic risk management.

Response 14c) – Yes, we think that the application of the PRA would provide useful information about dynamic risk management activities when the pricing index is used in dynamic risk management.

Section 5 SCOPE

Questions 15a) - 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)? Questions 15b) - 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? Question 15c) - 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? Question 15d) - 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?

Response 15a) and 15b) - We think that the PRA should be restricted to circumstances in which an entity has undertaken risk mitigation through hedging.

Our concerns with the PRA being applied to all managed portfolios included in an entity's dynamic risk management are outlined in our response to question 1, and include:

- concern about the resulting profit or loss volatility,
- our view that the PRA will not improve information provided to users of financial statements as there are already disclosures about financial risk management,
- the fact that users will not have information about how successful an entity was in managing exposures with its risk management framework and limits,
- we can foresee that the PRA would become a banking specific accounting standard, and believe that such an industry standard could confuse users of financial statements.

We understand that the IASB have intentionally not referred to the DP as a hedge accounting proposal, and instead are proposing a solution that reflects dynamic risk management activities in financial statements. The proposals are nonetheless a potential solution to the fact that derivatives are recognised on balance sheet at fair value, and the fact that the matching of hedged items and hedging instruments is overly onerous when the underlying hedging activity is dynamic.

Many entities have already developed hedge accounting solutions that work in practice, such as designating derivatives as hedging unrelated exposures. We do not want the use of the IFRS 9 hedge accounting provisions to be prohibited if they are effective and efficient solutions. We cannot say that a combination of the PRA limited to risk mitigation and the general hedge accounting requirements in IFRS 9 would provide a faithful representation of dynamic risk management, as in many cases derivatives continue to be designated as hedging exposures that are not the underlying economic exposure under the general hedge accounting provisions of IFRS 9.

Response 15c) - The operational complexities of the applying PRA only to the hedged portion of the dynamically managed portfolios could be overcome by the suggested approach to the bottom layer in Question 7 (hedging for the benchmark interest rate) or via very frequent update of the hedge coverage and the revaluation of the hedged exposure (likely reflecting reality of the risk management) which should minimise need for tracking and amortising.

Response 15d) - Likely not if the risk management approach is similar.

Question 16a) - 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?

Question 16b) - 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?

Response 16a) - We disagree with a mandatory macro hedge accounting approach focused on the dynamic risk management. We refer to our response to Question 1.

Response 16b) - We disagree with the mandatory application of the macro hedge accounting model and are indifferent if the IASB wish to allow its application on an optional basis. .

Any resulting lack of comparability due to the accounting policy choice can be addressed via disclosures. This is not dissimilar to the current approach where there is no direct comparability between entities applying hedge accounting and those who do not.

Question 17a) - 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?

(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.

Question 17b) - 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?

Response 17a) - As mentioned in our responses to earlier questions, we do not support PRA focussed on dynamic risk management.

Response 17b) - Application of the macro hedge accounting focused on the risk mitigation should require:

- Existence of the hedging activity (eligible hedging instrument)

- Existence of the hedged item/exposure and its quantification

Also, the interaction with IFRS 9 needs to be considered.

i) If the application would be mandatory, then definition of risk mitigation would have to be more specific to clearly set boundaries when the macro hedge accounting shall be applied.

ii) We agree with the optional application of the macro hedge accounting with the revaluation of the hedged exposure with the focus on the risk mitigation when the dynamic risk management and mitigation is applied by the entity. We do not propose any specific criteria for starting of its application and mandatory discontinuation upon cease of the hedging activity with the voluntary discontinuation without any specific criteria. Additionally, we suggest that macro hedge accounting could be applied in concurrently with IFRS 9 for the different types of the risks.

Section 6 PRESENTATION AND DISCLOSURES

Question 18a) - Which presentation alternative would you prefer in the statement of financial position, and why?

Question 18b) - Which presentation alternative would you prefer in the statement of comprehensive income, and why?

Question 18c) - 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.

Question 18a) - We believe that line-by-line gross up presentation would be inconsistent with the risk management on net basis and with the measurement basis of the underlying assets & liabilities. It would also give rise to potential operational complexities and actual recognition of items such as pipeline transactions or EMB.

For these reasons we also do not support separate lines for aggregate adjustments to assets and liabilities. Our preferred presentation alternative in the statement of financial position is the "single net line item" as reflects the aims and outcomes of the risk management.

Question 18b) - We support the "actual net interest income" presentation alternative to include additional interest line to present NII from risk management instruments and the revaluation impact (future NII) presented in OOI (i.e. below NII) being net of clean fair value changes from derivatives and the managed portfolios. We believe that this alternative provides better information on the outcome of the dynamic risk management to the users of the financial statements.

We do not support the "stable net interest income" presentation as this would not present NII actually achieved and it would be based on assumption that the risk management was 100% successful in stabilising NII as any realised ineffectiveness would be represented in the revaluation adjustment (OOI) as opposed in NII under the approach above.

Question 18c) - We propose to consider the presentation of the clean fair value changes from derivatives and revaluation changes of the managed portfolios separately within the actual NII.

Question 19a) - 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?

Question 19b) - Do you think that the described treatment of internal derivatives enhances the operational feasibility of the PRA? Why or why not?

Question 19c) - 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?

Consistent with the principles of dynamic risk management, where an entity utilises internal derivatives as part of their risk management activities it is appropriate to incorporate these in a macro hedging model. In these circumstances we support the grossing up of internal derivatives in the Statement of Comprehensive income as a practical expedient that does not impact financial reporting.

No additional conditions other than elimination of the P&L on the intercompany derivatives and demonstration of the inclusion of internal derivatives in the dynamic risk management should be required.

Question 20a) - 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.

Question 20b) - If you think that an identified theme would not provide useful information, please identify that theme and explain why.

Question 20c) - 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.

Response 20a) - We believe that the disclosures should be focused on the risk mitigation as opposed to the broader scope of the risk management, especially if some of those disclosures are already required by IFRS 7 or regulators. Also, we recommend considering linkage of the disclosures to the internal information used for risk management similar to IFRS 7 requirements.

We agree that qualitative information on the objectives and policies for dynamic risk management, including risk management and including the identification of risks within the exposures would be useful for the users of the financial statements.

We however, do not believe that qualitative and quantitative information on the net open risk position(s) and its impact on the application of the macro hedge accounting would enhance economic decisions of the users of the financial information as this type of the information is already required by the regulators. We refer to our response to Question 1.

We agree that disclosure on the application of the macro hedge accounting is useful because we support its optional application focused on the risk mitigation with the revaluation of the hedged exposure.

Response 20c) -We do not believe any additional disclosures would be required to those already listed.

Question 21a) - 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?

Question 21b) 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?

Response 21 – We support the scope of disclosure to equal the scope of the application of the PRA. IFRS 7 already requires risk management disclosures about the nature and extent of risks arising from financial instruments.

Response 21b) - Not applicable.

Section 7 OTHER CONSIDERATIONS

Question 22) - 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.

Response 21a) – Yes, rom a risk management perspective it is normal for exposures to be included in an open risk managed portfolio after an entity first becomes a party to a contract. Similarly, exposures may be removed from an open risk managed portfolio before they are derecognised on maturity, sale or redemption. To ensure risk management activities are reflected in financial reporting, a macro hedge accounting model should allow entities to include or remove exposures in open portfolios after their initial recognition or before derecognition, respectively.

a) We acknowledge that amortisation of any non-zero Day 1 revaluations creates operational complexity. However, we believe this would be required in order to achieve a fair representation of risk management in financial reporting.

Question 23a) - 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?

Question 23b) - 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?

Question 23c) - 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.

Response 23a) - We believe that the macro hedge accounting should appropriately reflect the dynamic risk management and therefore if the exposures are being removed from the managed portfolio prior to their maturity, the accounting should reflect this.

Response 23b) - As outlined above, the macro hedge accounting should follow the risk management approach.

Response 23c) - We propose to apply the same approach as for the fair value hedge accounting (i.e. EIR/straight-line amortisation) if operationally feasible. If the hedge cover is re-balanced on the daily basis, we propose to remove the whole revaluation amount to profit or loss.

Question 24a) - 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? Question 24b) - 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.

Response 24a) - Foreign currency risk is another major risk Australian financial institutions are exposed to. Australian financial institutions historically seek and issue debt outside of their functional currency in order to borrow from debt investors located offshore. Foreign currency risk exposures resulting from offshore debt issues are normally converted into domestic currency using cross currency interest rate swaps on a one-to-one basis. These derivatives are designated as hedging instruments in fair value and cash flow hedges of interest rate and foreign exchange risks of the foreign currency debt issues.

As noted in our earlier responses, the macro hedge solution should be optional. This would allow financial institutions to more closely align the accounting to how they manage risks, by providing the flexibility to apply either the macro or general hedging model as appropriate.

Response 24b) - Not applicable.

Section 8 APPLICATION OF THE PRA TO OTHER RISKS

Question 25a) - 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. Question 25b) - 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.

Response 25a) - Not applicable.

Response 25b) Not applicable.

Section 9 ALTERNATIVE APPROACH - PRA THROUGH OTHER COMPREHENSIVE INCOME

Question 26 - 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 refer to the submission from the Australian Bankers' Association for further comments on this alternative.