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David Craig
Chief Financial Officer

17 October 2014

Mr Hans Hoogervorst, Chairman
International Accounting Standards Board (IASB)
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst,

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

As the largest listed company and the largest bank in Australia, it is important that the Commonwealth Bank of Australia (CBA) raises issues and proposes solutions on important accounting changes. In our case, this is particularly important because the discussion paper as currently drafted would have the unintended consequence of making our reported regulatory capital volatile.

We support the comments put forth by the Australian Bankers' Association (ABA) dated 17 October 2014, including the ABA's alternative model, on the issue of developing a macro hedge accounting solution.

We understand that the overall objective behind the discussion paper is to reflect risk management of open portfolios through the financial statements. The model proposed in the discussion paper does not accurately represent how risk management occurs in practice in an Australian banking context, and has a number of adverse consequences.

CBA's balance sheet predominantly has a floating rate profile. Fixed rate exposures largely relate to core deposits and equity. As such, changes in market interest rates can have a significant impact on the net interest margin of CBA. CBA's objective in managing interest rate risk is to achieve a stable and sustainable net interest income in the long term. We achieve this by undertaking proxy cash flow hedge accounting in accordance with IAS 39.

The portfolio revaluation approach (PRA) proposed by the discussion paper is suited to banking books with a predominantly fixed rate profile. Where this is the case, proxy cash flow hedge accounting is not possible due to insufficient variable rate capacity on the balance sheet. As a result, fair value hedge accounting is undertaken instead.

Where the banking book has a floating rate profile, as is the case in CBA, the revaluation approach introduces earnings volatility for the unhedged position that is unrelated to CBA's risk management practices. This will destabilise net interest income. The PRA also overrides amortised cost accounting, which we believe is a relevant and reliable measurement basis of the banking book.

Managing interest rate risk not only has an impact on CBA's earnings, but is also important to consider in the context of capital adequacy. The local banking regulator, Australian Prudential Regulation Authority (APRA), requires Australian banks accredited for the Advanced Approach under the Basel III framework to incorporate regulatory capital for Interest Rate Risk in the Banking Book (IRRBB) in their assessment of total capital locally. The same adjustment is not required under the international Basel III framework. Total risk weighted assets associated with IRRBB as at 30 June 2014 for CBA was A$14.8 billion. Under the PRA, the earnings volatility created on unhedged positions would lead to volatility in the calculation of CBA's Common

Equity Tier 1 Capital Adequacy Ratios, unless there was a change to the calculation of capital adequacy by APRA.

We encourage the IASB to focus on solving the accounting mismatch arising from open portfolios measured at amortised cost and hedging instruments (that are used to manage the net risk position) held at fair value. We believe the alternative macro hedging solution put forward by the ABA addresses this issue and reduces the operational complexity of current hedge accounting practices. It would also more closely align hedge accounting to the actual risk management practices undertaken.

The alternative model is based on existing cash flow hedge principles and incorporates the following favourable elements from the discussion paper:

- incorporation of behavioural expectations,
- designation of pipeline transactions and equity model book,
- use of the bottom layer approach for prepayable exposures,
- hedging of sub-benchmark rate instruments, and
- the use of internal derivatives.

Managing structural foreign exchange risk is also an important aspect to risk management for CBA. This is the risk that movements in foreign exchange rates may have an adverse effect on CBA's Australian dollar earnings and economic value when the CBA's foreign currency denominated earnings and capital are translated into Australian dollars. At present, economic hedges of forecast foreign currency earnings from foreign operations are entered into. Whilst they cannot be designated as eligible hedges under existing accounting guidance, they are taken into consideration in the calculation of CBA's cash earnings disclosed to market. We encourage the IASB to also consider permitting these as eligible hedging strategies.

In light of the above and the arguments put forward by the ABA, we request that the IASB reconsiders its proposed model and develops a macro hedge accounting solution that focuses on addressing existing challenges. We would also reiterate the ABA's feedback that any such model developed, should be focused on risk mitigation and remain an optional election consistent with the general hedge accounting model.

Yours sincerely,

David Craig