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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,

PBrunner

Paul Brunner
Partner
PricewaterhouseCoopers

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

<u>Section 1—Background and introduction to the portfolio revaluation approach (PRA)</u>

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.

<u>Section 2—Overview</u>

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.

<u>Section 3—The managed portfolio</u>

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.

<u>Section 5—Scope</u>

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 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.

Section 9—Alternative approach—PRA through other comprehensive income

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.