Shane Buggle | Deputy Chief Financial Officer

17 October 2014

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

Dear Mr Hoogervorst,

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

Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange. Our operations are predominantly based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of A$9.0 billion and total assets of A$703 billion.

We welcome the opportunity to comment on this Discussion Paper (DP) and are supportive of the IASB's efforts to improve the accounting for hedging activities in respect of open portfolios of risk exposures (commonly referred to as 'macro hedging'). However, we believe the DP traverses two distinct topics which we encourage the IASB to separate as follows:

1. Refinements to the existing guidance in IFRS 9 *Financial Instruments* ('IFRS 9') and IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39') to accommodate macro hedging activities. In referring to existing guidance we mean:
   - the guidance regarding 'fair value hedge accounting for a portfolio hedge of interest rate risk' in IAS 39 paragraphs AG114-132 (referred to in this letter as the 'macro fair value hedge accounting requirements'); and
   - the implementation guidance in paragraphs IG.F.6.1-F.6.3 of IAS 39 for applying cash flow hedge accounting when a financial institution manages interest rate risk (referred to in this letter as the 'macro cash flow hedge accounting requirements'). We note that although this guidance was not carried forward to IFRS 9, the IASB clarified in IFRS 9 BC.93-95 that this did not mean it had rejected this guidance; and
2. The use of financial statements as a vehicle for reporting on the effectiveness of an entity's risk management activities more broadly.

We recommend that IASB's initial focus should be on the first topic with the second topic progressed in the longer term as part of the IASB's Conceptual Framework project, subject to demand from the financial statement user community. Although short term improvements to both the macro fair value and cash flow hedge accounting requirements are desirable, we believe there is a more pressing need for reform to macro fair value hedge accounting. Accordingly we support the focus of the DP provided that the macro cash flow hedge accounting requirements will not be superseded or replaced by any new standard that results from the DP proposals.

We believe refinements to the existing guidance to accommodate macro fair value hedging activities should focus on the following objectives:

- aligning macro fair value hedge accounting more closely with risk management activities to:
  - eliminate the volatility in profit or loss that arises when hedge accounting cannot be achieved under current requirements, noting that this is a principle driver of the reporting of and emphasis on non-IFRS financial information. This volatility arises

  - from the accounting mismatch between economically hedged items in open portfolios being measured at amortised cost while their hedging instruments are measured at fair value through profit or loss; and
  - reduce the incentive to 'use' a proxy hedge accounting solution whereby a hedging instrument is designated against an item which it is not necessarily economically hedging to achieve a desired accounting outcome; and
- reducing the operational accounting complexity that arises from 'macro fair value hedge accounting' due to the need to track and amortise hedge adjustments on closed portfolios.

In our view the Portfolio Revaluation Approach proposed in the DP (with either a focus on dynamic risk management or a focus on risk mitigation) does not fully achieve these objectives. The shortcomings include:

Portfolio Revaluation Approach with a focus on risk mitigation

- this approach has similar limitations to the existing macro fair value hedge accounting and macro cash flow hedge accounting requirements in terms of the potential for misalignment between the hedge accounting and underlying risk management activities because the risk management focus is on the total risk that is being managed holistically whereas the hedge accounting requires a potentially arbitrary selection of hedged items; and
- this approach will not fully alleviate the practical burden of tracking individual exposures that exists under current macro fair value hedge accounting requirements, and is likely to necessitate the imposition of accounting rules (e.g. re: adding or removing exposures to a net position, dealing with changes in behavioural assumptions and identifying situations of overhedging) which preclude full alignment between hedge accounting and risk management activities.

Portfolio Revaluation Approach with a focus on dynamic risk management

- while this approach eliminates the accounting mismatch for net positions that have been hedged, it introduces new profit or loss volatility in relation to unhedged net open risk positions; and
- this approach also deviates from the IFRS 9 principle of aligning the measurement of exposures with an entity's business model. In our view, this deviation is not justified as the decision usefulness of the resultant financial information is not enhanced.

Having regard to these shortcomings, we consider that the Portfolio Revaluation Approach in its current form requires further analysis and discussion before it is a valued added alteration (conceptually and practically) to the options available under IFRS 9 / IAS 39. Accordingly, we recommend further consideration of this model be deferred to a longer term IASB project, subject to demand from the financial statement user community.

In the short term, we recommend that the IASB investigate modifications to macro fair value hedge accounting requirements that leverage the macro cash flow hedge accounting requirements and aspects of the following DP proposals:

- Hedging of sub-benchmark rate instruments;
- Application of a bottom layer approach for portfolios with prepayable exposures;
- Ability to designate pipeline transactions as hedged items;
- Ability to incorporate behavioural expectations; and
- Macro hedging using internal derivatives.

Under these principles, gains/losses on a hedging instrument that is an effective hedge would be recognised in other comprehensive income ('OCI'). We believe such a model has the potential to reduce operational complexity and improve alignment of macro fair value hedge accounting with risk management activities.

Alternatively, if the IASB decides to continue to explore the Portfolio Revaluation Approach in the short term, we have a preference for the *focus on risk mitigation* alternative on the basis that it is the less conceptually problematic of the two alternatives outlined in the DP.

We believe that application of any new accounting model for macro hedging activities developed by the IASB should be optional, consistent with the general hedge accounting model under IFRS 9. In addition, we recommend that the IASB carefully consider the likelihood of widespread optional application prior to further developing the proposals.

In relation to the disclosure themes outlined in the DP, we have a general concern about the ever increasing disclosure burden that arises with the introduction of every new accounting standard. In this context, we encourage the IASB to ensure that each new disclosure requirement introduced is demonstrably decision useful for a wide range of users and supported by a well-argued justification to this effect. We also encourage the IASB to ensure any new disclosures are directly relevant to meeting the objective of financial reporting as set out in the *Conceptual Framework*, consistent with the outcome of the IASB's existing *Disclosure Initiative* project and do not duplicate information required to be produced and made publicly available pursuant to other requirements.

Although not addressed in the DP, we recommend that the next phase of the project include guidance on the accounting treatment of additional hedge ineffectiveness arising from evolving market practice for valuing derivatives (where additional risks inherent in derivatives that do not exist in the underlying exposure are being identified and measured). While this issue is not specific to macro hedging activities, it is nevertheless relevant to the proposals and has become increasingly important practically as more sophisticated derivative valuations highlight imperfections in hedge effectiveness.

In addition to our views on the DP proposals outlined above, we have provided responses to the questions raised in the DP as an Appendix to this letter. Those responses focus on a comparison of the alternatives presented in the DP and accordingly any views expressed should not be interpreted as unqualified support for a proposal.

Should you have any queries on our comments, please do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely

Shane Buggle

Deputy Chief Financial Officer

Copy: Chairman, Australian Accounting Standards Board (AASB)

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

Question 1—Need for an accounting approach for dynamic risk management

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

We think that there is a need for a specific accounting approach that addresses dynamic risk management activity undertaken by financial institutions involving:

- a continuous reassessment of net open risk positions arising from managed portfolios; and
- the execution of derivatives to hedge the continuously evolving net risk exposure ('macro hedging').

A plethora of patchwork hedge accounting solutions are applied to macro hedging activities under the existing guidance. While these solutions allow entities to minimise profit or loss volatility caused by accounting mismatches under the current mixed measurement model for hedging instruments and the items they are hedging, they are operationally challenging and often do not faithfully represent the economics of dynamic risk management (macro hedging) activity in the financial statements.

In referring to existing guidance in the previous paragraph we mean:

- the guidance regarding 'fair value hedge accounting for a portfolio hedge of interest rate risk' in IAS 39 paragraphs AG114-132 (referred to in this letter as the 'macro fair value hedge accounting requirements'); and
- the implementation guidance in paragraphs IG.F.6.1-F.6.3 of IAS 39 for applying cash flow hedge accounting when a financial institution manages interest rate risk (referred to in this letter as the 'macro cash flow hedge accounting requirements'). We note that although this guidance was not carried forward to IFRS 9, the IASB clarified in IFRS 9 BC.93-95 that this did not mean it had rejected this guidance.

Although improvements to both the macro fair value hedge accounting requirements and macro cash flow hedge accounting requirements are desirable, we believe there is a more pressing need for reform to macro fair value hedge accounting. Accordingly we support the focus of the DP on macro fair value hedge accounting with the understanding that the macro cash flow hedge accounting requirements will not be superseded or replaced by any new standard that results from the DP proposals.

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?

Our comments below refer only to the dynamic management of interest rate risk by banks. In our view the DP correctly identifies some of the key issues entities face when applying the current hedge accounting requirements to the dynamic management of interest rate risk. However we believe that the IASB should also consider the following additional items which are integral to managing interest rate risk:

1. Additional risks beyond "pure" interest rate risk. The DP focuses on 'pure' mismatches between fixed and variable interest rates exposures. The Asset Liability Management ('ALM') desk (which undertakes macro hedging activities) also manages a range of related risks including:
    - Gap/mismatch risk: the risk that earnings decline as a result of changes in interest rates due to differences in the maturity profile of assets and liabilities. Gap risk exposes a bank to changes in the level of the yield curve (parallel shift) or a change in the shape of the yield curve (pivotal shift). Therefore the maturity profile of the book will influence whether the bank is exposed to short or long term gap risk.

- Yield curve risk: the risk that non-parallel or pivotal shifts in the yield curve (where the shape of the yield curve changes) cause a reduction in net interest income ('NII').
- Basis risk: Even if all assets and liabilities held by the ALM desk are floating rate, they can still generate interest rate risk – for example, if assets pay 6 month LIBOR and liabilities pay 3 month LIBOR, there is an interest rate spread/basis risk between the two terms. Additionally, it is common for hedging instruments to be linked to a different interest rate to that of the product being hedged (e.g. an overnight indexed swap (OIS) rate versus LIBOR).

2. Evolving market practice for valuing derivatives. In developing an accounting approach for dynamic risk management, we encourage the IASB to include guidance on the accounting for imperfections in hedge effectiveness that are increasingly highlighted by more sophisticated derivative valuation methodologies. Moreover, we encourage the IASB to consider a pragmatic solution to prevent/reduce profit or loss volatility where an entity has used the best available hedging instrument and the identified imperfections in effectiveness are merely an incidental consequence of using that instrument. We discuss this further in question 18(c).

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

We do not think that the PRA (either with a focus on risk mitigation or a focus on dynamic risk management) would fully address the issues identified for the reasons highlighted in our covering letter. Moreover, we consider that the PRA in its current form requires further analysis and discussion before it is a value added alteration (conceptually and practically) to the options available under IFRS 9 / IAS 39. Accordingly, we recommend further consideration of this model be deferred to a longer term IASB project subject to demand from the financial statement user community.

As described in our covering letter, we recommend that the IASB consider an alternative short term approach involving modifications to macro fair value hedge accounting requirements that leverage the macro cash flow hedge accounting requirements and aspects of the following DP proposals:

- Hedging of sub-benchmark rate instruments;
- Application of a bottom layer approach for portfolios with prepayable exposures;
- Ability to designate pipeline transactions as hedged items;
- Ability to incorporate behavioural expectations; and
- Macro hedging using internal derivatives.

Section 2—Overview

Question 3—Dynamic risk management

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

We agree, that the description generically describes of dynamic risk management practices for interest rate risk in banks. We make no comment on the accuracy / completeness of the description as it applies to other risk classes and other industries.

Section 3—The managed portfolio

Question 4 —Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

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

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.

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.

If the IASB proceeds to introduce the PRA, our view is that the inclusion of Pipeline transactions (i.e. hedged items that don't yet exist), Equity Model Book and Behaviouralisation in a fair value hedging model would be inconsistent with the Conceptual Framework. Nevertheless we recognise that the inclusion of these items would enhance operational feasibility and alignment between the hedge accounting and the underlying dynamic risk management (macro hedging) activity. Accordingly we would be supportive of a pragmatic compromise to allow the inclusion of these items in the PRA and would encourage the IASB to consider the inclusion as a 'rules based' (as distinct from 'principles based') framework that places strict governance around the hedge accounting outcomes.

Alternatively, as mentioned in our covering letter, we encourage the IASB to consider whether modifications to macro fair value hedge accounting requirements that leverage the macro cash flow hedge accounting could deliver a more conceptually sound approach to these issues. Under such an approach, the items giving rise to the risk exposure could be analogised to 'highly probable forecast transactions' under IFRS 9 / IAS 39. This would avoid the conceptual difficulties associated with changing the measurement of hedged items that do not qualify for recognition as assets or liabilities or are measured on a contractual rather than behaviouralised basis.

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.

In our view, prepayment risk is typically managed based on behavioural assumptions using hedging instruments that do not incorporate optionality due to the relatively higher cost of instruments incorporating optionality.

If the IASB proceeds to introduce the PRA, our view is that although options are effective instruments for managing prepayment risk (and therefore should be viewed as a hedging rather than trading position), the challenges highlighted in paragraphs 3.5.8 and 3.5.9 of the DP will make the PRA very difficult to operationalise in these circumstances.

As an aside, we note that in the Australian market, prepayment risk typically materialises in an environment of declining market interest rates as customers seek to prepay fixed rate exposures to benefit from lower variable rates. In these circumstances, a break fee is charged to customers which acts as a hedge against the cost of breaking hedges executed as part of the bank's macro hedging activities.

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?

If the IASB ultimately introduces the PRA, we 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 when and to the extent they occur. Our rationale is that this would be consistent with the way changes in estimates generally are recognised under IFRS and would also be an operationally simpler approach.

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.

If a bottom layer approach is taken for dynamic risk management purposes, we think that it should be permitted within the PRA consistent with the objective of aligning the accounting with the underlying dynamic risk management (macro hedging) activity. We suggest the conceptual difficulties could be overcome by viewing the bottom layer approach as similar to a cash flow hedge that uses the first payments received/paid technique. For example, where an entity is hedging interest receipts on the first 100 (out of say 120) of loan principal expected over a specified period in the future. Some loans may prepay while new loans may be added to the portfolio, but as long as at least 100 of principal is outstanding, then the hedge would be considered to be effective.

However we think permitting a bottom layer approach would inevitably bring with it many of the operational difficulties that exist under current requirements around creation of closed sub-portfolios, tracking and amortisation.

Our view is similar if a proportion approach (as described in section 3.7.6 of the DP) rather than a bottom layer approach is taken for dynamic risk management purposes and we note that the operational complexity is likely to be greater under this scenario.

Question 8 —Risk limits

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

We believe risk limits are primarily relevant in the focus on dynamic risk management scenario since in the focus on risk mitigation scenario only the hedged proportion of the portfolio would be revalued. In the focus on dynamic risk management scenario, we do not think that that internal risk limits should be reflected in the application of the PRA. In our view, hedge effectiveness should be an objective test of whether risk attributable to an open portfolio is reduced after taking into account the effect of risk management instruments and we share the IASB's concerns regarding the perverse outcomes noted in 3.8.4.

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?

We 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. We have addressed the concept of behaviouralisation in our response to Question 4.

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

We do not think that guidance would be necessary for entities to determine the behaviouralised profile of core demand deposits. Such profile is the result of complex entity specific, modelling, analysis and judgement and imposing guidance on how it should be determined for accounting purposes increases the potential for divergence from the underlying dynamic risk management (macro hedging) activity. However, we encourage the IASB to consider safeguards that place strict governance around the hedge accounting outcomes. These could include disclosure of critical estimates and judgements such as the modelling / estimation methodology applied and any changes thereto in a given reporting period.

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 think that including sub-benchmark rate instruments in the managed exposures as benchmark instruments would be consistent with the way exposures are managed for dynamic risk management purposes and accordingly support this proposal. We view the sub-benchmark element as a customer/product margin. For example, when the retail BU of a bank accepts non-core deposits that can be used for funding on an overnight basis, the yield paid can be lower than the benchmark OIS rate. ALM will then manage for the benchmark OIS rate risk with the difference (sub-benchmark element) representing customer/product margin.

Given the above explanation, we support Approach 3 (as suggested in Section 3.10 of the DP).

(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?

We believe that any embedded floors can be included within the managed portfolio only to the extent this risk is actually dynamically managed by ALM. It is our understanding that embedded floors are typically not transferred to ALM. Nevertheless, we think the PRA should accommodate this scenario given diversity in entities' approaches to managing risk.

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 think that in a generic sense, the calculations in this section provide a faithful representation of dynamic risk management (i.e. the revaluation of the managed risk based on the benchmark index curve).

(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 are uncertain as to the intended interpretation of the phrase '*funding curve of a bank*' in this question. In our experience, the ALM desk's objective is to manage net interest income with respect to a benchmark index rate and in that circumstances we think it is appropriate for the managed risk to be the benchmark index rate.

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 think that transfer pricing transactions that centralise risk for management by the ALM desk would be an appropriate practical expedient to capture the managed risk in a managed portfolio for the purposes of applying the PRA, subject to the transfer pricing transactions:

- representing only the managed risk (e.g. the benchmark index rate) and excluding any margin for other factors; and
- excluding allowance for the bank's own credit, liquidity risk, term premium etc.

(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.

We believe that Approach 1 (Market funding index (excluding any other transfer pricing spreads)) would be preferred as the managed risk is usually a benchmark index rate and accordingly this approach provides the most faithful representation of dynamic risk management even if the risk being managed is higher than the actual risk included in the managed portfolios (i.e. sub-benchmark rate instruments). Additionally, we believe Approach 1 would be operationally feasible as actual data used for risk management could also be used for financial reporting.

(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?

Irrespective of an entity's transfer pricing arrangements, we believe that only the component of the transfer price that represents the benchmark index rate (which will vary by entity) should be an eligible for the purpose of applying the PRA as this is usually the managed risk and therefore will promote comparability.

(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?

If a standard resulting from the DP proposals allows transfer pricing to be used as a practical expedient, we believe it would be necessary for the standard to include rules requiring demonstration on a continuous basis that the transfer pricing is a suitable proxy for the managed risk.

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 do not think a single funding index for all managed portfolios would be appropriate if funding is based on more than one funding index as this would be inconsistent with the objective of aligning the accounting with the underlying dynamic risk management (macro hedging) activity. For example, a different benchmark funding rate (funding index) may be relevant to similar managed portfolios in different geographies within a consolidated group.

(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?

We do not think that criteria for selecting a suitable funding index or indexes are necessary we think the accounting should be aligned with the underlying dynamic risk management (macro hedging) activity. Moreover, if arbitrary accounting rules were imposed, they could result in volatility that is not representative of the underlying risk management activity.

Question 14 —Pricing index

(a) Please provide one or more example(s) of dynamic risk management undertaken for portfolios with respect to a pricing index.
(b) How is the pricing index determined for these portfolios? Do you think that this pricing index would be an appropriate basis for applying the PRA if used in dynamic risk management? Why or why not? If not, what criteria should be required? Please explain your reasons.
(c) Do you think that the application of the PRA would provide useful information about these dynamic risk management activities when the pricing index is used in dynamic risk management? Why or why not?

In our experience, risk associated with a pricing index is typically not managed dynamically. Accordingly we do not have any comments on these questions.

Section 5—Scope

Question 15 —Scope

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

Our covering letter outlines our views on these issues. In summary, we believe the PRA as proposed in the DP (with either a focus on dynamic risk management or a focus on risk mitigation) has various shortcomings including:

PRA with a focus on risk mitigation:

- this approach has similar limitations to the existing macro fair value hedge accounting and macro cash flow hedge accounting requirements in terms of potential for misalignment between the hedge accounting and underlying risk management activities because the risk management focus is on the total risk that is being managed holistically whereas the hedge accounting requires a potentially arbitrary selection of hedged items; and
- this approach will not fully alleviate the practical burden of tracking individual exposures that exists under current macro fair value hedge accounting requirements and is likely to necessitate the imposition of accounting rules (e.g. re: adding or removing exposures to a net position, dealing with changes in behavioural assumptions and identifying situations of over-hedging) which preclude full alignment between hedge accounting and risk management activities.

PRA with a focus on dynamic risk management:

- while this approach eliminates the accounting mismatch for net positions that have been hedged, it introduces new profit or loss volatility in relation to unhedged net open risk positions; and
- this approach also deviates from the IFRS 9 principle of aligning the measurement of exposures with an entity's business model. In our view, this deviation is not justified as the decision usefulness of the resultant financial information is not enhanced.

Of the two alternatives, we prefer the Portfolio Revaluation Approach with a focus on risk mitigation on the basis that it is the less conceptually problematic. Our covering letter also contains a suggestion on an alternative approach for the IASB's consideration.

(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?

Our comments on the usefulness of the information that would result from the application of the PRA under each scope alternative are as follows:

- PRA with a focus on risk mitigation: We think that the information that would result from the application this alternative will be useful as it has the potential to facilitate the application of hedge accounting to a wider range of hedged items/hedging instruments. This will reduce the volatility in profit or loss that arises from the accounting mismatch where hedge accounting cannot be achieved under the existing requirements, noting that this volatility is a principle driver of the reporting of and emphasis on non-IFRS financial information under existing requirements.
- PRA with a focus on dynamic risk management: We do not think that the information that would result from the application this alternative will be useful as it introduces new profit or loss volatility in respect of deliberately unhedged exposures and deviates from the IFRS 9 principle of aligning the measurement of exposures with an entity's business model which was noted as decision useful as part of the development of IFRS 9.

We think that the extent to which 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 will ultimately depend upon the accounting rules imposed to respond to the practical implementation issues identified in the DP.

(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?

Our comments on the operational feasibility of applying the PRA for each of the scope alternatives are as follows:

- PRA with a focus on risk mitigation: While perhaps more operationally feasible than the alternative, we think the PRA with a focus on risk mitigation will inevitably bring with it much of the operational complexity around creation of closed sub-portfolios, tracking and amortisation that exists under current requirements.
- PRA with a focus on dynamic risk management: We think that significant costs would be incurred in implementing new systems and processes to deal with this model.

(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?

While less relevant to risks other than interest rate risk for which dynamic risk management activities are less prevalent, the principles underpinning our answers to (a) to (c) would also apply to such other risks.

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?

If the IASB proceeds to introduce the PRA with either a focus on dynamic risk management or a focus on risk mitigation), we think its application should be optional. Hedge accounting has historically been voluntary and mandating either of the approaches proposed in the DP would be a significant and undesirable change.

Allowing optional application would enable an entity to apply the PRA or the IFRS 9 general hedge accounting requirements (or a combination of the two) depending on its view on the approach that provides the most faithful representation of its dynamic risk management (macro hedging) activities and in particular the approach that best addresses the accounting mismatch issues noted elsewhere in this letter.

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.

We do not support the PRA with a focus on dynamic risk management. Accordingly, we have not commented on this question.

(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.

If the scope of the application of the PRA were to be focused on risk mitigation, we think the following issues relating to eligibility criteria require further consideration by the IASB:

- interaction between the PRA and IFRS 9 general hedge accounting. Flexibility should be allowed to apply either model (but not both contemporaneously) to a given exposure; and
- whether a requirement should be imposed that a given exposure is "being dynamically managed" to be eligible for inclusion in the PRA and if so, the precise definition of that term.

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 prefer the single net line item presentation alternative as:

- it best reflects dynamic risk management (macro hedging) occurring on a net basis (i.e. focus is on net open position rather than gross risk on assets and liabilities).
- the amortised cost measurement for individual assets and liabilities would not be obscured by partial fair value adjustments; and
- this approach may minimise any capital implications and charges from grossing up the balance sheet which may arise under both the other approaches.

We do not prefer the other two presentation alternatives as they are inconsistent with the underlying dynamic risk management (macro hedging) activity which addresses the net open risk position and they would increase both compliance costs and operational risk due to the need to assign revaluation adjustments to assets and liabilities (either individually or in aggregate) separately.

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

We prefer the 'actual net interest income presentation' as the 'stable net interest income presentation' portrays an aspirational rather than actually result which we consider lacks decision usefulness and is potentially misleading.

(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.

As noted in question 2, we encourage the IASB to consider a pragmatic solution to prevent/reduce profit or loss volatility arising from imperfections in hedge effectiveness that are increasingly highlighted by more sophisticated derivative valuation methodologies. Specifically, in circumstances where an entity has used the best available hedging instrument, we recommend the IASB contemplate recognising this ineffectiveness in other comprehensive income ('OCI'). In this scenario, reclassifications from OCI to profit or loss would occur on a daily basis (with the previous day's ineffectiveness reversed to profit or loss and the current day's ineffectiveness recognised in OCI).

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?

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

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

Where an entity uses internal derivatives as part of its dynamic risk management, we are supportive of including them in the application of the PRA and presenting them gross in the statement of comprehensive income. We think that a gross presentation enhances the usefulness of information provided and operational feasibility by aligning the accounting with the underlying dynamic risk management (macro hedging) activity. In our view the conceptual issue arising from the non-elimination of intra-group transactions in the consolidated financial statements can be 'cured' through appropriate disclosures which delineate between the business models underpinning the banking and trading books.

Question 20 —Disclosures

(a) Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views.
(b) If you think that an identified theme would not provide useful information, please identify that theme and explain why.
(c) What additional disclosures, if any, do you think would result in useful information about an entity's dynamic risk management? Please explain why you think these disclosures would be useful.

We think it is premature to consider the appropriate disclosures given:

- the number of complex issues to be settled in relation to the application of the PRA for dynamic risk management (macro hedging) activities as noted elsewhere in this letter; and
- the status of the IASB's separate *Disclosure Initiative* project.

We do have a general concern about the ever increasing disclosure burden that arises with the introduction of every new accounting standard. In this context, once a recognition and measurement model has been settled, we encourage the IASB to ensure that each new disclosure requirement that is introduced:

- is demonstrably decision useful for a wide range of users and supported by a well-argued justification to this effect;
- is directly relevant to meeting the objective of financial reporting as described in the Conceptual Framework and consistent with the outcome of the IASB's existing *Disclosure Initiative* project; and
- avoids duplication of information required to be produced and made publicly available pursuant to other requirements (e.g. AASB 7 *Financial Instruments: Disclosures* and prudential regulations albeit that there is not international alignment in this space).

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?

We believe that the scope of the disclosures should be the same as the scope of the application of the PRA as we see the purpose of the disclosures as limited to supplementing the recognition and measurement applied to enhance the understandability of the hedge accounting outcomes reflected in the financial statements.

If the IASB proposes to introduce disclosures that are intended to describe the underlying dynamic risk management activities more broadly, we refer to our comments in our response to the previous question on the criteria that we believe any new disclosure requirement should satisfy.

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?

Not applicable.

Section 7—Other considerations

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 think that the PRA should allow for the inclusion of exposures in the managed portfolio at any time (i.e. not just when an entity first becomes a party to a contract) on the basis that this reflects the underlying dynamic risk management (macro hedging) activity. Exposures in open portfolios will be changing continuously. In addition to new exposures being added, changes will reflect an entity's preference for mitigating risk and positioning itself to benefit from expected changes in interest rates and other market factors (within risk limits). An entity may decide to maintain a particular risk exposure (i.e. unhedged) one period and choose to hedge it in another and then change again. This is the very nature of dynamically managing risk.

(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 think that this question is primarily relevant where the PRA with a focus on risk mitigation is applied since in the PRA with a focus on dynamic risk management scenario all exposures are revalued from Day 1 whether or not they are hedged.

In the PRA with a focus on risk mitigation scenario, we think that Day 1 revaluations may not arise when an exposure is included in a managed portfolio after an entity first becomes party to a contract <u>if</u> the benchmark funding rate is defined as the managed risk. That is, any difference in the benchmark funding rate between the time when an entity first became party to a contract and when an exposure is included in a managed portfolio would not be relevant as the managed risk is only that component of the exposure that represents the benchmark funding rate at the time an exposure is included in a managed portfolio.

Where a revaluation adjustment does arise when an exposure is included in a managed portfolio after an entity first became party to a contract, we concur with the issues identified in section 7.1.2 of the DP in relation to the two alternative treatments available (i.e. immediate recognition in profit or loss or deferral an amortisation of the revaluation adjustment). We think the only way these issues could be addressed is a pragmatic rules based solution which we acknowledge in itself may create divergence between the accounting and underlying dynamic risk management (macro hedging) activity. Nevertheless we view immediate recognition in profit or loss as the preferable outcome on the basis of operational simplicity.

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 do not think that once exposures are included within a managed portfolio they should remain there until derecognition on the basis that this would not reflect the underlying dynamic risk management (macro hedging) activity.

(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?

As described above in question 22, we think that removing exposures at any time would be consistent in way risk is dynamically managed.

(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.

Similar to our response to question 22(b) above, we concur with the issues identified in section 7.2.2 of the DP in relation to the two alternative treatments available (i.e. immediate recognition in profit or loss or deferral an amortisation of the revaluation adjustment). We think the only way these issues could be addressed is a pragmatic rules based solution which we acknowledge in itself may create divergence between the accounting and underlying dynamic risk management (macro hedging) activity. Nevertheless we view immediate recognition in profit or loss as the preferable outcome on the basis of operational simplicity.

Question 24 —Dynamic risk management of foreign currency instruments
(a) Do you think that it is possible to apply the PRA to the dynamic risk management of FX risk in conjunction with interest rate risk that is being dynamically managed? (b) Please provide an overview of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not. We do not dynamically manage FX risk in conjunction with interest rate risk therefore we have not commented on this question.

Section 8—Application of the PRA to other risks

Question 25 —Application of the PRA to other risks
(a) Should the PRA be available for dynamic risk management other than banks' dynamic interest rate risk management? Why or why not? If yes, for which additional fact patterns do you think it would be appropriate? Please explain your fact patterns. (b) For each fact pattern in (a), please explain whether and how the PRA could be applied and whether it would provide useful information about dynamic risk management in entities' financial statements. The dynamic management of risks other than interest rate risk does not have wide application to us therefore we have not commented on this question.

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?
In our view, OCI volatility while not desirable is preferable to profit or loss volatility. Therefore, while we do not think that an approach incorporating the use of OCI in the manner described in paragraphs 9.1–9.8 should be considered, we have suggested an alternate approach which contemplates the use of OCI in our covering letter. We have also suggested in our response to question 18(c) that certain hedge ineffectiveness could be recognised in OCI.