AUSTRALIAN BANKERS' ASSOCIATION INC.

Aidan O'Shaughnessy
Policy Director, Industry Policy

AUSTRALIAN BANKERS' ASSOCIATION INC.
Level 3, 56 Pitt Street, Sydney NSW 2000
p. +61 (0)2 8298 0408 **f.** +61 (0)2 8298 0402

www.bankers.asn.au

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Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Mr Hoogervorst,

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

The Australian Bankers' Association (**ABA**) appreciates the opportunity to comment on the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (**the DP**). By way of background the ABA was established in 1984 and works with its members to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services.

Whilst we welcome the International Accounting Standards Board's (**IASB**) continued efforts in developing a macro hedge accounting model to allow financial institutions to reflect the effect of their risk management activities over open portfolios in financial reporting and address existing practical challenges, we strongly disagree with the DP's scope and proposed approach.

The proposals introduce a model that attempts to reflect risk management activities in an entity's financial statements, however, it does not provide decision makers with useful information concerning these activities nor comparability with other entities. Furthermore, depending on the entity's risk management strategy, the model can introduce earnings volatility. This is particularly the case for unhedged net risk positions. In our view, a macro hedge accounting model should solely focus on eliminating the accounting mismatch arising between open portfolios measured at amortised cost and their hedging instruments measured at fair value through profit or loss. This model is explored further below and in our response to the IASB's specific questions.

Financial institutions manage interest rate risk as well as other risks on a net risk exposure basis. This is in response to the nature of open portfolios being managed, where the composition is constantly changing through the addition, repayment and expiration of financial assets and liabilities.

Whilst the risk management activities undertaken are often highly effective in achieving economic offset of managed risks, IAS 39 / IFRS 9 prohibit the designation of these net open positions as hedged items. Over time, alternative compliant hedge accounting designations have been developed by financial institutions to reduce this accounting mismatch, however, they have contributed to significant operational

complexities and a lack of alignment between the objectives and outcomes of risk management and their presentation in entities' financial statements.

We note that the DP's scope does not focus on the current issues identified in hedging open portfolios, but rather risk management as a whole. Specifically, the DP proposes a dynamic risk management approach which would require revaluation of all risk managed portfolios without consideration of the level of hedging undertaken by an entity. Whilst this addresses the existing accounting mismatch for net positions hedged, it also creates significant unwanted earnings volatility by requiring all portfolios that are dynamically risk managed to be revalued through profit or loss.

Take for example two entities with similar risk exposures but with different risk management practices. Entity A undertakes dynamic risk management activities, whereas Entity B does not. Under the DP, Entity A is required to revalue the portfolio subject to risk and will experience earnings volatility to the extent its risk is unhedged. The other entity will not be required to revalue its portfolio.

We do not believe this volatility will explain the outcomes of risk management to the users of financial statements or be decision-useful for management. It also penalises entities that hedge a proportion of their portfolios, as the unhedged position is revalued and introduces earnings volatility unrelated to its risk management activities. Whilst this is consistent with entities that have undertaken no risk management activities, it is a counterintuitive result, as both portfolios are revalued despite ultimately having different net risk exposures, as a result of their risk mitigation activities. It will ultimately lead to a lack of comparability between financial institutions.

Significant operational challenges will also arise by requiring entities undertaking dynamic risk management to revalue the managed risk (benchmark interest rate risk) for all financial assets and liabilities in risk managed portfolios on a recurring basis. Significant changes to systems and processes will be required, resulting in undue costs without providing more decision useful financial information.

Whilst we understand the IASB's intention is to improve the alignment between risk management activities and presentation in an entity's financial statements, we believe such alignment is already achieved through existing risk management disclosures – for example, the requirements of IFRS 7 and the reporting of risk management activities through other channels, such as Basel III Pillar 3 reporting.

We encourage the IASB to focus the scope on solving the accounting mismatch arising between open portfolios measured at amortised cost, but where the net risk is managed through the use of derivatives held at fair value through profit or loss.

An alternative to the portfolio revaluation approach proposed by the DP is to implement a macro hedge accounting model that follows principles similar to cash flow hedges under IFRS 9. Hedge accounting would be applied where hedging instruments were highly effective in achieving offsetting changes, and the amount hedged did not exceed the net risk of the open portfolio. In these instances, the fair value of hedging instruments would be deferred through other comprehensive income. Hedging undertaken in excess of the net risk would result in over hedging and ineffectiveness recognised in profit or loss. This model is explored further in our detailed responses. This approach would resolve existing concerns around hedging open portfolios and allow financial institutions to reflect risk mitigation activities undertaken through the financial statements.

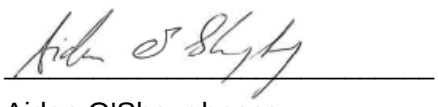
We also welcome the following specific proposals in the DP that could be incorporated as amendments to the general hedge accounting model under IFRS 9 or the alternative model proposed above:

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

Finally, we strongly believe if the risk mitigation approach were implemented its application should be optional and entities should be allowed to apply this option to each portfolio that is separately risk managed consistent with the general hedge accounting model. Consideration should also be given to hedging forecast foreign currency earnings of foreign operations, which is a common issue in Australia.

We encourage the IASB to continue its efforts in developing a sound macro hedge accounting model focusing on addressing the key existing challenges.

Yours sincerely,



Aidan O'Shaughnessy

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 agree that an accounting solution is required to allow financial institutions to reflect the effect of their risk management activities over open portfolios in financial reporting, particularly as current designations under the general hedging model create operational complexity (as acknowledged by the DP). However, we disagree that dynamic risk management should be reflected through the application of the portfolio revaluation approach (PRA). In our view the scope should be restricted to circumstances where risk mitigation through hedging has been undertaken.

As the name suggests, the composition of open portfolios is constantly changing through the addition, repayment and expiration of financial assets and liabilities. As a result, the risk management activities undertaken by financial institutions will manage the net risk of these portfolios, within predefined risk limits.

Conversely the current general hedge accounting model is suited towards closed portfolios, where the underlying risks are not constantly changing and a one-to-one designation of hedging instruments can be achieved. It also prohibits the designation of net positions as an eligible hedged item. In practice, financial institutions have been able to develop compliant hedge designations in respect of open portfolios, including through the use of proxy designations, however it has led to significant operational complexity.

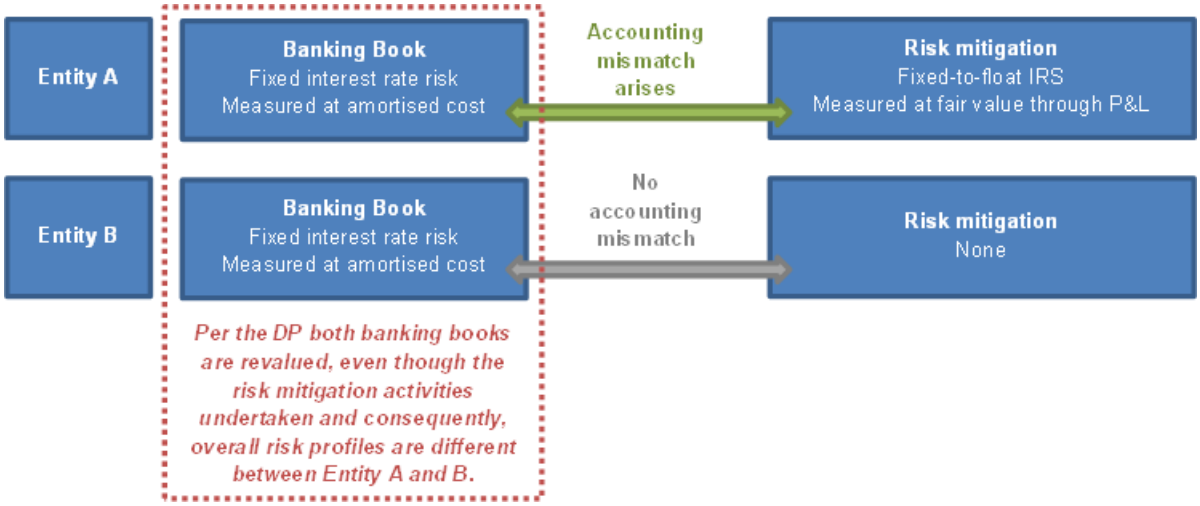
As such, there is a specific need for a hedge accounting approach towards open portfolios that helps reduce the accounting mismatch arising between financial institutions' banking books (measured at amortised cost) and hedging derivatives (measured at fair value through profit or loss).

The main PRA model proposed by the DP revalues managed net open risk positions for changes in risks that are being dynamically managed. Per the DP, dynamic risk management is a broad concept. It involves the identification and analysis of risks, decisions on whether those risks are mitigated, and if so, how.

As a consequence, entities that have identified certain risks but decided not to undertake risk mitigation activities (whether this is because the entity is willing to absorb this risk or there is an economic offset elsewhere in the business) will still be captured by the DP's requirements and the portfolio revalued for the identified risk. This is despite no risk mitigation activities being undertaken and no accounting mismatch arising. In practice, all open portfolios held by a financial institution would be captured under this definition, as active risk management is integral to operations.

In our view, this mandatory PRA approach does not provide a faithful representation of an entity's risk profile or differentiate the risk management activities undertaken by entities. This is clearly illustrated in the example below.

In this example, two entities hold a banking book with a similar fixed interest rate risk profile. Both entities will undertake dynamic risk management, to identify and analyse the effects of interest rate risk, however one of the entities will undertake risk mitigation and the other will not. Under the mandatory PRA both entities will revalue their banking book, irrespective of the risk mitigation activities undertaken.



As illustrated through the example, under this approach:

- Users are unable to identify whether an entity has undertaken risk mitigation activities or not through the mandatory application of the PRA in isolation,
- Revaluation of open portfolios in itself does not provide users with an understanding of the entity's exposure to the risk arising from the portfolio, and the net risk after any risk mitigation activities undertaken. The revaluation amount is ultimately only a point in time measure, and is not reflective of how the risk may impact the entity's future performance,
- Earning volatility unrelated to an entity's activities is introduced for unhedged open portfolios, which is not related to an entity's performance or risk management activities, and
- The amortised cost business model under IFRS 9 is effectively overridden by requiring all open portfolios that are dynamically managed to be revalued. This is despite the IASB noting that the amortised cost business model resulted in decision useful information as part of the development of IFRS 9.

In our view, the mandatory application of the portfolio revaluation approach in an entity's primary financial statements has the effect of obscuring a user's understanding of the entity's performance and how it has managed risks, rather than improving transparency.

We believe the project should focus on a hedge accounting model that reduces the accounting mismatch arising from hedging open portfolios. This would be consistent with the project's original objective when it was carved out from IFRS 9, as well as the principles underpinning the general hedge accounting model.

> *"The objective of hedge accounting is to represent, in the financial statements,* ***the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss****...This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect."*

(IFRS 9, para 6.1.1)

A number of aspects are important to our overall response to the DP, as such, we have included our response to questions 15, 16 and 26 next.

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 (ie a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (ie a scope focused on risk mitigation)? Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

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?

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?

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?

a) We disagree that dynamic risk management should be reflected through an entity's primary financial statements through the portfolio revaluation approach (PRA). Please refer to our response to question 1 for the detailed reasoning behind this.

   In our view the scope should be restricted to circumstances where risk mitigation through hedging has been undertaken. We have proposed an alternative macro hedge accounting model that follows principles similar to cash flow hedges under IFRS 9 below.

Alternative model

Financial institutions manage open portfolios to certain risk limits established by management. These risk limits may be based on market value sensitivity or net interest earnings at risk limits.

Under this alternative model, we propose to reflect this risk management practice through the financial statements using cash flow hedging principles.

Key aspects are as follows:

Hedged item	Net risk position of a defined open portfolio
Hedging instruments	Derivatives
Commencement	Upon designation by the entity, following similar documentation principles under the general hedge accounting model
Designation	Entities would need to demonstrate at inception that the types of hedging instruments to be utilised will be highly effective in achieving offsetting changes in the cash flows of the underlying open portfolio. Specific designation of derivatives is not performed, as given the nature of open portfolios the derivatives are expected to change over time. Rather the types of instruments to be used to mitigate the relevant hedged risk are identified (for example, fixed to floating interest rate swaps), as well as any other relevant parameters so as to illustrate how risk will be mitigated in the portfolio.
Ineffectiveness	In order to assess whether ineffectiveness has arisen, the open portfolio would be stratified into appropriate maturity buckets. In respect of each component, where the level of hedging exceeded the net risk position of the open portfolio, ineffectiveness would arise in respect of the over hedged position. The over hedge means that the derivative position is higher than the open position excluding these derivatives. Ineffectiveness would also arise to the extent that the hedging instruments' maturity exceeded the expected maturity of the underlying component of the portfolio.
Accounting - effective hedges	Changes in the fair value of derivatives would be deferred through other comprehensive income (OCI). Cash receipts / payments under the derivatives would be recognised through net interest margin, as and when they occurred. This would result in an equal but opposite decline in the fair value of the derivative which would then be recorded through OCI. Other fair value adjustments on derivatives (for example foreign currency basis risk, counterparty credit risk (CVA), own credit risk (DVA), effect of collateralisation (OIS), and funding costs (FVA)) are viewed as a cost of hedging and deferred in OCI. They are subsequently amortised to profit or loss over the life of the macro hedges. Such treatment would be analogous with requirements in paragraph 6.5.16 of IFRS 9 for foreign currency basis spread and forward points which are considered to be costs of hedging.
Accounting - ineffective hedges	The ineffective portion of the derivative is recognised through profit or loss immediately.
Cessation of hedge accounting	Where a decision is made to cease risk mitigation activities, and all relevant hedging instruments are sold, terminated or exercised, or the open portfolio being hedged is sold, terminated or the underlying exposures expire. Amounts deferred in OCI would be released to profit or loss upon cessation.

b) A combination of a hedge accounting solution focused on risk mitigation and appropriate disclosures concerning risk management activities would be sufficient in providing transparent information to users concerning dynamic risk management activities. This approach would also be consistent with the general hedge accounting model.

As noted in question 1, a dynamic risk management approach where all risk managed portfolios are mandatorily revalued would not provide useful information to users as:

- Revaluation of open portfolios does not provide users with a greater understanding of the underlying risk and an entity's exposure to these risks, as it is just a point in time measure,
- Users are unable to distinguish between portfolios where risk mitigation activities had been undertaken and those where they had not through the application of the PRA in isolation,
- Earnings volatility created on unhedged portfolios would be introduced, and would not allow a meaningful analysis of net interest margin,
- The approach is inconsistent with the underlying business models of IFRS 9. It would largely eliminate the amortised cost measurement model, which as part of the development of IFRS 9 was noted as providing decision useful information, and
- The approach does not resolve the operational complexities associated with existing designations under the general hedge accounting model.

c) We have not considered the operational feasibility of applying the PRA in depth. We note that the approach would involve significant operational difficulties and additional cost, as it would require entities to remeasure all open portfolios that were dynamically managed, irrespective of whether hedging was undertaken, on a periodic basis. The proposals also introduce operational complexity, which will require tracking of individual exposures, changes in behavioural assumptions, and other specific factors.

Under the alternative model proposed above the operational difficulties associated with changes to the identified hedged sub-portfolio and/or proportion to be accommodated is not relevant. Hedging would be based on the net risk position of an open portfolio and the level of hedging undertaken. Financial institutions already have systems and processes in place to identify and manage these positions.

d) Our views would not change in respect of risks other than interest rate risk. A hedge accounting model that eliminates accounting mismatches arising from mixed measurement methods should be developed in response to open portfolios that are focused on risk mitigation.

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?

Whilst we do not support the application of the PRA, if the IASB proceeded with this model, we would prefer the scope be limited to risk mitigation and, similar to hedge accounting, should be optional.

Entities should be allowed to apply this option to each open portfolio that is separately risk managed. This would also allow flexibility for entities that would look to use a combination of general and macro hedging models. Mandating application would create inconsistency with the general hedge accounting model, where application is optional. Similarly, allowing a choice is consistent with the IASB continuing

to allow companies the choice of electing to carry a financial asset or liability at FVTPL, where it would otherwise be measured at amortised cost.

Whilst this may cause a lack of comparability between entities, this can be addressed by requiring disclosures about an entity's risk management and specific hedging activities.

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 noted through our responses, we disagree that dynamic risk management should be reflected through an entity's primary financial statements through the PRA. The main reason for this view is that the scope of a macro hedging solution should be to resolve the accounting mismatch created from measuring hedged items at amortised cost and hedging instruments at fair value through profit or loss. The other challenge with the PRA is that it creates earnings volatility through the revaluation of unhedged positions through profit or loss.

An alternative dynamic risk management model of presenting the net revaluation adjustment from managed exposures and the changes in the clean fair value of risk management instruments in OCI is not solely focused on resolving the accounting mismatch, but rather reflecting risk management activities within the primary financial statements.

We have proposed an alternative model, in question 15 that utilises key principles of the existing cash flow hedging model, including the use of other comprehensive income.

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?

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

The DP has correctly identified a number of issues that entities face when applying the current hedge accounting requirements to open portfolios. Specifically, IAS 39 and IFRS 9 prohibit or significantly limit those exposures that can be designated as hedged items. Exposures that are often a part of the economic hedges of interest rate risk in open portfolios include:

- Pipeline transactions,
- Equity model book,
- Sub-benchmark rate instruments, and
- Behaviouralised rather than contractual cash flows.

Due to these limitations entities are often not able to easily reflect these economic hedges in their financial statements and are required to develop complicated hedge designations to comply with accounting standards. Such hedge accounting designations reduce the accounting mismatch arising but do not reflect risk mitigation strategies.

As discussed earlier in this letter we believe that the scope should be limited to a risk mitigation model that eliminates the accounting mismatch arising from mixed measurement models to the extent hedged risks are economically offset.

One issue that is not discussed in the DP is the impact of emerging valuation practices for derivative instruments, and the potential ineffectiveness this creates for hedge accounting. The market approach to valuation of derivatives has undergone significant changes since the beginning of the global financial crisis. Derivative instruments are no longer measured using only risk-free curves but are adjusted to reflect additional risks inherent in derivatives including:

- Foreign currency basis risk,
- Counterparty credit risk (CVA),
- Own credit risk (DVA),
- Effect of collateralisation (OIS), and
- Funding costs (FVA), etc.

Under the PRA, open portfolios would only be revalued for interest rate risk. As a result, ineffectiveness will arise from these risks being factored into derivative valuation. This is despite interest rate risk of the open portfolio being economically hedged. This issue also arises with fair value hedges under the general hedge accounting model.

One way to resolve this issue is to view such adjustments as costs of hedging. This is analogous with the requirements in paragraph 6.5.16 of IFRS 9 for foreign currency basis spreads and forward points. We encourage the IASB to explore the possibility of allowing recognition of such adjustments in OCI with subsequent amortisation to profit or loss over the life of underlying hedge instruments. We also believe the principals behind cost of hedging should be defined, as derivative valuation practices continue to be developed, that may create greater ineffectiveness.

In addition, for risk management purposes financial institutions economically hedge the forecast foreign currency earnings of their foreign operations. For example, in Australia, the major Banks have significant NZ operations. These operations typically have a NZD functional currency and their results are translated into the functional currency of the overall group (being AUD). As part of the Bank's risk management processes, forward contracts are entered into to lock in the AUD equivalent earnings.

This position does not qualify for hedge accounting; however, the Australian Banks adjust for the impact of this economic hedging in their non-GAAP measures (cash earnings). We would encourage the IASB to also consider whether this could qualify for hedge accounting under the proposals being developed.

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?

At the most basic level, we agree that dynamic risk management involves the continuous reassessment of the net open risk positions arising from managing open portfolios. We also concur that exposures arising in open portfolios frequently change, and that risk management processes will respond to this.

The manner in which financial institutions respond to risk exposures will vary. As such the characteristics outlined in 2.1.2 may not be representative across the board. Also they do not appear to consider characteristics arising due to risks other than interest rate risk.

As we disagree with the PRA and believe that the scope should focus on risk mitigation, the definition and characteristics of dynamic risk management is not important to define.

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).

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.

Pipeline transaction and equity model book

Pipeline exposures and equity model book should be allowed as eligible hedge items in macro hedges if they are economically hedged as part of open portfolios with interest rate risk. If entities are not allowed to include such notional exposures, hedges that are effective in offsetting risk economically result in an accounting mismatch, i.e. as the derivative is being recognised at fair value through profit or loss and the pipeline transaction has not yet been brought to account. Whilst these relationships are economically hedged, hedge accounting is prohibited. As a result, local practice by Australian financial institutions is to develop compliant proxy hedge relationships to reflect the impact of the economic hedge through the financial statements.

We are concerned, however, that the approach proposed in the DP may lead to recognition of revaluation adjustments on pipeline transactions and equity model books in the statement of financial position. This will not be consistent with the Conceptual Framework as pipeline transactions and equity model book are not contractual or constructive obligations and would not meet the criteria for recognition in the statement of financial position.

No such inconsistency would arise under the alternative approach we proposed in question 15. Specifically, hedging derivatives would be revalued through OCI as the macro hedge relationship remains effective. Assets and liabilities in the hedged portfolio will continue to be measured on the basis consistent with their business model and will not be revalued for the hedged risk. Under this approach no revaluation adjustment would be recognised in the statement of financial position for the pipeline transactions or equity model book included in the hedged portfolio. Interest rate risk exposures arising from pipeline transactions and equity model book would be included in measuring hedge effectiveness for each hedged open portfolio.

We note that for pipeline transactions and equity model book our proposed alternative treatment appears to be consistent with IAS 39 and IFRS 9 requirements for hedges of highly probable forecast transactions under which no assets or liabilities are recognised in the statement of financial position in relation to hedged forecast transactions.

We believe our proposed approach will not present significant operational challenges to those entities that already economically hedge pipeline transactions and equity model book as they already have data and infrastructure to produce information necessary to reflect their hedges in financial reporting.

Behaviouralisation

For risk management purposes, the interest rate risk profile of fixed rate products in open portfolios is often determined on the basis of behaviouralised expectations of prepayments (including prepayment rates), rather than on a contractual cash flow basis for items where no break costs are required.. Due to availability of historical data on prepayment experience, financial institutions are able to determine an interest rate risk profile on open portfolios accurately and design economic hedges that are effective in offsetting the risk.

To the extent entities use behaviouralisation for interest rate risk management, they should be allowed to replicate the same approach in accounting for macro hedges as this will allow the elimination of the accounting mismatch and ensure that risk mitigation is faithfully reflected in financial reporting.

Financial institutions that use behaviouralisation data as part of their risk management will have the systems and data required to produce financial information to reflect this approach in financial reporting. They will therefore not face significant operational challenges in implementing behaviouralisation in accounting for macro hedges.

Question 5—Prepayment risk

When risk management instruments with optionality are used to manage prepayment risk as part of dynamic risk management, how do you think the PRA should consider this dynamic risk management activity? Please explain your reasons.

As noted in question 4, interest rate risk of open portfolios is managed taking into account customer behaviour, including prepayment rates, rather than contractual cash flows for items where no break costs are required. Financial institutions use a variety of hedging instruments to manage this risk, including the use of options. Interest rate options help mitigate downside risk associated with prepayments in a declining interest rate market.

Under our alternative approach, risk management instruments with optionality can be designated as hedging instruments provided they form part of the overall risk framework in managing interest rate risk of the open portfolio and where the instrument remains effective.

Question 6—Recognition of changes in customer behaviour

Do you think that the impact of changes in past assumptions of customer behaviour captured in the cash flow profile of behaviouralised portfolios should be recognised in profit or loss through the application of the PRA when and to the extent they occur? Why or why not?

As we do not agree with the mandatory PRA model, we have considered the recognition of changes in past assumptions of customer behaviour in the context of our proposed model.

Cash flow profiles of behaviouralised portfolios do change as external factors impact customer behaviour. As changes in assumptions about customer behaviour occur risk managers rebalance macro hedges to ensure they continue to deliver the required economic offset of risks. Such rebalancing is seen as a natural part of risk management activities.

Entities can rebalance their hedges in a number of different ways such as entering into new derivatives to eliminate effects of under or over hedging following changes in assumptions about customer behaviour, or, adding new items to open portfolios. We believe changes in assumptions about customer behaviour should not, by default, result in hedge ineffectiveness. For example, if an entity is able to adjust the hedging instruments following a change in the assumption about prepayment period, such that the hedge remains effective in offsetting economic risks, no ineffectiveness should be recognised in profit or loss. The determination of ineffectiveness under our alternative model is addressed further in our response to question 15.

We note that measuring hedge effectiveness upon changes in behaviouralisation assumptions may be operationally challenging. Many financial institutions assess and manage economic risk on open portfolios using a bottom layer approach. Our comments on bottom layer approach are provided in the following question.

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 we do not agree with the PRA model, our response is provided in the context of the alternative model proposed.

Bottom layer and the proportions approach outlined in the DP are widely used by risk managers to assess and manage interest rate risk. We therefore agree that this approach should be allowed for hedge accounting purposes when used for risk management purposes as it will reduce the accounting mismatch and reflect risk management strategies in financial reporting.

We agree with the comment in the DP that by applying the bottom layer approach entities effectively ignore the risk of prepayments. It's important to note though that in applying this approach entities hedge interest rate risk, not the prepayment risk. Therefore, the occurrence of unexpected prepayments in the portfolio should not impact the effectiveness of interest rate hedges to the extent the initially defined bottom layer remains in place, i.e. the unexpected prepayments do not exceed the size of the top layer.

Question 8—Risk limits

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

As discussed above we do not agree with the PRA proposals in the DP in general. Hence, we have not commented on the use of risk limits in the PRA.

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?

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

For risk management purposes interest rate risk profile of demand deposits is often determined on the basis of behavioural expectations rather than on contractual cash flows basis. Entities are often able to determine a portion of their demand deposits portfolio that is not sensitive to changes in interest rates and therefore behaves in a way similar to fixed interest rate products. Interest rate risk on core deposits is then managed according to their behavioural rather than contractual characteristics.

As discussed in our responses to question 4 the main objective of the new macro hedge accounting model should be elimination of accounting mismatch to the extent hedged risks are economically offset. Accordingly, entities should be allowed to include core demand deposits in open portfolios on a behaviouralised rather than contractual characteristics basis to the extent they are economically hedged.

Determination of a behaviouralised profile of core demand deposits is a complex risk management matter that requires sophisticated modelling and analysis of data. We are concerned that any guidance on behaviouralisation will be incapable of addressing all its critical aspects and complexity. If anything, such guidance will limit entities' existing approaches to behaviouralisation and will likely increase the potential for further accounting mismatch.

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

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?

Financial institutions manage interest rate risk arising from instruments priced both at a margin and discount to benchmark interest rates. We envisage under the alternative model proposed in question 15, sub-benchmark instruments can form part of the composition of an open portfolio. Designation of hedging instruments and the identification of ineffectiveness would follow the principles we have outlined in question 15.

We concur with the interest recognition pattern outlined in the DP concerning sub-benchmark instruments – being the actual coupon on the instrument accrued, including the effect of the negative margin and any embedded floor.

If a PRA model was to be implemented by the IASB, we note that inclusion of sub-benchmark instruments would be similar to current practice whereby multiple hedge designations are entered into so as to reflect economically hedged position.

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?

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?

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)?

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.

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?

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?

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.

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?

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 relation to questions, 11-14, we disagree with the revaluation of open portfolios under the PRA. We have proposed an alternative approach based on cash flow hedging principles that would not involve revaluation of open portfolios. Refer to the response in question 15.

As a consequence we have not provided any further responses to these questions relating to the calculation of the portfolio revaluation adjustment. We do, however, support the principal of leveraging the relevant transfer pricing methodology.

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.

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.

a) Whilst we disagree with the PRA, if the IASB were to proceed with this approach its scope should be restricted to circumstances where risk mitigation through hedging has been undertaken. It should also be an optional election. The reasons for this have been stated in our earlier responses.

b) The scope should be restricted to circumstances where risk mitigation through hedging has been undertaken, and this should be an optional election.

We do not believe specific criteria are required to identify what is considered "risk mitigation through hedging under dynamic risk management." The scope should however be limited to open portfolios that are dynamically managed and where the relevant risk has not been designated as part of general hedge accounting relationship.

The principles of cash flow hedge accounting are utilised under the alternative approach we proposed in question 15. Similar to existing requirements under the general hedge accounting model, the criteria regarding the commencement and cessation of hedge accounting under this alternative approach is outlined as follows:

Commencement

- Upon designation by the entity

Cessation

- A decision is made to cease risk mitigation activities, and all relevant hedging instruments are sold, terminated or exercised
- The open portfolio being hedged is sold, terminated or the underlying exposures expire

Question 18—Presentation alternatives

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

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

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.

a) As discussed above we do not agree with the PRA proposals in the DP in general. Out of the 3 presentation alternatives provided presenting the net revaluation adjustment in 'single net line item' in the statement of financial position is preferred. This approach is consistent with the principle of dynamically risk managing a net open position.

   We believe that both the 'line-by-line gross up' and the 'aggregate adjustment' presentation in the Statement of Financial Position would increase operational complexity and costs; and would not provide users with useful or transparent information.

b) We disagree that dynamic risk management should be reflected in an entity's Income Statement. Both presentation alternatives increase the volatility of net profit or loss, and are inconsistent with the amortised cost measurement model for banking book instruments (i.e. those portfolios under IFRS 9 that meet the business model objective of 'hold assets in order to collect contractual cash flows').

Also see our response to question 2, which considers that certain fair value adjustments on derivatives should be viewed as a cost of hedging and deferred in other comprehensive income, with their subsequent amortisation to profit or loss over the life of the macro hedges. Such treatment would be consistent with requirements in paragraph 6.5.16 of IFRS 9 for foreign currency basis spread and forward points which are considered to be costs of hedging.

We have proposed an alternative approach based on cash flow hedging presentation principles. Under this methodology all hedging instruments would be measured at fair value with gains or losses on the hedging instrument deferred in other comprehensive income. The net interest accrual from the hedging instrument would be recognised in net interest income and any other fair value adjustments would be recognised in profit or loss over the life of the macro hedges. Where hedging activities exceeded the net risk position of the open portfolio, the excess would represent ineffectiveness and would be recognised through profit or loss immediately.

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?

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

If this approach was taken we support the following specific safeguards:

- any profit or loss on internal derivatives are to be eliminated so there is no net profit or loss impact; and
- an entity demonstrates that the risk transferred via the internal derivatives has substantially been passed onto external counterparties.

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.

One of the IASB's key objectives through this DP is to provide decision useful information to stakeholders concerning dynamic risk management. As outlined in our responses, we believe the application of the dynamic risk management approach to an entity's primary financial statements does not achieve this.

We view there being two aspects to a discussion concerning disclosures:

1) The nature of hedge accounting undertaken – whether under a macro or general hedge accounting model, and

2) The risk management policies and activities of an entity broadly – including, but not limited to, dynamic risk management.

We concur that information around both aspects is useful to stakeholders in order to develop a better understanding concerning an entity's current risk exposure and methods in managing this.

Each aspect has been considered below.

1) Nature of hedge accounting undertaken

IFRS 7 currently contains disclosure requirements concerning general hedge accounting. As such, any disclosures developed in respect of a macro hedge accounting model should not be determined without reference to these existing requirements.

In our view, some of the existing requirements in IFRS 7 can be applied to a macro hedge accounting model, in particular:

- A description of the hedges undertaken,
- A description of the financial instruments designated as hedging instruments, including their fair value, and
- The nature of risks being hedged.

In respect of the alternative model proposed in question 15, and considering the existing cash flow hedge requirements of IFRS 7, the following disclosures are suggested:

- The amount recognised in other comprehensive income during the period,
- The amount that was reclassified from equity to profit or loss for the period, and
- The ineffectiveness recognised in profit or loss for the period.

2) Risk management broadly

We believe disclosures in the area of risk management should be considered broadly, rather than addressing elements on a piecemeal basis – in this instance, only focusing on dynamic risk management. It could form part of the larger projects being undertaken by the IASB around the Conceptual Framework and disclosure initiatives.

We note paragraph 6.3.2 of the DP outlines that "users of financial statements have previously emphasised the importance of having information about entities' risk management in the financial statements." From our discussions with users, they have also expressed a sense of "disclosure overload" more generally. As such, development of any risk management disclosures should involve extensive stakeholder outreach to consider the specific needs of users, and how this differs between regions and sectors. The IASB should also consider whether such disclosures are better addressed by local regulators.

Any such project should also assess risk management disclosures in the context of existing disclosure requirements – whether mandated under IFRS or through other channels – so as to not duplicate information. This is particularly relevant to financial institutions that apply the Basel III requirements, where periodic reporting of qualitative and quantitative risk management activities is already required.

Question 21 - Scope of disclosures

a) Do you think that the scope of the disclosures should be the same as the scope of the application of the PRA? Why or why not?

b) If you do not think that the scope of the disclosures should be the same as the scope of the application of the PRA, what do you think would be an appropriate scope for the disclosures, and why?

As noted in question 20, we believe disclosures concerning hedge accounting and risk management more broadly should be considered separately.

Disclosure requirements in respect of hedge accounting should apply where such risk mitigation activities have been undertaken and it is considered material to the entity.

Conversely, any disclosure requirements in respect of risk management broadly would apply to all entities irrespective of whether risk mitigation activities had been undertaken or not. With that being said, we reiterate the importance of not duplicating existing disclosures whether mandated under IFRS or another mechanism. This is particularly relevant to financial institutions that apply the Basel III requirements, where periodic reporting of qualitative and quantitative risk management activities is already required. We believe any discussion concerning risk management disclosures should be considered in light of the IASB's existing disclosure initiatives and Conceptual Framework project.

Question 22—Date of inclusion of exposures in a managed portfolio

Do you think that the PRA should allow for the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract? Why or why not?

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

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

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

We understand practical challenges mentioned in the DP in relation to recognition, amortisation or derecognition of revaluation adjustments on hedged items when they are included in an open portfolio after initial recognition or removed from an open portfolio before derecognition. Such challenges would not arise under our proposed alternative model discussed in question 15. Under this model hedged items will not be revalued for risk in the statement of financial position, whilst revaluations of risk management instruments will be recognised in OCI. To the extent that inclusion of exposures after initial recognition or removal of exposures before derecognition does not impact hedge effectiveness, hedging derivatives will continue to be measured through OCI without any impact on profit or loss.

Question 23—Removal of exposures from a managed portfolio

a) Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?

b) Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from a managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?

c) If exposures are removed from a managed portfolio prior to maturity, how would you propose to account for the recognised revaluation adjustment, and why? Please explain your reasons, including commenting on the usefulness of information provided to users of financial statements

Refer to our response to question 22.

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.

A macro hedge accounting solution should be developed that can address risks beyond interest rate risk. Foreign currency risk is another major risk Australian financial institutions are exposed to. Australian financial institutions historically seek and issue debt outside of their functional currency in order to borrow from debt investors located offshore. Foreign currency risk exposures resulting from offshore debt issues are normally converted into domestic currency using cross currency interest rate swaps on a

one-to-one basis. These derivatives are designated as hedging instruments in fair value and cash flow hedges of interest rate and foreign exchange risks of the foreign currency debt issues.

As noted in our response to question 16, the macro hedge solution should be optional. This would allow financial institutions to more closely align the accounting to how they manage risks, by providing the flexibility to apply either the macro or general hedging model as appropriate.

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.

Refer to our response to question 24.