ITC31 sub 8

The Institute of Public Accountants

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

31 October 2014

Partnership beyond numbers

IPA INSTITUTE OF PUBLIC ACCOUNTANTS

31 October 2014

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
Australia

Dear Sir/Madam

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

Thank you for the opportunity to comment on the Discussion Paper DP/2014/1 'Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging'. While the IPA acknowledges the current options for hedge accounting for interest rate risk in the banking book are sub-optimal, the IPA does not support the Portfolio Revaluation Approach (PRA) proposed in the Discussion Paper (DP).

For the reasons set out in the DP the existing accounting options available under IFRS 9 'Financial Instruments'/IAS 39 'Financial Instruments: Recognition and Measurement' do not faithfully reflect the manner in which banks' manage their net interest exposures. The current portfolio hedging requirements are operationally difficult to implement and require a series of "closed portfolios" rather than the open portfolios used in banks' management of their net interest disclosure. As a result, cash flow hedges designated to variable rate mortgages are used to achieve hedge accounting under current rules. While such "work-arounds" have ensured minimal profit and loss volatility, they are not a true representation of the actual risk management process for managing interest rate risk in the banking book.

The IPA does not support the PRA proposed for the following reasons.

1. Management of interest rate risk in the banking book is effectively the management of the bank's net interest cash flows and as such a model based on fair value revaluations does not reflect the substance of the risk management activities and, therefore, is subject to some the same criticisms applicable to the current requirements;
2. The model effectively requires the recognition on the balance sheet as a fair value "increment" the net future cash flows arising from assets and liabilities held at amortised cost; we do not believe that there is basis for such accounting under the Framework
3. While we agree with a number concepts underpinning the proposal, some are inconsistent with the Framework, including:
    a. The inclusion of the Equity Model Book (EMB) as part of the managed portfolio;
    b. The treatment of core demand deposits; and
    c. Sub-benchmark managed risk instruments.
4. We are concerned with the ease of operationalising the proposals, including the use of transfer pricing as a practical expedient; and

5. The DP attempts to reflect in financial statement risk management activities, and we are of the view that the current Framework is inconsistent with such an objective. On a more fundamental basis, whether the existing financial statements are the appropriate format for the recognition and measurement of risk management activities (even on a limited basis as contemplated by the DP); and
6. The IPA is concerned with the proposal to extent to concepts on the DP to areas outside interest rate risk in the banking book, where there currently have been no demonstrated concerns in relation to the existing hedging options.

The IPA believes the revaluation model is not appropriate to reflect the substance of risk management of interest rate risk in the banking book and recommend the IASB consider a cash hedging based model.

Finally, the IPA believes the IASB should consider a broad risk management disclosure framework including qualitative and quantitative disclosures applicable to all entities, not just those that adopt hedge accounting.

Our detailed comments and responses to the questions in the Discussion Paper are set out in Appendix A.

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 24,000 members nationally, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investment Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA) on issues affecting the profession and industry.

If you would like to discuss our comments, please contact me or our technical adviser Stephen La Greca, GAAP Consulting, (0417 451 315, or stephenlagreca@aol.com).

Yours faithfully

Vicki Stylianou
Executive General Manager Public Affairs

APPENDIX A

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?

IPA response

While the IPA believes there is a need to address the failure of the current hedging rules to appropriately cater for the manner in which financial institutions manage the interest rate in their banking books, we do not believe the proposed dynamic risk management (DRM) approach is an appropriate manner to do so.

The IPA does not believe a method based on the recognition of future net interest margins as a balance sheet item is consistent with the Framework. Further, we have reservations that a number of concepts used in the dynamic risk management are also not consistent with the current purpose of financial reporting.

Financial reporting is currently not based on the recognition and measurement of the various business risk of entity and while there is a case for the disclosure and quantification of such risks, the IPA believes such objective would be better served by disclosure in the notes rather than the recognition of balance sheet items. Therefore, we believe the IASB needs to focus on cash flow hedging model that reflects the hedging of net interest income flows rather than a revaluation model.

Question 2 – Current difficulties in representing dynamic risk management in entitles financial statement

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?

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

IPA response

The IPA agrees the DP has identified the main issues with the interest rate risk management under current hedge accounting rules. However, the DP does not make the case of the need and appropriateness or otherwise of dynamic risk management in relation to hedging of other net risk exposures. As mentioned is our response to question 1, the IPA does not believe the DRM approach based on a PRA is appropriate.

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?

IPA response

The IPA agrees that the DP describes many of the characteristics of management of interest rate risk in the banking book. However, it is unclear whether these characteristics of other risk dynamically managed by banks or in other industry sectors.

Question 4 – Pipeline transactions, EMB and behaviouralisation

Pipeline Transactions

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

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

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.

IPA response

The IPA has reservations in relation to the inclusion of pipeline transactions. However, we believe that as long as the pipeline transactions are considered highly probable they should be included as hedged items.

The IPA acknowledges that EMB can be used as part of management of interest rates. However, under a revaluation model where some of the items being hedged are equity instruments there are issues with consistency with the Framework that need to be addressed. The other issue is whether the inclusion of EMB interest rate management should be limited to equity instruments with “preferential coupons” (i.e. hybrid tier 1 equity) or all equity.

The inclusion of behavioural considerations of core deposits is integral to the management of interest rate in the banking book. Any accounting model attempting to apply hedge accounting to these risk management activities needs to acknowledge the behavioural characteristics of items comprising the net exposure. The IPA does not see the behavioural characteristics as inconsistent with the Framework as they simply represent a methodology of estimating the forecast cash flow.

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.

IPA response

The IPA supports the view that any model of hedge accounting of risk management of interest rate in the banking book should include those instruments that are used to manage prepayment risk. The management of prepayment risk in the banking book is an integral part of managing interest rate risk in the banking book.

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?

IPA response

Material changes in customer behaviour should be reflected in the expected cash flows to the extent such changes are material to the net cash flow exposure being hedged. Appropriate disclosures need to be made of both the underlying assumptions of customer behaviour and the basis and quantification of any changes.

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? If yes, how would you suggest overcoming the conceptual and operational difficulties identified? Please explain your reasons.

IPA response

The IPA does not have a view on whether a bottom layer or proportional basis is superior with the PRA. However, we believe both methods have serious operational implementation issues.

Question 8 – Risk limits

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

IPA response

Risk appetite and consequential risk management policies should not be mandated by accounting standards; this is the purview of boards and prudential regulators. Therefore, the IPA does not support the imposition of risk limits for the application of the PRA. The IPA would support general qualitative and quantitative disclosures on risk appetite and risk limits and the relationship with risk management in general and the application of such limits to the PRA.

Question 9 – Core demand deposits

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?

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

IPA response

The IPA believes there is no doubt the inclusion of core demand deposits is integral to the management of interest rate in the banking book and therefore needs to be included in any accounting approach purporting to portray the hedging activities in relation to interest rate management. We believe appropriate quantitative and qualitative relating to core deposit behavioural assumption should be made.

Question 10 – Sub-benchmark rate managed risk instruments

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?

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?

IPA response

The IPA supports Approach 3 ("Risk included in ALM") as it represents the activities undertaken to manage interest rate risk in the banking book. To the extent embedded floors are included in the net risk position being hedged they should be included.

Question 11 – Revaluation of the managed exposures

Do you think that the revaluation calculations outlined in this Section provide a faithful representation of dynamic risk management? Why or why not?

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?

IPA response

As previously noted the IPA does not support a PRA basis for the measurement of interest rate risk in the banking book. We reiterate our position that the management of interest rate risk in the banking book is the management of net interest cash flows and therefore a fair value model for hedge accounting is inappropriate. The IASB should be developing a cash flow hedging model for interest rate risk in the banking book.

Question 12 – Transfer pricing transactions

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)?

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.

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?

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?

IPA response

The IPA understands the need for operational expedients to implement the PRA as set-out in the DP. However, we are concerned with management bias in the measurement of the hedged position. We believe that internal transfer pricing systems are not normally subject to external audit and therefore additional audit costs will necessarily be incurred to establish the adequacy of the control environment of transfer pricing systems including the consideration of management bias.

If the funding rate is used a market funding index (excluding transfer pricing spreads) is the basis the IPA would support. If transfer pricing is to be used as a practical expedient theoretically there should be no restrictions on indexes and spreads otherwise system changes may be required to achieve compliance, diminishing the benefits of the use of transfer pricing. However, the IPA is concerned with management bias and the potential lack of external audit scrutiny.

Transfer pricing can only be considered a practical expedient, to the extent ongoing linkages are identified. If this is not the case or no longer is the case, the use of transfer pricing represents ongoing linkages to the hedged items then it is no longer appropriate.

Question 13 – Selection of funding index

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.

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?

IPA response

The IPA believes the selection of a funding index is the part of the entity's risk management process and should not be mandated by accounting standards. However, there should be adequate documentation supporting the selection of a funding index explaining its relationship to risk management processes and transfer pricing objectives.

Question 14 – Pricing Index

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

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.

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?

IPA response

The IPA has no basis for comment.

Question 15 – Scope

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 (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?

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?

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?

Would the answers provided in questions (a) – (c) change when considering risk 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?

IPA response

The IPA does not support the use of PRA to represent hedge accounting of interest rate risk in the banking book. As has previously stated, we consider the hedging of interest rate risk in the banking book as a hedge of future net interest cash flows and as such a cash flow hedge model would be the appropriate mechanism for such hedging activity.

Question 16 – Mandatory or optional application of the PRA

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?

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?

IPA response

The IPA believes preparers should be able to choose whether to adopt general hedging requirements or the proposed PRA method. A move to mandate a specific hedging approach would also require preparers to potentially incur additional operational costs, when they believe the alternative is a more faithful representation of the hedging relationship. However having made the choice to apply one method there should be no option to change.

Question 17 – Other eligibility criteria

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?

Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.

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.

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.

Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.

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.

IPA response

If the IASB proceeds with dynamic risk management PRA model, the IPA believes a preparer should demonstrate the following to use the method:

1. The exposure must be managed on a dynamic risk management basis;
2. The exposure is not already hedge accounted as a fair value or cash flow hedge under IFRS 9; and
3. Prospective effectiveness testing supports the economic effective of hedge relationship.

Question 18 – Presentation alternatives

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

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

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.

IPA response

As previously stated, the IPA does not support the use of revaluation model to represent hedging of interest rate risk in the banking book. Nonetheless, if is such a method was to be used a single line item representing the revalued net interest exposures would be most appropriate. The IPA prefers the representation of actual net interest income as it represents the contractual interest cash flows. However, we believe the current label on the net revaluation impact is uninformative and an alternative descriptor should be developed.

The IPA does not support the other alternative presented.

Question 19 – Presentation of internal derivatives

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?

Do you think that the described treatment of internal derivatives enhances the operation feasibility of the PRA? Why or why not?

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?

IPA response

The IPA does not see the benefit from the grossing-up of risk management exposures for use of internal derivatives. The IPA sees no operational benefit from the proposal as most preparers have already put in place processes to externalise exposures.

Question 20 – Disclosures

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.

If you think that an identified theme would not provide useful information, please identify that theme and explain why.

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.

IPA response

The IPA in general supports the disclosures proposed. However, we would like to see an integrated risk identification and risk management framework, including existing disclosures. We agree with assessment at 6.3.11 disclosures by class are unlikely to be meaningful disclosures when risk is managed on a net basis.

Furthermore, we are also of the view that risk disclosures need to be made not just by entities adopting PRA hedge accounting but all entities regardless of whether they adopt hedge accounting (either fair value, cash flow or PRA hedging) or have uncovered positions.

Question 21 – Scope of disclosures

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?

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?

IPA response

As mentioned in response to question 20, the IPA believe there should be integrated risk reporting framework including the use of hedging instruments when applicable.

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?

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

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

IPA response

As has been previously raised, the IPA does not support a revaluation model for risk managed on a dynamic basis. In the event a PRA methodology is adopted the IPA's view is that it is at the entity's option as how and when it decides to hedge exposures. Such decisions are integral to the concept of dynamic risk management.

To maintain consistency with current requirements in relation to day one valuations, such gains/losses should be recognised over the period of the hedge relationship. This would ensure no additional volatility arises on inclusion of an exposure in the PRA.

Question 23 – Removal of exposures from managed portfolio

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?

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?

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.

IPA response

The nature of dynamic risk management is such that exposures may be added and removed on a continuous basis. Therefore, it should be permitted to remove exposures prior to maturity to reflect changes in the underlying risk or the risk management strategy. The accounting for a resultant change in underlying risk position should result in an immediate impact on profit and loss. However where there has been a change in risk management strategy the issue becomes more problematic, if a similar treatment is proposed to the removal of underlying risk position, the possibility exists for the cessation of a hedge relationship as a result of management discretion gains may be recognised on an opportunistic basis.

Question 24 – Dynamic risk management of foreign currency

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?

Please provide an over view of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not.

IPA response

The IPA has no basis for comment at this time.

Question 25 – Application of the PRA to other risks

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.

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.

IPA response

Where a risk is managed on a net basis it is possible the PRA dynamic risk management in the DP may be applicable. The approach in the DP has been developed for exposures relating to interest rate risk in the banking book and guidance would need to be of more general basis.

The IPA does not support a revaluation model for what are effectively hedges of expected cash flows.

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 be conceptual and practical difficulties identified with this alternative approach be overcome?

IPA response

The IPA does not believe the use of OCI is appropriate for fair value hedge accounting model. A fair value hedge model implicitly implies that movements in the hedged item are offset by movements in the hedge instrument; any differences between the fair value of the hedged item and hedge instrument reflects the ineffectiveness of the hedge. If one part of the transaction was to be reflected in OCI this relationship would be severed and hedge effectiveness would no longer be reflected in profit and loss.

If the IASB developed a cash flow hedge accounting model for the management interest rate risk in the banking book the use of OCI would be appropriate.

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