ACCOUNTING FOR DYNAMIC RISK MANAGEMENT: A PORTFOLIO REVALUATION APPROACH TO MACRO HEDGING

ICAEW welcomes the opportunity to comment on the discussion paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* published by The International Accounting Standards Board (IASB) on 17 April 2014, a copy of which is available from this link.

This response of 17 October 2014 has been prepared on behalf of ICAEW jointly by the Financial Services Faculty and the Financial Reporting Faculty.

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MAJOR POINTS

1. We welcome the publication of this discussion paper which usefully sets out the accounting issues resulting from trying to reflect certain risk management approaches in financial statements. More accessible information about the management of risks arising from financial instruments can benefit users, but must produce results that are consistent with the conceptual framework. This is a challenging project which could continue to involve significant resource at the IASB, so should be focussed on what is likely to result in a successful standard. In addition, new approaches are always costly and complex to implement and the costs of change come at a time when many entities, especially banks, the main users of this standard, are facing cost and investment pressures across the board.

2. In summary, we do not support the IASB trying to develop a standard based on the Portfolio Revaluation Approach ('PRA') as a full replacement to the existing hedge accounting model. Feedback received from this consultation process should nevertheless draw out very helpful responses to assist the IASB in framing further work in this area. This may be to pursue some of the ideas in the DP in conjunction with hedge accounting or to determine whether and how existing hedge accounting requirements can be enhanced to better reflect common risk management approaches. In this context, there may be improvements to the existing restrictions in hedge accounting which can cause difficulties regardless of whether the risk management strategy is particularly dynamic.

A full scope portfolio revaluation approach (PRA) is unlikely to result in an operational accounting standard

3. A "full scope portfolio revaluation approach" applied to all portfolios for which a specific risk is identified and analysed (regardless of whether it was mitigated through the use of derivatives), is in our view not worth exploring further. An approach reflecting all the different perceptions of risk managers would lead to such divergence from the Conceptual Framework that it would be unlikely to meet the objectives of financial reporting. There is an acute risk that significant inconsistency would also be introduced due to the diversity of risk management practices, which would lead to difficulties in defining what activities would be sufficient or necessary to bring a portfolio in scope.

4. A PRA will not always best reflect risk management activity so should not be the only approach available. If it were to be introduced, it would need to fit with existing hedge accounting and would therefore need to be carefully defined. This definition would become even more critical if the PRA were to be made mandatory, but we do not think this could be made operational. There is a danger that entities not otherwise involved in hedging activity may be brought into scope of a mandatory requirement merely as a result of its identification and analysis of interest rate risk.

5. A full scope PRA is also at odds with the mixed measurement model which has just received support within IFRS 9. Since most banks identify and analyse interest rate risk for the majority of their on-balance sheet banking assets and liabilities but may not mitigate the risk through hedging, a full scope PRA would result in the majority of a bank's balance sheet being essentially measured at fair value with respect to interest rate risk. Yet IFRS 9 confirmed the view that a mixed measurement model was appropriate, as certain financial instruments are most usefully measured at amortised cost.

6. Existing hedging practice is well established, but accounting rules are not perfect and could be enhanced. The benefits to users of a full scope PRA, in terms of meeting the objectives of financial reporting, are uncertain given the diversity that would result from a its application and the uncertain information content of the fair value component recognised on balance sheet.

A narrow scope portfolio revaluation approach could be considered

7. While it may be possible to develop a standard based on risk mitigation, i.e., a "narrow scope PRA", the challenges should not be underestimated. A curtailed scope will reduce the potential conflicts with the Conceptual Framework and perhaps such remaining conflicts could be an acceptable trade off, since the increased scope of permissible hedged items would result in better alignment with risk management. It would also reduce the need to measure and record the fair value in respect of interest rate risk that is not being mitigated by derivatives. This may help such an approach to gain acceptance.

8. There would still be a need for cash flow and (individual) fair value hedge accounting in some situations. This would create complexity in defining the narrow scope PRA and differentiating it from hedge accounting, both for the purpose of applying the standards and for explaining the resulting presentation and disclosures. In addition, the narrow scope PRA will have many of the same issues as current hedge accounting with regard to determining the portfolio or portion of a portfolio that is subject to the PRA, including tracking the movements in these portfolios as they change dynamically. At this stage is it not clear whether the solutions to these tracking issues would necessarily be different to existing hedge accounting practices or result in simplification. As such it is difficult to differentiate a narrow scope PRA from modifications to existing fair value hedge accounting.

9. In the interest of developing a standard that will improve certain aspects of hedge accounting with the minimum cost and disruption, we believe the IASB should consider whether making a few enhancements to IFRS 9 hedge accounting would meet the objectives of improving the reflection of risk management practices in financial reporting. If the scope of hedged items were expanded to address behaviouralisation practices, to include core deposits and instruments with sub-benchmark interest rates, and to permit bottom layer approaches, existing hedge accounting would be able to better reflect risk management practices in these important areas.

Whichever option is taken, further enhancements to disclosure should be considered

10. The key challenges discussed must be addressed in order to secure real improvement for users. Once the changes to IFRS 7 introduced by IFRS 9 have been implemented, the overall risk, risk management and hedge accounting disclosures should be reviewed and, where appropriate, amended to improve users' understanding. Enhanced qualitative and quantitative disclosure about risks and how they are managed (whether or not hedge accounting is achieved) is the best way to increase the value of reporting to users.

11. A 'through the eyes of management' approach to such disclosures, reflecting how management measure and report risk, which may not be on a fair value basis[1], may facilitate more effective dialogue in this area. Users want to understand how effective entities are at articulating risks arising, what they seek to mitigate and how successful they are in that mitigation.

RESPONSES TO SPECIFIC QUESTIONS

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?

12. We believe that there will be a benefit to investors from greater understanding of how entities manage risk. However we are not convinced that developing an entirely new form of accounting with as wide a reach as the full scope PRA will be the most efficient and effective way of presenting the information which will enable investors to gain this understanding. As

[1] Information about how derivatives change the net interest income profile and how tail risks are addressed are examples of potentially useful disclosure that is not based on fair value.

noted in our major points above, the ability for entities to articulate more clearly their approach to risk management within existing frameworks, rather the creation of a new model, may be more appropriate and cost effective.

13. Entities can currently choose whether fair value or cash flow hedge accounting best fits their available hedged items and hedging instruments. Where the entity's risk management is seeking to achieve a net stable margin, the form of hedge accounting that is used (cash flow or fair value) is fairly arbitrary and either can be said to reflect risk management within the context of accounting requirements, with hedge accounting bridging the economic mismatch between fixed rate assets and variable rate funding. This is even the case where there is no obvious link between any particular designated hedged item and the designated hedging instrument. IFRS 9 BC6.98–100 sets out further examples where the financial statements cannot present an exact copy of the actual risk management activities and explains why hedge accounting is perfectly acceptable in these circumstances. We agree with this analysis and therefore we do not think there should be concern about reducing or eliminating so called "proxy hedging". However, following the application of IFRS 9, a review should be undertaken to see if disclosures in this area need further improving to better link risk management to the accounting. There may also be further improvements that can be made to better communicate how risk is managed and mitigated whether through use of derivatives or other means.

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?

14. The discussion paper identifies issues which create a disconnect between how risk is considered and managed and accounting requirements. There are a variety of risk management practices and each entity addresses its risks differently. As a result, even if a form of PRA were developed that addressed all the issues, we would be concerned about the resulting inconsistencies with the Conceptual Framework and the divergence in practice that would be reflected in financial statements. However there are still ways in which reporting can be enhanced to better portray risk management. Please refer to our answer to question fifteen in this regard.

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?

15. We largely agree with the description of dynamic risk management and consider it to be articulated at a sufficiently high level as to be widely applicable. However, we do not believe dynamic risk management has been defined in a way that can be used to develop the scope of an accounting standard, particularly if such a standard were to be mandatory, where it would be critical to differentiate dynamic risk management from other forms of risk mitigation. Indeed, it would be challenging to make such a definition operational.

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).

16. A full scope PRA would have to include elements which may be inconsistent with the Conceptual Framework if it were to align with the risk management approach. The information content of the resulting fair value adjustment is uncertain. Including pipeline transactions where the entity manages their risk also could be a source of inconsistency in balance sheet measurement as a result of the differences in entity's risk management approaches and we question whether such differences would be in keeping with the objectives of financial reporting.

17. Hedge accounting can often not be achieved for many items that could be considered to be pipeline transactions. A less broad definition which set out what types of pipeline transactions could be included in a PRA or hedge accounting approach (perhaps those which constituted an offer for which the entity's exposure to interest rate risk could not be withdrawn in normal circumstances) might go some way to better aligning risk management and accounting without contradicting the Conceptual Framework. This could build on the notion in IFRS 9 that permits expected losses to be recognised in respect of certain revolving facilities for a period longer than contractual notice period in circumstances when the exercise of contractual rights does not necessarily limit an entity's exposure to credit losses.

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.

18. Changing regulation means that banks have an increasing amount of equity which must be deployed in their business. Therefore it could become increasingly important for banks to be able to reflect the risk management activities resulting from the need to invest equity funding in assets. While we understand that remeasuring equity is not in accordance with the Conceptual Framework, this can be seen as a consequence of the PRA. Where cash flow hedge accounting is used, the risk manager is seeking to earn a stable return and the accounting is based on the cash flows expected from the investment of the assets. Therefore some relaxation of the "highly probable" criteria in current hedge accounting could be another way of improving the alignment of risk management and accounting without involving the remeasurement of equity. We also note that the fair value related to interest rate risk is essentially a component of equity under the PRA, which is not dissimilar to the result arising from cash flow hedge accounting. Therefore, we believe it should be possible to accept including equity (or the investment of equity) in a PRA or hedge accounting and consider it to be sufficiently consistent with the Conceptual Framework. However, a similar result may be achieved, without the need to revalue equity, if the economic risk of net interest income is subject to a cash flow hedge. The transparency of risk management would be improved if accounting could recognise the linkage between derivatives and the risks in the instruments subject to mitigation.

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.

19. Allowing consideration of cash flows on a behaviouralised basis would lead to better alignment of risk management activities (which is often considers the cash flows arising from assets and

liabilities on a behavioural basis) and accounting. There is some precedent for considering the behaviour of financial assets in other in other aspects of financial instrument accounting such as impairment and the recognition of effective interest in accordance with IFRS 9. Here the expected life of financial instruments is used in the calculations where this is shorter than the contractual life. While the behavioural life of a demand deposit is longer than the contractual life, the behavioural assumptions are supported by experience and would reflect how the risk is actually managed. The unit of account would have a role to play and the nature of portfolios defined clearly by the entity. The consequences of expected behaviours not being borne out in practice will need to be addressed as set out in question 7 below.

20. We acknowledge that considering cash flows on a behaviouralised basis introduces subjectivity into the accounting and different entities will make different assumptions, resulting in some divergence. Disclosing the assumptions used in decision making on a behaviouralised basis would provide useful information and allow stakeholders to compare those assumptions across entities and with their own assumptions. IASB guidance on suitable disclosures would facilitate consistency in this are as banks and other entities may have significantly different models and assumptions.

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.

21. While risk management instruments with optionality may be used to manage prepayment risk in some situations, this is not as common practice as creating a bottom layer that isolates the risk in another part of the portfolio. In the first instance, we believe the IASB should consider how the more common risk management should be reflected in financial reporting and only then address optionality in hedging instruments. Nevertheless, the IFRS 9 treatment for the time value of options may provide a helpful precedent.

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?

22. We do not believe the effect of changes in past assumptions about customer behaviour should necessarily be recognised in profit or loss when they occur. Where the effect of such changes will reverse over time, recognition in this fashion would portray increased volatility which is not consistent with the economic situation. However, there are other changes in customer behaviour which will not reverse over time and which should be recognised immediately in profit or loss. Further consideration should be given to the broad range of changes in customer behaviour and whether their fair value impact should be spread or recognised immediately.

23. Please refer to Appendix 1 on the bottom layer approach for more consideration of how such an approach might operate in practice.

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.

24. We believe a bottom layer approach should be an option to facilitate practical implementation of a portfolio based approach. It would allow entities to reflect the decisions and judgements that risk managers take when considering the behaviour of their assets and the way that they subdivide portfolios in order to isolate and manage risk effectively. We acknowledge that there will be some ineffectiveness when applying this approach, particularly where unexpected behaviours result in a breach of the bottom layer, but consider it would be more beneficial overall. Indeed, consideration should be given to whether permitting such an approach in hedge accounting would be beneficial to its alignment with risk management.

25. Please refer to appendix 1 for further consideration of this and an example.

Question 8—Risk limits

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

26. Risk limits are important, and must be clearly understood by those within the entity responsible for risk management and there may be value in users of financial statements having more insight into how they are used and applied, albeit without disclosing potentially commercially sensitive information. However, we do not support a full scope PRA and risk limits are not relevant to a narrow scope PRA or to hedge accounting, which only depicts the effect on the financial statement of the risks that has actually been mitigated through the use of derivatives..

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?

27. We think that core demand deposits should be included in a PRA or enhanced hedge accounting on a behaviouralised basis and that the bench mark component of interest rate risk should be included whether or not the instrument pays a sub-benchmark rate (see question 10). Including demand deposits, and those at sub-benchmark rates, would be a significant improvement to better align accounting to risk management.

28. We do not think guidance regarding how to behaviouralise portfolios would be necessary, but we note that different institutions will make a variety of different assumptions when behaviouralising for risk management, and therefore specific disclosure may be necessary in order for users to be able to understand these assumptions and draw a conclusion as to their reasonableness. Guidance regarding this disclosure (not the activity the disclosure seeks to describe) may help facilitate a common denominator which would assist user understanding.

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?

29. If core demand deposits are to be included in a PRA, then to be effective, sub-benchmark instruments must also be included, where this is consistent with the entity's risk management approach. The existing requirements for sub-benchmark rate instruments should be reconsidered. Even where the margin becomes negative, the component of the benchmark rate remains, representing interest rate risk that is being managed.

30. Of the alternatives presented, we believe that alternative 3 best reflects the risk management approach where it generally addresses only the benchmark rate. However further consideration can be given to the mechanics of the double entry when there is a better understanding of how sub-benchmark instruments would be included in a PRA or in hedge accounting.

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?

31. No. As set out in the major points section and in question 15 we do not think that a full scope PRA would provide a faithful representation of dynamic risk management and would meet the objectives of financial reporting in terms of the Conceptual Framework. Revaluing all positions that are identified and analysed for interest rate risk but that are not mitigated through hedging would result in amounts recognised in the balance sheet that do not satisfy the definitions of assets or liabilities and would result in the recognition of a component of fair value for many items for which amortised cost is considered the more appropriate measurement. Even a narrow scope PRA may not faithfully represent risk management when cash flow hedge accounting would be a better representation, for example when managing variable interest rate risk.

32. Since we do not support a full scope PRA, we do not think that it is necessary at this stage to definitively address the discount rate to be used in the fair value measurement and this view is reflected in our responses to questions 12-15. However we note that any approach that seeks to measure by means of using the transfer price could change risk management in banks. There are various practices for determining transfer prices and permitting this price to be used would result in diversity in practice in the accounting or changes to transfer prices as entities include only what is permitted in accounting terms. We note that there is a current debate around funding fair value adjustments and basing the discount rate on the funding rate could exacerbate this issue. In addition, entities can only reduce risk using rates that are available in the market which is a natural limitation to the rates that could sensibly be considered as part of a PRA.

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?

33. See our comments in question 11.

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?

34. See our comments in question 11.

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?

35. See our comments in question 11.

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?

36. As noted above, we do not believe a full scope PRA is worth exploring further. An approach that truly reflected all the different perceptions of risk managers in financial reporting would introduce such divergence from the Conceptual Framework that it seems unlikely to meet the objectives of financial reporting. In addition there is such diversity in risk management

practices that the inconsistencies introduced in financial reporting would be of significant concern.

37. Since most banks identify and analyse interest rate risk for the majority of their on-balance sheet banking assets and liabilities but may not mitigate the risk through hedging, a full scope PRA would result in the majority of a bank’s balance sheet being essentially measured at fair value with respect to interest rate risk. IFRS 9 confirmed the view that a mixed measurement model was appropriate with certain financial instruments, mainly those where banks identify and analyse interest rate risk but do not necessarily mitigate it through hedging, being most usefully measured at amortised cost. Therefore a full scope PRA would seem at odds with the mixed measurement model and also seems unlikely to receive support given that IFRS 9 has just been issued.

38. While it may be possible to develop a standard based a narrow scope PRA, the challenges should not be underestimated: A curtailed scope will reduce the potential conflicts with the Conceptual Framework and perhaps such conflicts could be an acceptable trade off, since the increased scope of permissible hedged items would result in better alignment with risk management.. It will also reduce the need to measure and record the fair value in respect of interest rate risk that is not being mitigated by derivatives. This may help such an approach to gain acceptance. However there would still be a need for cash flow and (individual) fair value hedge accounting in some situations resulting in complexity in defining the narrow scope PRA and differentiating it from hedge accounting, both for the purpose of applying the standards and for explaining the resulting presentation and disclosures. In addition, the narrow scope PRA will have many of the same issues as current hedge accounting with regard to determining the portfolio or portion of a portfolio that is subject to the PRA, including tracking the movements in these portfolios as they change dynamically. At this stage is it not clear whether the solutions to these tracking issues would necessarily be different to existing hedge accounting practices or result in simplification. Costs and benefits would also require careful consideration.

39. In the interests of developing a standard that will improve certain aspects of hedge accounting with the minimum cost and disruption, we believe the IASB should also consider whether making enhancements to IFRS 9 hedge accounting would meet the objectives of improving the reflection of risk management practices in financial reporting. If the scope of hedged items were expanded to address behaviouralisation practices, to include core deposits and instruments with sub-benchmark interest rates, and to permit bottom layer approaches, existing hedge accounting would be able to better reflect risk management practices in these important areas. If the IASB is unable to address these issues, even the context of a form of PRA, then it seems doubtful that a new method will result in significant improvement over existing practices. If so, the costs to preparers and benefits to users of implementation must be carefully considered. If this is the case, the IASB and the constituency may have to accept that existing IAS 39 will remain as an accounting policy choice for the longer term

40. While existing hedge accounting could be enhanced, these practices are well established. A completely new approach will be costly to design and implement. We have serious concerns about whether a full scope PRA would provide relevant and understandable information to users as noted in paragraph 5.2.7. It is also unclear how a narrow scope PRA would be different to fair value hedge accounting in terms of operational complexity.. Cost and benefit considerations are particularly important in determining the merit of new proposals. Such costs come at a time when many entities, especially banks, the main users of this standard, are facing cost and investment pressures across the board.

41. We are not aware of any pressing need for a PRA to be applicable to foreign exchange risk or other risks. Indeed we were unable to get input from entities outside the financial services and believe this is because their hedge accounting issues are expected to be addressed by IFRS 9.

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?

42. We do not believe the application of the PRA should be mandatory. As set out in question 15, we are not convinced that a full scope PRA would meet the objectives of financial reporting in terms of the Conceptual Framework. Even a narrow scope PRA would result in some tension with the Conceptual Framework and tracking effort that may not be that different from existing practice. From a standard setting view point, the PRA could only be made mandatory if it can be properly defined and differentiated from other forms of risk management resulting in hedge accounting, since we believe the PRA would have to co-exist with hedge accounting rather than fully replace it. Given the wide variety of risk management practices and the difficulties in defining what activities would be sufficient or necessary to bring a portfolio in scope, we do not think it would be possible to develop an operational standard based on a full scope PRA, particularly if it were a mandatory requirement. There could even be the danger of inadvertently bringing into the scope of a mandatory requirement an entity not otherwise involved in hedge activity merely as a result of its identification and analysis of interest rate risk. Even a narrow scope PRA, where application could be limited based on the existence of derivatives, would still be difficult to differentiate effectively from existing hedge accounting practices.

43. As a result, we could only support pursing a narrow scope PRA as an option that co-existed with existing forms of hedge accounting.

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.

44. Since we do not believe it will be possible to define the scope of application of the PRA in manner that could create an operational accounting standard, we have no suggestions at this stage. A narrow scope PRA would be difficult if not impossible to differentiate from fair value hedge accounting and, if an entity is able to apply either on an optional basis, there may be no need to further define its scope.

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.

45. In the statement of financial position a single net line presentation is preferable to the gross up which may appear to be artificially constructed. A meaningful disaggregation of the net fair value is unlikely to be possible, which further casts doubt on the consistency of the PRA with the Conceptual Framework.

46. In the statement of comprehensive income we believe actual net interest income should be presented in profit or loss consistent with IFRS 9. Presenting income separately from the effect of risk management may be more helpful to users than a stable net interest income.

47. With regard to other presentation possibilities, we are not aware of any which would garner sufficient support to warrant further development at this stage of the discussion paper analysis.

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?

48. We are not wholly convinced about the proposals regarding internal derivatives which will result in the gross up of profit or loss. Depending on how internal transactions are priced and organised (i.e. whether transfer pricing represents an internal derivative in all cases), this may or may not result in sensible accounting. We do not think it is necessary to address internal derivatives to deal with the most pressing areas where hedge accounting could be enhanced. Therefore we suggest that the IASB need not spend resources on this issue.

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.

49. We believe that the themes are potentially helpful, but feel that disclosure should holistically focus on risks arising and their management, for example considering sensitivities, expectations and whether management have been successful in meeting their expectations with regard to mitigation. Specific recognition of interest rate risk may also be helpful. Since management often does not consider risk in fair value terms, more 'through the eyes of management disclosures' such as sensitivity analysis may be more helpful to users than fair values recognised on balance sheet. Understanding the accounting impact of risk management activity may be somewhat secondary to presenting information about the risks themselves and the activities and practices management undertake to mitigate and manage them. Hedge accounting or a PRA focussed on risk mitigation both can only address the accounting mismatches arising from the use of derivatives. This is not the entirety of risk management activities.

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?

50. We believe disclosure should take a holistic approach and should consider risk management as a whole, both policies and practices. There will be particular forms of accounting which arise from risk management practice which will require further disclosure, but users may benefit more from disclosure which allows them to understand more broadly the risks arising and the approach the entity is taking to managing them, rather than how an accounting principle has been applied.

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.

51. Based on the scope of our response, we do not consider this to be a relevant question.

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.

52. Based on the scope of our response, we do not consider this to be a relevant question.

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.

53. We do not think that foreign exchange risk is often managed together with interest rate risk but that separate designations and methods are used. Therefore there is unlikely to be a demand to include foreign exchange risk in the PRA as other options are available, for example net investment hedges and cash flow hedging. In any case, any PRA approach should address interest rate risk as the first priority.

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.

54. In developing this response, we found it challenging to gain engagement from entities outside the financial services and believe this is because their hedge accounting issues are expected to be addressed by IFRS 9. They may be uninterested in PRA concepts as they do not often use fair value hedge accounting. In addition, we believe corporate entities and their stakeholders are satisfied with the use of non GAAP measures to describe their risk management activities where relevant.

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?

55. We do not consider that there would be an advantage to using OCI rather than P&L as it would introduce additional complexity as well as creating volatility in equity which would be equally difficult to explain.

APPENDIX ONE: A BOTTOM LAYER APPROACH

Background

Risk managers do not consider individual financial assets or liabilities for risk management purposes, instead focusing on the (net) risk profile of the financial assets and liabilities, and strategies to hedge the risk profile to maintain adherence to risk limits.

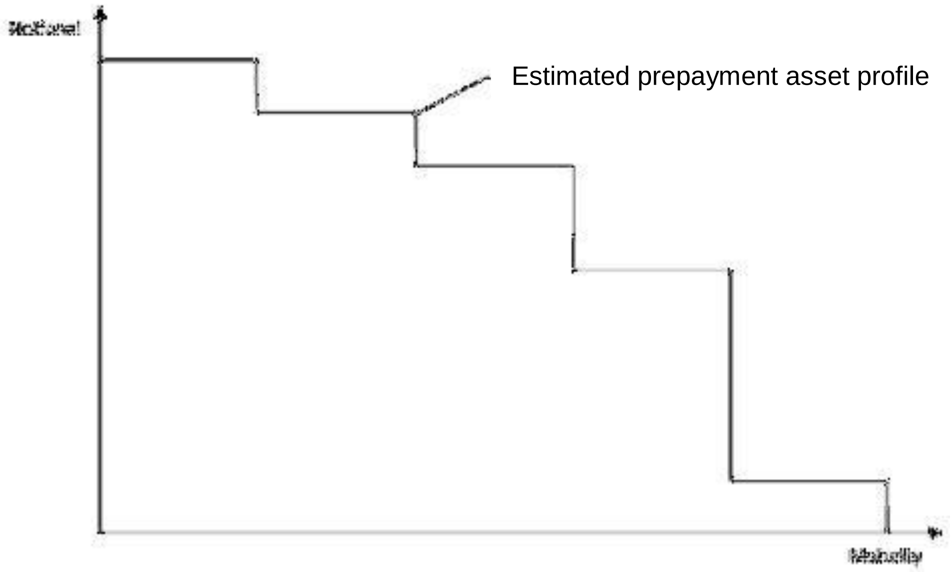
This means that once the source assets and liabilities are transformed into ‘risk strips’ (or other risk measures), the risk manager would not further consider the specific source of the risk.

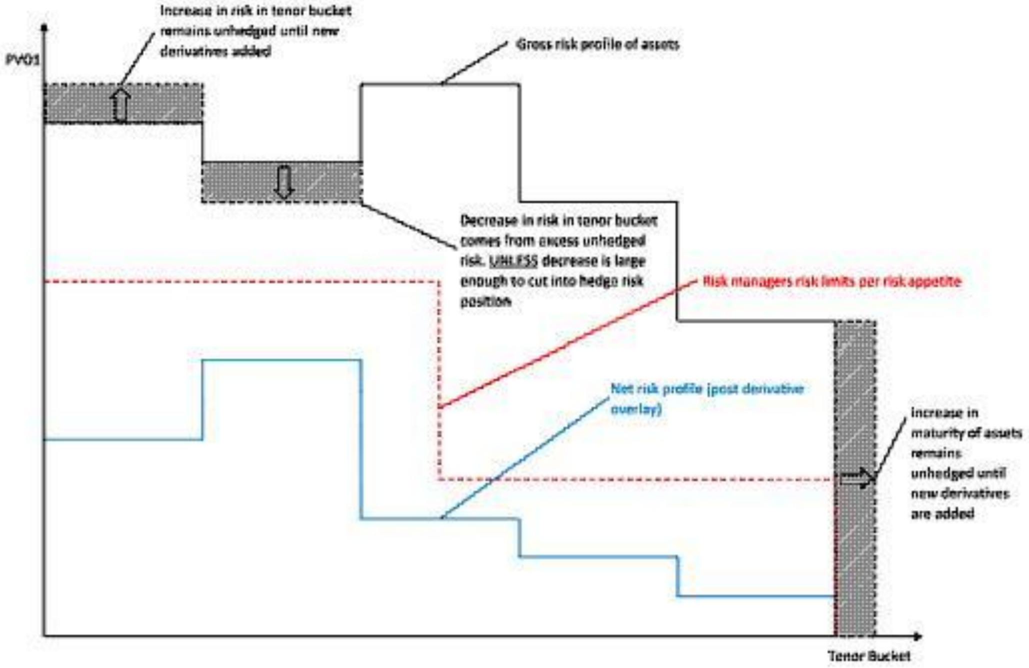
Therefore, applying valuation adjustments to particular assets or liabilities from an accounting perspective is difficult to reconcile with risk management practices.

Application to pre-payable portfolios and the bottom layer

A risk manager is tasked with managing the risk profile (‘risk strip’) to comply with his preset risk limits.

In the context of a prepayable portfolio, risk managers (and the business unit) would behaviouralise the portfolio, which converts the prepayable portfolio from its contractual profile into a series of forecast maturities. This prepayable profile is then transformed into the risk strip, and hedged accordingly. This is illustrated on the diagram below:





For a risk manager, the hedging of the risk is unaffected by:

- The prepayable portfolio shortening or extending in maturity, or
- The prepayable portfolio prepaying to amount less than the behavioralised profile,

Put another way, the risk manager is satisfied that he has hedged the relevant risk when he has reduced the risk to within his risk limit. Providing that there is more asset risk than derivative risk, the risk manager may consider that no action is required. As and when the gross asset risk increases (due to new assets, changes in prepayment assumption etc), new derivatives are added as required when the net risk position increases beyond the agreed risk limit.

Recognising an amount in profit or loss at the point a new derivative is added does not reflect the way the risk is managed, given that the risk gap created by changes to the prepayable profile has been closed with new swaps. In effect, if the prepayable portfolio (for example) extends in maturity by a significant amount the risk manager reacts by hedging the incremental risk with the new swaps.

The exception to this is when the gross asset profile changes such that there is more derivative risk than asset risk, i.e. the bottom layer is affected resulting in the net risk profile (i.e. asset and derivative risk taken together) becoming negative. Some risk managers are granted limits that can tolerate this. This is not dealt with here, but is inherent in the fact that risk managers are neutral as to the source of risk – they just maintain it within limits. Extant accounting and hedging principles suggest that a net open risk position that is attributable to derivatives should be recorded at fair value. Given that as a constraint, changes in profile that cause the bottom layer to be impacted should generate ineffectiveness as there will be a larger fair value change in the derivative position than in the asset position.

Therefore, to apply a bottom layer that does not generate ineffectiveness from prepayment/changes in profile, it should be proved that the risk has been closed in the relevant time bucket, to within the risk limit, but not more than the risks that exists.

Example:

PV01s	1m	3m	6m	12m	2yr	3yr	5yr+
Portfolio	80	90	100	110	120	130	150
Swap	60	75	90	100	115	120	140
Under hedged	20	15	10	10	5	10	10
Risk limit	30	30	30	30	30	30	30
	OK	OK	OK	OK	OK	OK	OK

In this scenario, there would be under-hedges and the open risks are within the risk limits, which demonstrates that the bottom layer has been hedged appropriately. In such a case, in effect, the hedged item would mirror the swaps, however in reality it is the hedged bottom layer that in this scenario behaves just like the swap.

However, when the risk is over-hedged, the bottom layer approach should not work. For example:

PV01s	1m	3m	6m	12m	2yr	3yr	5yr+
Portfolio	80	90	100	110	120	130	150
Swap	60	75	110	100	115	120	140
Under hedged	20	15	(10)	10	5	10	10
Risk limit	30	30	30	30	30	30	30
	OK	OK	Overhedged	OK	OK	OK	OK

The issue now is that the risk manager has a PV01 risk component of ineffectiveness, however it would be difficult to track it to specific assets, and calculation of the amount of ineffectiveness arising from such an incident would be difficult. The overhedge measure has to be “reversed” from a risk measure to a fair value measure. However, it is possible to construct a hypothetical instrument that has a matching PV01 to the overhedge, to obtain the fair value change that the overhedge represents.

The fair value change of the over hedge calculated above would be recognised as the change in fair value of the prepayable portfolio (or as a single line item).

Further application issues

As with any model that relies on a risk measure such as PV01, it is divorced from the actual assets. Therefore dealing with the accounting entries for specific assets may be complicated. For example, dealing with adding assets to the model with initial fair values different to carrying amounts or dealing with the withdrawal of assets from the hedge accounting model (e.g. through impairment or sale) creates difficulties with how much hedge adjustment should be taken with them. Such issues should be capable of being dealt with using a systematic and rational approach, coupled with a variant of the hypothetical instrument described above.

Note – it is not possible to address this issue without considering the effect of risk limits and the manner in which they are incorporated into a future standard. For example, if the gross asset position in a given bucket increases due to a decrease in prepayment rates, then the overall proportion of risk being hedged is clearly reduced. This means that the risk managers risk position, while still being below the risk limit, is closer to the risk limit than previously. The question from an accounting perspective is whether this should result in any P&L effect compared to an entity where such a change in prepayment rates does not happen. Both are still meeting their risk management objectives in full.