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Dear Members of the IASB

Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

The Corporate Reporting Users' Forum welcomes the opportunity to comment on the discussion paper*: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* ("the DP"). Our response is set out below.

Introduction

The CRUF has long been concerned about the way that risk management activities of both financial and non-financial entities are measured and reported. An accounting model which increases the volatility of an 'entity's reported profit and loss when it uses instruments that reduce the volatility of economic outcomes (because strict hedging criteria are not met) is a model that needs to change. The CRUF welcomes the DP as a step in the direction of better aligning accounting results with economic reality.

The DP is substantial and detailed. It is a work in progress that has general application to both financial and non-financial reporting entities. However, the DP and its detailed questions are substantially focussed on the implications of the proposals, and of the issues they raise, for banks. Therefore this response will also reflect a work in progress, as the CRUF community has considered the DP from both general and financial sector specialist perspectives, with some having had the opportunity to consider the DP in depth and others having considered only an overview.

Having invited the CRUF globally to consider responses to the DP, we have therefore presented below views and detailed answers from Japan and reflected discussions in South Africa, Canada and the UK.

General Comments

CRUF Japan

The Corporate Reporting Users' Forum Japan highly appreciates the IASB's efforts to develop a new approach, a Portfolio Revaluation Approach (PRA), to depict the reporting entities' dynamic risk management activities. We believe it is a worthwhile endeavour for IASB at this research phase to explore the alternative accounting approach to describe risk management in addition to the traditional approach of hedge accounting.

We have found the PRA is still at a very early stage of development and has some practical and theoretical shortcomings to be overcome. We are not optimistic that these problems have solutions. We therefore encourage the IASB not to give up developing a simpler approach to macro hedging that would focus on the hedging activities associated with an open portfolio.

That said, we believe the PRA makes a lot of sense and is based on theoretically sound principles. We encourage the IASB to explore its pros and cons further as one of the most promising alternatives.

Comments of CRUF Japan participants are summarised under Questions 1, 2, 4, 5, 9, 15, 18 and 26.

CRUF UK

CRUF UK also welcomes the IASB initiative. We would agree with our colleagues in Japan that not all the problems raised are likely to be capable of solution and a developed approach to dynamic risk management should be kept as simple as it may be. The large volume and often tortured logic of the Implementation guidance of IAS 39 running to 300 pages, like the similarly voluminous guidance for FAS 133, are experiences that should ideally not be repeated.

Because much of the risk management and hedging activity conducted by entities has always been essentially dynamic in nature, the DP's approach has the benefit of much better alignment with what businesses actually do when they are trying to reduce risk. Better alignment would mean less difficulty in application.

Key general comments from the CRUF's internal discussions and discussions with the IASB staff include:

U1. The examples provided by the IASB were not enough to illustrate clearly the impact of the changes. We need to be provided with some real life illustrations to show what a set of accounts might look like before and after the proposed changes – or something much closer to reality.

(What is in mind is not a formal impact study, but a set of reality based illustrations). This will help us assess what we are potentially missing by using the current accounting standards. Particularly useful illustrations would include a retail bank (without a significant wholesale or rate trading activity) and a non-financial corporate where their borrowing strategy involves hedging practices that fall outside the current IFRS criteria for recognition.

U2. The information needs to be auditable, with a preference for separate presentation on the face of the P&L.

U3. International differences in behavioural assumptions that reflect different behaviour should be accommodated. The subjective judgements involved in doing so need to be explained, with disclosure of assumptions used.

U4. Banks' concerns about commercial sensitivity of some of the relevant information are noted, though some UK CRUF participants believe they are much overplayed and the competitors already have a good understanding of each other's situations.

U5. The relevant information for disclosure should be easy to obtain since the banks will currently use it for risk management purposes. Such information would, for example, prove useful where current disclosure of contractual maturities is not.

U6. On disclosures generally, the IASB is referred to the EDTF report and in particular the disclosures on liquidity.

U7. Disclosures should also address the current effect of IFRS that accounts for the instruments used, rather than also disclosing and distinguishing the different purposes for which those instruments are used. How much better it would be, for example, if we could distinguish derivatives used to modify the effective currency or rate of borrowing alongside the measure of the bonds or loans that they have in effect modified from derivatives entered into for another purpose such as hedging broader economic risk.

U8. Some participants were concerned to avoid a further move towards "fair valuing" the balance sheet, particularly in relation to liabilities.

Individual comments also included:

U9. Full gross and net exposure. The gross exposure and fair value movements of hedges should always be made visible in the P&L and balance sheet. I want to understand the gross exposure and I want to separately understand how it is hedged, as opposed to just seeing a net figure. There are several reasons for this. Hedges can be imperfect, and I want to judge for myself the risk of a failed hedge. Any hedge introduces counterparty risk (non-negligible when you think that interest rate derivatives global gross volume stands at more than $500 trn). And when you're hedging future or notional exposures, there is the risk that your cash-settled hedging instrument moves against you and is settled before these exposures result in any meaningful cash flows, implying illiquidity risk.

U10. Clear differentiation between current actual, future anticipated and notional exposures. This is an extension of the illiquidity argument. Also, I may not agree with management's assessment of future and notional exposures and want to be able to recalculate the hedge ratio based on my own assumptions.

U11. Asset values on the balance sheet should have some sort of intrinsic meaning. An asset value should have the same meaning in different entities' P&Ls, i.e. should be independent of the manner in which the asset is hedged. So I think we should decide for any type of asset (and hedges are also assets for purposes of the balance sheet) whether it should be carried at amortised cost or fair value. To the extent that any exposure arising from the asset was hedged and there is the need to specifically segregate out the fair value changes of the dynamically risk managed portfolio (either the whole portfolio or the hedged part, as discussed under U10), there should be a separate line in the balance sheet, where something like "fair value change from PRA accounting" is shown as an asset or liability (again with some disclosure around the gross exposures/hedges).

CRUF Canada

CRUF Canada participants discussed the proposals in the DP at their meeting on 18 September 2014.

Participants noted:

C1. Net Interest Income (NII) is a very important source of profits of banks. Users have significant interest in the drivers of a bank's NII, and the corresponding risks (ie customer margin for specific products vs. taking open risk positions vs. 'traded' positions (including sources of funding) at Treasury.

C2. General support for PRA in the DP. However, please note that through the discussions, it was implicitly assumed that the scope of the application of PRA is at least broad enough to capture the entire picture of NII. Some participants feel that the PRA would have to be broader to include all risks identified in the assets/liability portfolios on the basis that these risks are not managed in isolation.

C3. Decomposed information of NII into 1) customer margin, 2) the change in the mixture and volume of portfolio and 3)positioning at Treasury is critical (that is, the impact of unmatching of non-trading assets and liabilities on non-interest revenue). It was noted that the third variable alone could overpower the first two, distorting the view of the change in margin.

C4. For instance, if the NII has changed from 1,000 million in the last year to 950 million this year, we want to know the decomposition to show us how it took place. It was noted that it would not be expected that all margins on products would be disclosed; however, it would be helpful if the impact of unmatching was disclosed, not using a change in fair value approach.

C5. Accounting geography in the presentation of NII is important. Participants voiced concern about the presentation on the hedged item in one line and hedging item in another, and the inherent volatility in each affected line item. How net interest revenue is generated is important for users. Any accounting changes should not make it more difficult to carve out trading net interest revenue from other interest revenue so that it can be combined with trading fee revenue.

C6. Even if the PRA shows the expected (discounted) value for the future NII based on the best available information (ie balance sheet structure and yield curve at the end of the current period), too much volatility in the P&L makes analysis difficult.

C7. The participants discussed whether users' needs could be met by further disclosure rather than through re-measurement.

C8. Interest rate risk and other risks (eg credit risk) are inter-related. Hence, fair value measurement is better than revaluation with respect to identified portfolios.

C9. In order to make PRA results meaningful, the same discount rates (yield curve) should be used for assets and liabilities.

C10. Many participants were concerned that the effect of macro hedging would be a smoothing of income. At least one participant reminded the group that smoothing was one of the principle user concerns with the original financial instruments standard. The original approach had been to limit hedge accounting to reduce the opportunities to change the accounting for investments ex post facto. During the financial crisis, there was in fact significant pressure to change the rules to permit reclassification.

C11. Several CRUF participants encouraged the IASB staff to apply macro hedging to all companies that meet specific criteria and in any case for all instruments if macro hedging is an optional accounting treatment (although this might a difficult standard to write from a technical point of view given there will likely be many boundary issues).

C12. In connection with the discussion on presentation in the statement of comprehensive income, one participant questioned who would determine the 'stable margin' and how it would be audited. It was noted that this would be more closely controlled in a banking environment in terms of what is permissible, but that it is less clear what will occur in entities which are less subject to regulation.

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?

CRUF Japan

J1. Most of CRUF Japan participants support the development of a new accounting approach for dynamic risk management. While our view varies on the sectors to which the new model should be applied, most participants agree that it is needed to reflect the interest rate risk management by banking industry. Given that the current disclosure on an entity's hedging activities in the notes is very much limited and that the open portfolios are managed dynamically through macro hedging, we strongly support the Board's endeavours to develop an alternative accounting approach to depict such activities.

J2. The current hedge accounting model has such deficiencies as below:

- It requires the particular hedged items to be designated to the corresponding hedging instruments, which makes it difficult for the financial statements of an entity to represent faithfully the risk management activities associated with open portfolios.
- It lacks the accounting treatment to handle net exposures of hedged positions, which entities usually intend to manage through the dynamic risk management.

J3. We believe the proposal to develop an accounting approach for dynamic risk management is an attempt to address those issues and highly appreciate the Board's proposal. We think such an approach would be useful when we analyze not only financial institutions but also other industries such as commodity trading companies, which manage actively their risk exposure on their open portfolios.

J4. We believe the accounting model for dynamic risk management should also be applied to companies such as trading firms which have shadow banking functions, which are virtual financial intermediaries that are not subject to the banking regulations. The IASB may need to consider consistency between the proposals and the regulations such as the Basel regulatory capital framework for banks as well as those on shadow banking.

J5. On the contrary, some participants point out the accounting approach such for dynamic risk management is most useful when applied to financial institutions, and the Board should be prudent to expand the scope of the PRA to other businesses, taking into account the cost for those types of entities to implement it.

CRUF UK

U12. Yes. Because much, if not most, risk management in the real world is dynamic, approximate, adjusted and targeted on net positions rather than individual gross components.

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?

CRUF Japan

J6. Yes, we think this DP has correctly identified the main issues of the current hedging accounting. As we pointed out in the paragraph J2 on question 1 above, the current hedge accounting model requires a one to one hedging relationship between the hedged items and the hedging instruments. Such a requirement is difficult to apply to the open portfolios subject to dynamic risk management, where it is difficult to designate the particular hedged items to the corresponding hedging instruments.

J7. Another main issue of the current hedge accounting model is that it cannot be applied to the net exposures of open portfolios, which entities such as financial institutions that would manage risk dynamically. For example, the presentation of exposures to derivatives at fair value as stipulated in IAS 39 would result in volatility in the balance sheet despite the fact that the risk is managed on the net exposure basis. We believe the model proposed by the DP can offset the volatility.

CRUF UK

U13. Broadly. However, the extensive reference to banks throughout the paper should not distract the discussion from non- financial entities that are also affected by these issues.

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

CRUF Japan

J8. We appreciate the Board's effort to develop the PRA as an alternative model to faithfully represent the dynamic risk management practice of such entities as banks. We believe the PRA would address the issues which we mentioned in the paragraphs J6 and J7 in question 2 above. That said, we believe the Board should explore the scope for the application of the PRA rigorously and make it clear.

J9. The model would make it easier for users of the financial statements to understand the relationship between the source of profits and the associated risks. However, whether users could in fact understand the underlying risks more easily or not may depend on the richness of information provided through the presentation on the balance sheet and the disclosures in the notes.

CRUF UK

U14. The PRA has the potential to address or at least mitigate many of the issues arising from the IAS 39 model that remain after the recent IFRS 9 amendment to include hedge accounting. While the PRA may not address all the issues raised by the current hedge accounting model due to the inherent problems posed by a mixed measurement approach without flexibility in how derivatives are measured, it could represent significant progress and improvement.

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?

CRUF UK

U15. The description is *illustrative* of dynamic risk management in certain circumstances that would relate, in 2.1.2 (a) for example, mainly to a bank. However, the potential application of the PRA approach is much wider and therefore as a description of circumstances in which the PRA could be applied it is neither accurate nor complete and could not usefully serve as *definitive*.

U16. It would be better to describe the types of open risk position to which it is envisaged the PRA could be applied: that might be a matter of stated purpose and policy, where, for example in line with loan covenants, "interest rate risk on borrowings is hedged to a minimum level of X%" (i.e. not necessarily a fixed % nor for a fixed period).

U17. As a general point, the DP is understandably focussed on financial institutions where interest in this PRA approach might be greatest. But to the fullest extent possible, the principles on which the approach is based should be kept broad because of the much wider potential scope of useful application.

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.*

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.

CRUF Japan – re Questions 4, 5 and 6

J10. Most participants support the PRA to reflect the behaviouralisation as we believe it represents the underlying economic substance. That said, we are concerned it could be misleading when the forecast turns out to be wrong if the behaviouralisation is applied more broadly than it should be. Some participants believe that the Board should allow behaviouralisation to be applied only when entities forecast the outstanding amount of core demand deposit and prepayment expectations, which are overwhelmingly important among applications of behaviouralisation.

J11. We believe that the Board should be cautious to include pipeline transactions in the PRA. We are sceptical about whether such transactions would meet the definition of assets or liabilities. Some of us point out that the Board should consider carefully the conceptual implication of recognition of the cash flow hedge for such transactions as pipeline transactions, which may not satisfy the definition of either assets or liabilities.

J12. As mentioned in the paragraph J10, we generally support the idea that core demand deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA. Some participants, however, do not favour developing guidance on core demand deposits, because they do not believe such guidance is necessary. They are not convinced that the Board can develop the guidance which rigorously defines core demand deposits and provides the proper methodology to forecast its outstanding balance. They are concerned that noises could arise in profit or loss by errors in estimation if entities improperly determine the behaviouralised profile of core demand deposits based upon such incomplete guidance.

J13. The behaviouralised profile of core demand deposits should be different among banks, and we doubt if it is possible for the Board to develop some specific numerical threshold in the guidelines. The PRA may fail to represent the economic substance faithfully if this is the case. Instead of developing guidance, we would rather recommend that the Board develop disclosure requirements about the estimated average durations and average outstanding of core demand deposits used as the key inputs to the dynamic risk management and the actual outcomes of these parameters, which we believe would provide users with important information to assess the effectiveness of behaviouralisation.

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?

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.

Question 8—Risk limits

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

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?

CRUF Japan

[See paragraphs J10-J13 above]

CRUF UK – re Questions 4 to 9

U18. Questions 4 to 9 raise at least two kinds of issue: recognition issues which introduce significant judgement and measurement issues.

U19. The recognition issues relate to pipeline transactions and Equity Model Book. While management might perceive both as risks to be managed, neither involves currently recognised assets or liabilities.

- We would expect these issues to be dealt with by disclosure and do not think it appropriate to extend the boundaries of recognition to pipeline assets or liabilities that are, by definition, not yet assets or liabilities, or to broad objectives for return on equity (RoE) that do not reflect a liability.

U20. Behaviouralisation, prepayment, and core demand deposits all involve significant judgement about uncertain measures of, in this particular section of the DP, maturities in the context of interest rate risk.

- These matters are at the heart of loud discomfort historically expressed by some institutions about the volatility in earnings introduced by attempts to manage the actual interest rate risk of demand deposits.
- The interest rate risk is real and arises because one aspect of the contractual maturity – the earliest that the depositor may exercise – is not usually, or for material proportions of a deposit book, often not at all, the likely maturity.
- We believe it is very much worthwhile seeking to accommodate behavioural estimates (for example, realistically judged estimates of the likely maturity of a deposit book) within a PRA approach to avoid the results of applying a maturity measure that is certain and, in prospect, precisely wrong.

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?

CRUF Japan

J14. Our views are evenly split between those who favour (A) a scope focused on the dynamic risk management and those who favour (B) a scope focused on the risk mitigation. Participants who support (A) tend to be those who agree with the conceptually broader application of the PRA while the other tend to be those who believe the scope of the DP should be limited to the macro hedging, which is the original objective of this research project, rather than dynamic risk management.

(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?

CRUF Japan

J15. Most members who support view (A) generally advocate the full fair value measurement to be applied to the balance sheet of financial institutions such as banks and insurance companies. At the same time, they believe that relevance of the profit and loss could be maintained as well if the changes in fair value are recognized through the OCI. The followings are the major reasons why they support view (A):

- View (B) is conceptually very similar to the one-to-one designation of hedged items and hedging instruments, which is not consistent with the dynamic risk management practices of financial institutions.
- It appears to be very difficult for a reporting entity to distinguish the hedged potion of the open portfolios from those that are un-hedged.
- If an entity practices any one of the three elements of dynamic risk management, the PRA should reflect the un-hedged position as well as the hedged position, because the decision to be a certain exposure to be un-hedged, i.e. the decision to take risks itself should be regarded as the part of the risk management activity. In order to assess the effectiveness of dynamic risk management, these participants believe the PRA should be applied consistently with a scope focused on dynamic risk management.

J16. Meanwhile, the other participants argue as follows to support view (B);

- It appears that a scope focused on risk mitigation should provide users with more relevant information than the other. They agree that view (A) might provide users with important information to understand the dynamic risk management, but still believe that it is more useful to know the performance of the hedged position, and accordingly insist that a scope focused on risk mitigation provides users with more relevant information.
- As they do not believe a full fair value measurement is less relevant even for financial institutions, they prefer a scope focused on the risk mitigation in order to prevent the PRA from getting closer to the full fair value measurement.
- The scope focused on the dynamic risk management may reflect all fair value (or present value) changes due to changes in interest rates, which seems to be too significant for financial institutions to accept. NII and PL reported through this scope appear to be the numbers just for reporting’s sake.

J17. One participant is sceptical about the merits of the PRA. The following summarizes his view on the PRA:

- The PRA appears to be very similar to the accounting for the fair value hedge. The accounting for the fair value hedge includes a special treatment that allows an entity to recognize the changes in fair value of a hedged item in regard to the risks to be hedged, to offset the changes in fair value of derivatives. This exceptional treatment appears to be justified only to represent the hedging activities faithfully and should be acceptable only under special situations, i.e. the risk mitigation. The PRA appears to extend the application of this exceptional accounting treatment to the whole of the financial statements. As a result, the whole financial statements would be based on the undefined measurement, which is neither a cost basis nor a fair value basis. In addition, net income and net assets become more volatile by using the risk management activities under the PRA, which is counter-intuitive. There seems to be no justification for the risk to which the PRA should be applied to be limited to the interest rate risk. He believes that the PRA, if it reflects only a certain type of risks, such as interest rate risk, does not faithfully represent the entity's risk management activities.

CRUF UK

U21. Our colleagues from Japan have usefully set out some of the key issues in relation to this, one of the key questions in the DP. CRUF UK views include:

- **Alternative A** – recognises volatility in the open position with respect to a particular risk, whether or not it is managed. If the approach is only applied where there is actually some dynamic risk management taking place, it will introduce volatility in earnings from the "residual exposure side" which might well exceed that currently introduced by instruments intended to manage it. In either case, PRA under alternative A or current accounting, the volatility would be greater than that of an entity which had the same risk exposure but did not take any steps to manage it at all.
  (E.g. two companies have an interest rate exposure gap of 100 in 5 year maturity amortised cost assets. Company 1 hedges 30% of the risk with derivatives: via P&L or OCI, the result is increased volatility of net worth. PRA is then applied on alternative A: the result is even greater volatility in the opposite direction, being the volatility of the 70 unhedged position. In both cases, the volatility of net worth is greater than that of company B that does not manage the risk at all). The problem here is not necessarily volatility per se, but comparability between different entities.
- A different view, favouring **Alternative A**, for the following reasons. The accounting method applied to an asset or portfolio should not depend on whether and how it is hedged. As our Japanese colleagues point out, the decision not to hedge is in itself an important part of the risk management process and determines the overall risk profile. The purpose of hedging is

to mitigate risk, so if you deliberately choose not to hedge a risk, you shouldn't be allowed to pretend that the risk didn't exist in the first place. Allowing entities to apply the PRA to the hedged part of portfolios might effectively result in them looking at the fair value movements of their "hedges" and retrospectively picking "exposures" (including future anticipated and notional exposures such as pipeline transactions and equity model book) to offset these movements and reverse engineer the P&L in that sense. On this view the starting point must be, not how we account for hedges, but how we want to reflect overall risk, arising from exposures and partly mitigated by hedges, in the accounts.

- Further to this view, the classification of assets into those that give rise to exposure, those that mitigate the exposure and thus act as natural hedges and those that have been purchased for the sole purpose of hedging existing exposures can be somewhat arbitrary, and the PRA has the potential to address these issues by defining portfolios that are dynamically risk managed, i.e. you look at the portfolio as a whole for the gross and net exposure to various risks. Any attempt to include only hedged exposures in the P&L would probably trigger very complicated discussions around the inclusion or exclusion and thus the accounting treatment of natural hedges.
- It is very rare for risks to get hedged 100%, instead you have a hedge ratio that can be higher (say 50%) or lower (say 30%), and the hedge ratio itself is often adjusted dynamically in a certain corridor as the perceived exposure as well as the cost of hedging changes. In this sense, the decision not to hedge is simply a 0% hedge ratio that is not fundamentally different a very low, but non-zero hedge ratio. It is also worth noting that hedges are seldom perfect - in fact, in times of severe economic stress (which is really when you need the hedge most!), correlations between asset prices break down and your hedge ratio is different from what you intended it to be. (For example, many companies disclose the profit impact of every 1% movement in foreign currencies vs the base currency, and they are accurate when currencies move 1%, 2% or 3%, but the whole dynamic changes dramatically when currencies move 20%). So if you decide to hedge 30% of any given exposure, but the hedges you picked aren't perfect and in actual fact, you ended up hedging only 27% (or conversely, 33%) of your exposure, how would you account for the under- or over hedge? Would you include 30% in the PRA, because that was your intention, or 27%, because that's what happened in reality?
- **Alternative B** – as set out in J16 above, this approach is not just about risk mitigation: it is also mitigating the impact of accounting for derivatives at fair value in a mixed measurement framework where the hedged position is measured at amortised cost. It has the advantage of introducing a method of correcting some of the distortions introduced by the current accounting framework without introducing further and similar distortions. Where the potential unmanaged risk is material, it would remain important that it is adequately disclosed.

(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?

CRUF Japan

J18. Almost all members who support view (B) believe it is worthwhile to explore the sub-portfolio approach, while few support the proportionate approach.

Question 18—Presentation alternatives

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

CRUF Japan

J19. Most participants support the idea to show the dynamic risk revaluation as the separate line item, which appears in alternatives (b) and (c). However, the support for (b) and (c) are evenly divided.

J20. Those who support alternative (b) believe this is the more informative and useful alternative than alternative (c). They believe it is the most appropriate presentation in light of the fair disclosure to present the separate lines for aggregate adjustments to assets and liabilities. They point out that the net amount can be easily calculated if both assets and liabilities are shown.

J21. Those who support alternative (c) insist that the netting-out of the dynamic risk revaluation is consistent with the concept of the PRA and sufficiently informative. An entity would usually manage the risks arising from the net position of interest-rate-risk related assets and liabilities including the core demand deposits, using such hedging instruments as interest-rate swaps. Given this situation, alternative (c) which just shows the net revaluation adjustment for all exposures subject to the PRA would provide users with more concise information, which lets users understand more easily the relationship between the hedged positions and the hedging instruments.

J22. There are a few participants who support alternative (a) line-by-line gross up. They support this alternative for the more detailed information than those provided by other alternatives. Other participants counter this argument, insisting that either alternative (b) or (c) would be no problem if the Board requires the preparers to disclose more detailed information in the notes, so that the users could understand the scope of and the breakdown of the managed portfolio.

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

CRUF Japan

J23. Most CRUF Japan participants support alternative (a) to present actual net interest income.

- What we want to know is how the contractual cash flows are affected by the hedging activities. We do not believe the alternative (b) provides users with this important information. It is important for us to know if the entity's business model of collection of contractual cash flow generates stable cash flow regardless of the hedging.
- Revaluation gains or losses for the current period are the excellent leading indicator of future net interest income, which provides financial statement users with useful information.
- That said, we are concerned that volatility of the profit and loss may be amplified by the PRA, as a result of the revaluation effect of dynamic risk management to be presented as profit or loss. Some of our members point out that the stabilization of the net interest income should be just an intermediate target to stabilize the net profits. It appears to be counter-intuitive even from a user's point of view that the dynamic risk management would make the net income more volatile, even if it is the case in reality.
- One participant suggests an alternative approach to present actual net income according to alternative (a) together with the disclosure of stable net income in the notes. This approach appears to would enable users to understand the difference between the stable net income, the target set by the banks, and the actual net interest income, which would be useful.

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?

CRUF Japan

J24. Some the CRUF Japan participants, more specifically those who believe the scope of the PRA should be that of the dynamic risk management support an approach incorporating the use of OCI as discussed in the paragraphs J14 and J15. Below summarizes their view:

- We can confirm by examples on page 71 and 72 of the DP that the dynamic risk management would in fact make the net interest income more stable either in the presentation of actual net interest income or stable interest income. That said, the net income could become more volatile than the case without hedging due to the effect of the dynamic risk management. We are concerned that there would be no incentive for entities to implement the dynamic risk management and the PRA, if this is the case.

- The revaluation effect of dynamic risk management on the net income may not be so significant, if the scope of PRA is limited to the risk mitigation. If the scope of the PRA is the managed portfolio as a whole under the dynamic risk management, the effect could be too significant to accept and thus the use of OCI should be considered. In this case, the changes in the fair value of the managed portfolio as well as those of the derivatives should be recognized through OCI under the PRA, as opposed to the current cash flow hedge accounting, under which only the fair value of derivatives are recognized through OCI. This approach would not generate the huge volatility of net income for every reporting period, although the net assets would continue to be substantially affected by the changes in interest rates when the net position is significantly under-hedged.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective. The CRUF does not seek to achieve consensus views. However, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. The participants in the Forum that have specifically endorsed this response are listed below.

(Signatures)

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