



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via email: hhoogervorst@ifrs.org

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

Dear Hans

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Discussion Paper: *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* ("Macro hedging"), published by the International Accounting Standards Board ("IASB").

The Committee would like to reiterate its strong interest in promoting transparent and high quality financial reporting by banks. Macro hedging is an important topic for many banks since it significantly affects the presentation of their financial performance and position. We appreciate the fact that the Discussion Paper extensively analyses banking practices related to the dynamic management of interest rate risk. We are grateful for the IASB's efforts so far and the proposals put forward to address the difficulties reporting entities and users currently face as they seek to appropriately reflect and understand, respectively, such practices within the context of the financial statements.

When considering the proposals included in the Discussion Paper, the Committee has drawn on its *Guiding principles for the replacement of IAS 39*,¹ together with key comments set out in its response to the IASB's Exposure Draft of Proposed "Amendments to IAS 39, *Financial Instruments: Recognition and Measurement – Fair Value Hedge for a Portfolio Hedge of Interest Rate Risk*"² (2003), which are still relevant in specific areas.

¹ www.bis.org/publ/bcbs161.pdf

² www.bis.org/bcbs/commentletters/iasb12.pdf

In particular, we believe the final macro hedging accounting model should not lead to an undue expansion of quasi fair value accounting for traditional credit intermediation activities where certain risks, such as interest rate risk, are dynamically managed. In that sense it is of utmost importance for the model to be consistent with IFRS 9 Phases I and III. While the hedge accounting model may be seen as an overlay to the primary classification and measurement principles for financial instruments and may require some financial instruments to be re-measured in response to certain fair value movements, its use should be strictly limited to items that are actually hedged, in particular for lending instruments held with the objective to collect the cash flows.

We also support the proposal that hedge accounting should be aligned with the entity's risk management strategy and implementation. The model should allow banking transactions to be portrayed in a robust and consistent manner in line with their economic substance. However, it is essential that appropriate discipline surrounds the use of the macro hedging accounting model. Therefore, the Committee believes that it is very important to elaborate additional eligibility criteria to avoid cherry-picking of hedge accounting models and the creation of opportunities to manage profit or loss. The current IAS 39 includes provisions which may have been designed with an overly strong emphasis on "anti-abuse rules," which have created significant difficulties in the implementation of the general hedge accounting model. Against that background, it is important that any future macro hedging accounting model strikes an appropriate balance between discipline and flexibility. Though some provisions that enforce discipline ought to be uncontroversial, others may lead to certain aspects of a bank's risk management practices not being reflected in the financial statements.

In conclusion, the macro hedging accounting model should enhance the quality and consistency of information available about firms' risk profiles, risk management practices and related gains or losses. This emphasises the need to require relevant disclosures in addition to prescribing an appropriate treatment for recognition and measurement in the primary financial statements and in the notes.

Rather than answering all the questions raised in the Discussion Paper, the Committee has decided to highlight the guiding principles which in its view should be considered when developing a macro hedging accounting model. Indeed, while the Committee sees some merit in the main features of the proposed model, these guiding principles remain relevant regardless of the approach the IASB exposes in the next steps of its due process.

The comments in this letter and in the appendix have been prepared by the Committee's Accounting Experts Group, chaired by Rene van Wyk, Registrar of Banks, South African Reserve Bank and have been approved by the Committee. The Committee trusts that you will find its comments useful and constructive. If you have any questions regarding our comments, please contact Mr van Wyk (+27 12 313 3601) or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Stefan Ingves', with a stylized, flowing script.

Stefan Ingves

Appendix: Detailed comments

Introduction

Need for a macro hedging accounting model

The Committee supports the IASB's work to improve the accounting principles for macro hedging (Question 1). This stance is underpinned by the following considerations:

- The need to have a specific accounting model for a risk management practice of particular importance for banks (dynamic risk management). Doing so will help to address the existing "patchwork" application of IAS 39.
- Current difficulties in the application of IAS 39, for instance, regarding what are eligible hedged items, which have made it difficult for banks to reflect the economics of some hedges within the financial statements and have led some banks to use proxy hedging. This situation has led the European Commission to carve out some provisions of IAS 39 to the detriment of the comparability of the financial statements.
- Disclosures are not a substitute for appropriate accounting information in the primary financial statements. Indeed, currently diverging implementation of macro hedging accounting, and patchwork use of other accounting techniques such as the fair value option, makes it difficult to drive high-quality disclosures off the accounting about the use of derivatives or about risk management.

All these issues have to be addressed and developing an accounting approach for dynamic risk management seems appropriate, with the overall objective being to strengthen the relevance and comparability of financial statements. The IASB has chosen to develop a completely new approach. While we do not oppose the construction of a new macro hedging accounting model, for the sake of completeness we would have welcomed consideration in the Discussion Paper of additional alternatives, including the opportunity to build on the current IAS 39 or the recently issued IFRS 9 general hedge accounting models.

Reminder of the Committee's previous viewpoint

The Committee has already had the opportunity to comment on an earlier proposal by the IASB on macro hedging. We believe it is useful as an introduction to restate some of the key comments, which have formed the basis for defining the Committee's stance toward the current Discussion Paper.

As expressed in the Committee's comments on the IASB's Exposure Draft of Proposed *"Amendments to IAS 39, Financial Instruments: Recognition and Measurement – Fair Value Hedge for a Portfolio Hedge of Interest Rate Risk"* (2003), the Committee is concerned that burdensome rules for designation of derivatives as hedges of individual assets or liabilities or specific transactions, and overly stringent requirements for assessment of hedge effectiveness, may deter banking organisations from undertaking prudent actions to manage risk exposures. In addition, it is well known that banks and other large companies seek

to hedge net risk exposures, ie the remaining exposure when certain risks inherent in a group of assets are substantially offset naturally by the same risks embedded in a group of liabilities.

We believe that many aspects of the IASB's proposals in this Discussion Paper may help to address these concerns by permitting banks to elect to treat a net position as a hedged item. There are a number of other aspects of the proposal that we view as beneficial. In particular:

- We would support the IASB continuing to work on how risk management approaches and systems can provide sound inputs into the application of accounting approaches (eg scheduling cash flows on the basis of expected rather than contractual repayment dates);
- We would support one single accounting approach for dynamically hedged assets and liabilities – including, in particular, demand deposit liabilities – that increases comparability of financial statements; and
- We would recommend that changes in the fair value of hedged items be reported separately on the balance sheet instead of being included in the amounts presented on the balance sheet for the hedged assets or liabilities. This will avoid having a mix of measurement bases for items that are dynamically hedged.

Key guiding principles

The IASB's proposal for macro hedging has been assessed against the following five guiding principles: (i) Consistency with the underpinnings of IFRS 9, (ii) Alignment with risk management, (iii) Discipline, (iv) Robust disclosures and (v) Avoidance of undue complexity. We have included in the discussion of these guiding principles answers to a number of key questions posed in the Discussion Paper.

(i) Consistency with the underpinnings of IFRS 9

We consider that the macro hedging accounting model should be consistent with the underlying philosophy of IFRS 9, and more specifically Phases I and III. Business models have been a leitmotif in designing the new approach to classification and measurement of financial instruments. For this reason, the implementation of the macro hedging accounting model, even if the hedge accounting model may be understood as an overlay, should not represent an opportunity for banks to quasi-fair value items which are managed on an amortised cost basis in accordance with the firm's business model, except in cases where effectively an individual item or a net risk exposure is hedged or dynamically hedged. The aim of the project should be to define a suitable accounting model for macro hedging and not to create a "partial fair value revaluation" model for all banking book positions. Fair value is an appropriate measurement for trading activities, stand-alone or freestanding derivatives, financial assets held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and potentially other instruments managed on a fair value basis, but its expansion needs to be strictly limited. Moreover, IFRS 9 Phase III provides that only hedged items are revalued

under a fair value hedge relationship (paragraph 6.5.8). We do not see in the present proposal a justification to depart from this principle.

In the context of the Discussion Paper, these considerations lead the Committee to support the so-called Risk Mitigation Approach (RMA) – in which only hedged and hedging exposures are revalued – rather than the so-called Dynamic Risk Management Approach (DRMA), under which unhedged exposures also are revalued. Indeed, the RMA is more in line with banks' business model that generally consists of hedging only a portion of the interest rate risk.

The DRMA would lead to effects on profit or loss when exposures come within the scope of an entity's dynamic risk management but where it has chosen not to hedge – because the revaluation of those managed but not hedged exposures will not be offset by the fair value changes of hedging instruments. We find that counterintuitive, especially bearing in mind that such effects would not exist where an exposure accounted for at amortised cost falls outside the boundary of an entity's dynamic risk management. This also indicates that to apply the DRMA it would be particularly important to determine the scope of dynamic risk management – but we believe that would be very difficult to do on an objective basis.

(ii) Alignment with risk management

In the Committee's opinion, it is important to align accounting with firm's actual risk management practices while respecting the conceptual framework. To be sufficiently robust, this alignment implies: (a) an appropriate definition of what activities comprise "dynamic risk management"; (b) a clear understanding of the extent to which it is possible to reflect dynamic risk management in the accounting; and (c) appropriate documentation that satisfies IFRS 9, paragraph 6.4.1(b), which requires *"formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk that is being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements"*.

The better accounting principles and requirements are at reflecting the offsetting economic effects that exist between hedged items and their hedging instruments, the less need there will be for practices such as so-called proxy hedges.

As a corollary of this guiding principle, the Committee could accept, to a certain extent, the "behaviouralisation" of financial instruments for accounting purposes, including the sensitive aspect of the so-called "core demand deposit".

Regarding the latter issue, the stability of a portion of demand deposits has to be considered.

In most cases the "stickiness" of demand deposits is a fundamental feature of banking, contributing to maturity transformation, that is, lending for longer maturities than the contractual maturity of much of banks' funding. Core demand deposits are therefore an essential part of interest rate risk management by banks, and should be included within any model seeking to depict dynamic risk management. In other words, if the existence of a stable portion within demand deposits is disregarded, we are of the view that the entire macro hedging

accounting model would be undermined. However, some questions are still open regarding the determination of this stable portion and how discipline would best be introduced as the behavioural modelling of deposits is a complex area.

While there is indeed a need to fully understand how banks determine their core deposit base, introducing bright lines which set limits on such a determination for accounting purposes would not be feasible or desirable, as this would prevent banks from adequately depicting the economics of their business. For instance, the model should be responsive to changes in the assumptions affecting the determination of the core deposit base, such as aggressive strategies to attract funds, increased competition, crowding-out effects by shadow banking structures or government debt, or indeed increased risks of depositor runs which can arise in certain circumstances.

By contrast, we do not support the inclusion of “pipeline transactions” as described in the Discussion Paper or other future hypothetical transactions because it would imply the recognition of revaluation adjustments for items that are not recognised in the balance sheet according to the conceptual framework. That said, it may be appropriate to include forecast transactions that meet stringent criteria for recognition, such as the requirement in the general hedge accounting cash flow approach that forecast transactions be “highly probable”.

In the same vein, the application of the model to the equity model book would mean a significant departure from the conceptual framework, where equity is defined as the residual interest in the assets of the entity after deducting its liabilities and does not have a fixed return. Moreover, the absence of any fixed or guaranteed return on equity is critical to such instruments forming the core part of banks’ capital. Thus, assuming a fixed return on equity, as proposed in the Discussion Paper, would be both inconsistent with the conceptual framework and could be taken to suggest that bank equity has a quality which it does not, and cannot, possess.

The third consequence of this guiding principle is that the Committee would support using the proposed portfolio revaluation approach (PRA) to hedge the internal funding rate when such a rate is intended to be a close proxy for the actual external funding cost, but would not support an approach that gives banks and other entities a wide transfer pricing choice. This is another area where strong discipline is needed. We would be inclined to prohibit the use of any rates that are not closely related to the actual external cost of funding. The choice of an internal funding rate is closely linked to specific characteristics of the entity, such as how a bank passes funding to individual entities and operating divisions, so appropriate disclosure would be needed to explain how the internal funding rate chosen properly represents the funding cost of the entity. As an alternative, benchmark interest rates could be used within the PRA model instead of internal rates in order to ensure more objectivity.

Finally, the Committee is in favour of a profit or loss revaluation model. Revaluation through other comprehensive income (OCI) (of both the hedged items and the hedging instruments) may not fairly portray the objective of the accounting model, considering that hedge ineffectiveness should be reported in the profit or loss statement. In addition, as the IASB noted, the definition and conditions of use of the OCI category are still under review, so it is premature to consider the inclusion of an additional element in OCI.

(iii) Discipline

As suggested above, we are of the view that there needs to be strong discipline around the use of the macro hedging accounting model, and therefore an acceptance that the economically offsetting effect of some dynamic risk management activities will probably not be fully reflected in the accounting.

This need for discipline could imply that the macro hedging accounting model should be mandatory for banks that engage in dynamic risk management. As banking supervisors, we acknowledge that there may be some merit to mandatory application of the model by banks applying the same dynamic hedging strategy, which would achieve broadly the same accounting outcome for these banks. However, in line with the approach taken in the general hedging model under IFRS 9, and also because of the complexity of macro hedging and the diversity of banks' practices, it would be more practical to allow an optional application of the macro hedging accounting model, at least initially.

The need to establish safeguards to avoid cherry-picking of hedge accounting models, for example, to achieve a target level of profit or loss, could be partially addressed through use of additional eligibility criteria. The following might also help to reinforce the consistency of the principles between the general hedge accounting model and the macro hedging accounting model:

- A requirement to clearly define the objective of the hedging relationship, together with related designation and documentation requirements: building on the IFRS 9 Phase III General Hedging Model, the Committee suggests that *“at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge”* (IFRS 9, paragraph 6.4.1(b)).
- An effectiveness/ineffectiveness criterion: we are not suggesting that the hedge should be perfectly effective – economic hedges are seldom fully effective for all manner of reasons – but stringent requirements along the lines of the existing general hedge accounting effectiveness/ineffectiveness criterion (IFRS 9, paragraph 6.4.1(c)) should impose some useful discipline.
- An obligation to maintain accounting hedging relationships unless risk management changes: again, the Committee proposes to adapt IFRS 9 Phase III General Hedging Model requirements to the macro hedging accounting model and to enable *“discontinuing hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)”* (IFRS 9, paragraph 6.5.6).
- A requirement that the elements included within the macro hedging relationship for accounting purposes be capable of separate identification and reliable measurement, including clarification on how the precise amount of the ineffectiveness derived from the differences in the change of values between the hedged items and the hedging instruments should be determined.

(iv) Robust disclosures

It is of utmost importance that disclosures enable users of financial statements to understand the nature of an entity's risks, the approach taken to manage those risks, how such risk management activities are reflected in the accounts, and the source and magnitude of profit or loss arising from the entity's risk management activities. This suggests that the IASB should develop a comprehensive disclosure framework, which could embrace all accounting techniques used to depict risk management, including "natural" on-balance sheet hedging (where the measurement attribute for the hedged item and the hedging instrument is the same), the fair value option, the general hedge accounting model, and macro hedging.

Given the probable extensive use of internal assumptions and judgements in the macro hedging approach, appropriate disclosures about the application of this accounting technique will be particularly important. The Committee suggests that the disclosure requirements should be proportionate to the use of internal models and assumptions. Indeed, the more the accounting treatment relies on internal assumptions and models, the more these internal procedures need to be both appropriately documented and made transparent externally in order to avoid "black box" phenomena. For instance, appropriate disclosures should be provided regarding:

- Quantitative information about the portion of the entity's interest rate risk exposure that, in effect, is hedged. Under the RMA, it is of the utmost importance to also provide qualitative information on the risk management strategy for this aspect and any changes in it;
- The approach taken to address the behaviour of customers. Key assumptions should be explained, for example, the determination and quantification of the stable portion of demand deposits and the behavioural maturity of loans (eg mortgages where the behavioural maturity can be much shorter than their contractual life);
- The use of an internal funding rate. Sufficient quantitative information should be provided to allow users of financial statements to evaluate the impact of the rates adopted.

In that vein, disclosures should also provide qualitative information on risk management practices that are not captured in the accounting, for example, due to the approach the IASB takes toward imposing discipline over the use of the macro hedging accounting model (eg the introduction of eligibility criteria).

(v) Avoidance of undue complexity

Macro hedging accounting is a challenging issue. As expressed in its comments on the IAS 39 macro-hedging proposal in 2003, the Committee still considers that, on the one hand, it is not desirable to have standards that are so flexible that they open the door for entities to inappropriately manage their reported financial results but, on the other hand, it is similarly undesirable to have rules that are so complex that – even if accompanied by a robust disclosure regime – they may stifle sound risk management and put barriers in the way of properly depicting the economics of risk management in the financial statements. An approach to hedge accounting that strikes a better balance in terms of complexity and ease of application would

be a welcome improvement on the current approach to macro hedging. This is a sensitive issue from both preparers' and users' perspectives.

The Committee acknowledges that the RMA involves operational complexity that the IASB will have to address effectively. We encourage the Board to continue to work closely with the various interested parties to ensure that the accounting model leads to the most meaningful financial information obtainable while striking a reasonable balance between costs to preparers and benefits to users. We understand that the proposal will create a number of challenges for preparers and their auditors. In particular, the reliable estimation of the value of hedged items will create some significant practical challenges.

As regards presentation in the statement of financial position, bearing in mind the IASB's decisions regarding classification and measurement the Committee would not support an approach that would lead to the revaluation of each line on the balance sheet according to the hedged risk (the so-called "line-by-line gross up" approach). Rather we prefer the effect of the revaluation to be isolated on a separate specific line item, whether on a gross or net basis, in line with the approach taken to macro hedging under IAS 39.

In the statement of comprehensive income, the Committee would strongly favour the "actual net interest income" presentation because the alternative ("stable net interest income" approach) is likely to be more difficult for users of financial statements to understand, and also is more operationally complex for preparers.

Finally, the Committee believes that internal derivatives should not be reported on the face of the financial statements. It could create undue complexity while not providing useful accounting information. Financial reporting concerns transactions and exposures between the reporting entity and the outside world. Therefore, only external derivatives, which involve engagements with external parties, should be considered in accounting while the role and the effect of internal derivatives could possibly be described in the disclosure related to hedge accounting in order to portray a comprehensive view of hedging which is consistent with risk management practices.