Accounting Standards Board AcSB
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International Accounting Standards Board

30 Cannon Street, 1st Floor

London EC4M 6XH

United Kingdom

Dear Sirs:

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

This letter is the response of the Canadian Accounting Standards Board (AcSB) to the International Accounting Standards Board's (IASB) Discussion Paper, "Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging," issued in April 2014.

The AcSB is Canada's national accounting standard-setting body, which has adopted a strategy of importing IFRSs into Canada for publicly accountable enterprises. The AcSB consists of members from a variety of backgrounds including financial statement users, preparers, auditors, and academics. Additional information about the AcSB can be found at www.frascanada.ca

The views expressed in this letter take into account comments from our outreach with Canadian stakeholders, individual members of the AcSB and its staff. Our outreach activities included holding discussions with interested stakeholders in the financial services industry through various committee and task force meetings, meeting with the AcSB's Academic and User Advisory Councils and outreach to the additional users of financial statements. However, the views expressed in this letter do not necessarily represent a common view of the members of the AcSB, its committees or staff. Formal positions of the AcSB are developed only through due process.

Based on the outreach the AcSB has conducted, Canadian stakeholders are supportive of creating a standard that reflects the dynamic risk management activities that occur within an entity. Accordingly, the AcSB is generally supportive of creating a standard based on the feedback received. We appreciate that what the discussion paper is proposing could be comprehensive and reflect the risk management activities that occur within an entity. This could greatly reduce or eliminate the main issue of hedging relationships being identified on a static basis that arises from IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement.* The current hedging requirements are viewed as artificial and not consistent with the risk management process in an entity. In practice, portfolios are constantly changing (open) and risk managers consider the latest new open risk position and determine if action is required to manage the net open risk position. Therefore, we think that an accounting model to reflect the dynamic risk management practices of an entity would be helpful.

We understand that accounting for dynamic risk management is a new concept that the IASB is trying to explore and as such, there will be many difficulties that need to be considered and addressed when moving forward with this project. We think that the IASB should take the time needed to further explore and understand the dynamic risk management that occurs in organizations to determine if creating an accounting standard will best reflect these activities. If the additional analysis confirms that the creation of an accounting standard would appropriately reflect the dynamic risk management activities and provide more transparency, then the next step of issuing an exposure draft would be appropriate.

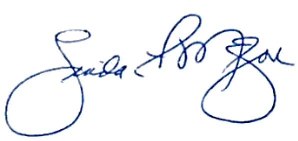
One of our main concerns is that the discussion paper was written with a focus on financial institutions. Understandably, the banking industry would be a key user of a standard that focuses on dynamic risk management. However, other industries that manage their risks dynamically could also benefit from the portfolio revaluation approach (PRA) being explored. Many stakeholders in other industries could not understand how the PRA would apply to their risk management activities as it was written from the perspective of interest rate risks in banks. We think that the PRA could be used by other industries as well as for other risks such as foreign exchange risk and commodity risk. Therefore, we think the IASB should develop materials that demonstrate the model's application to these risks (foreign exchange, commodity etc.) on which further outreach could be conducted.

The other main concern we have is how the model would reflect the dynamic risk management of an entity when the entity does not eliminate the risks of the entire portfolio thus keeping open risk positions. The discussion paper is unclear if the dynamic risk management approach would include the whole portfolio including open risk positions or just the portion of the portfolio for which the risks have been mitigated. However, we would be concerned that dynamic risk management might be seen as merely a way for an entity to offset risk exposures by creating a scope that meets the needs of the entity and is not reflective of the dynamic risk management; therefore, we would encourage the IASB to emphasize the purpose for pursuing this project in all communications related to this project. We would also encourage future documents to be less focused on the banking industry – so that stakeholders beyond this industry would be encouraged to consider the project and respond.

The discussion paper asked a series of 26 questions. As these questions were practical in nature and focused on specific internal processes of an entity, the AcSB did not think they were in the best position to provide insight into those questions. Instead, the Appendix to this letter discussed the key issues that were identified through the outreach conducted. The feedback received addressed three main concerns being the scope, behavioural characteristics and whether the standard should be made mandatory or optional.

We would be pleased to elaborate on our comments in more detail, if you require. If so, please contact me or, alternatively, Rebecca Villmann, Director, Accounting Standards (+1 416 204-3464 or email rvillmann@cpacanada.ca) or Katharine Christopoulos, Principal, Accounting Standards (+1 416 204-3270 or email kchristopoulos@cpacanada.ca).

Sincerely,



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Appendix

Scope

1. Through the numerous outreach activities we conducted, scope of the application of the PRA was the main concern we heard from our stakeholders. All of the preparers involved in our outreach supported the risk mitigation approach. The preparers think that the risk mitigation approach is more in line with their entities' current risk processes and reflects the appropriate level of detail about the risks that the entity has chosen to mitigate. The strategies of financial institutions focus on mitigating risks and leaving certain positions unhedged when a level of risk is tolerable.
2. A focus on dynamic risk management would lead to volatility in profit and loss that is unintentional. The preparers are concerned that requiring the full portfolio to be revalued through profit and loss would treat the banking book as a 'trading book' for accounting purposes. This could lead to confusion for users of financial statements as it would not provide useful information to analyze the entity as it is revaluing amounts that have deliberately not been subjected to risk mitigation.
3. The input received from financial statement users was primarily from those that analyze financial statements of financial institutions. These users expressed the need to understand the net interest revenue number in more detail as it is usually the largest revenue item in the financial statements of financial institutions. These users are seeking a better understanding of what drives the changes in net interest revenue, such as the product mix, the product margins and the treasury group taking open risk positions. The only way these users think that this model would provide useful information to them is if the scope was focused on dynamic risk management. These users are interested in knowing more about what is hedged as well as what is not hedged. As a result, dynamic risk management model would provide more transparency about an entity's risk mitigation activities. There was concern that the risk mitigation approach would only provide part of the picture and not provide insight into the unhedged positions.
4. These users also mentioned that they are less concerned about where this information is provided; be it on the face of the financial statements or in a detailed table contained in the notes to the financial statements. This flexibility introduces the potential of a presentation and disclosure only approach and whether that could meet the needs of the users, at least in the short term. Once the financial markets understand the disclosures, a second phase of the project could be undertaken focused on revising the measurement and recognition requirements, if needed.
5. Several academics consulted also preferred the dynamic risk management approach. The key focus for these academics was transparency within the financial statements that could

only be achieved through an approach that represented the full picture. A few auditors commented that if an entity identifies and analyzes risk, the dynamic risk management approach would better reflect how they manage risks.

6. However, under both of the scope approaches there was an overall concern on how the model would be audited. Having an approach that focuses on dynamic risk management would create a large population for auditors to obtain comfort over. A risk mitigation approach could lead to auditing issues regarding the determination of the scope of the sub portfolio or proportional approach.

Customer Behaviour

7. When looking at the dynamic risk management of an entity, the strategy is based on determining what cash flows are expected from financial instruments. These expected cash flows consist of exposures that are determined based on a behavioural and/or a contractual basis. As such, preparers we consulted think that to appropriately reflect the risk management strategies of an entity, both behavioural and contractual exposures should be included.

8. These preparers are very supportive of including core demand deposits as this is usually a significant portion of banks' risk management activities. These entities have many decades of historical data regarding customers past behaviours to support the level of core demand deposits that they deem static. These behavioural assumptions are constantly updated to take into account the market factors such as change in unemployment rates or market interest rates. Therefore, an amount can be estimated as what will provide fixed interest rate funding and impute a fixed market interest rate and term for dynamic risk management purposes. These preparers also think that in order for core demand deposits to be included, sub-LIBOR deposits must be allowed as many of the core demand deposits are based on sub-LIBOR funding.

9. Most stakeholders other than preparers expressed concerns about using behavioural factors in the model as they are subjective. There was some concern over whether historical trends are a valid representation of what would occur in the future.

10. Staff of the AcSB think that both the contractual terms and the economic substance need to be considered when accounting for the item. Contractual terms are used to determine if the entity has a liability and when it should be recognized. The economic substance reflects the nature of the obligation and those factors are considered in determining the measurement. For example, IFRS 13 *Fair Value Measurement* requires the use of estimates in level 3 inputs when level 1 and 2 inputs are not available. For these level 3 inputs, the entity must look for the best information available which might be the entity's own data. Core demand deposits are contractual obligations of a financial institution requiring recognition as they meet the definition of a liability. For measurement purposes, historical data and expectations of the future are behavioural factors that could be considered in applying duration to core demand deposits.

Mandatory or Optional

11. The accounting within IAS 39, *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* allows the entity the ability to elect hedge accounting. Most of the stakeholders we consulted (preparers and auditors) think that it would inconsistent to require the application of the dynamic risk management model while allowing entities the choice to use the general hedging model regardless of whether they are or are not economically hedging.

12. Another issue with making the standard mandatory is that it would require the IASB to define dynamic risk management clearly even though it was not clearly defined in the discussion paper. As with any definition, it would be subject to interpretation within an industry, across industries and across various jurisdictions. This could reduce the comparability that is one of the key factors for mandatory application.