



Financial Reporting Committee

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

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Dear Hans

Discussion Paper DP/2014/1 – Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

Who we are

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the UK FTSE 100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, these views are not necessarily those of our individual members or their respective employers.

Our views

We welcome the opportunity to comment on the Discussion Paper (DP).

Whilst we have a number of banks represented among our membership, we understand that their views will be communicated to you either in their own individual responses or in responses from bodies representing the banking sector. Our response therefore focuses on dynamic risk management from a corporate perspective outside the financial services industry.

In summary, our views are as follows:

- Whilst we believe that a debate on accounting for dynamic risk management is worthwhile, we are concerned that the Board appears to be developing a model for macro hedge accounting in isolation from existing hedge accounting principles. We consider that the DP should more clearly articulate:
 - i) the reasons why the general model in IFRS 9 cannot be applied to certain situations;
 - ii) why these issues cannot be addressed within the general model for hedging groups of items; and
 - iii) whether the proposals discussed are consistent with the hedge accounting principles of IFRS 9.
- We believe that, as a matter of principle, any DRM model needs to be applicable to all risk management strategies managed on a dynamic basis. Such a model might also provide a means for some corporates to account for their risk mitigation activities where currently this is not feasible under the existing hedge accounting model, or provide a

more appropriate and cost effective solution for those that currently apply existing hedge accounting models, but where in doing so, this creates practical difficulties.

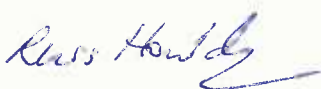
- Given the DP's focus on interest rate risk management within banks, we have found it difficult to comment meaningfully on much of the paper as it is difficult to assess how the proposed model would apply to many of the risk management strategies undertaken by corporates.
- We are concerned that the level of engagement and response from individual corporates might be low as they too may struggle to understand how the proposals are relevant to them. We would therefore advise that a low response from corporates should not lead the Board to conclude that macro hedge accounting is of little relevance or interest to corporates.
- In the past, the Board has been unwilling to develop industry-specific standards (particularly with regard to financial instruments). We therefore consider that the Board would be inconsistent with its principles if the DP were ultimately to lead to an industry-specific portfolio hedge accounting model for banks.
- We recommend that the DP is developed and reissued to include consideration of the risk mitigation activities and issues facing corporates, thereby allowing corporates to fully engage on this matter. In particular, the DP should address how the PRA model would apply to cash flow hedging strategies, which we believe is more relevant for many corporates that hedge exposures arising on future transactions.
- Consistent with general fair value hedge accounting, we consider that the carrying amount of the hedged item should be adjusted only for the gain or loss attributable to the hedged risk. If the entire hedged item were to be fair valued, as is suggested by the DP, the effect would be to introduce volatility into the income statement which would defeat the purpose of hedge accounting which is to avoid the volatility that would otherwise be caused by measurement mismatches.
- We believe that application of the PRA should be optional (not mandatory as is proposed in the DP), since this would be consistent with the general hedging model in IAS 39 and IFRS 9. Some companies choose not to apply hedge accounting even where it is available to them because the administrative burden involved significantly outweighs the benefits.

Dynamic risk management by corporates

We understand that the Board has found it difficult to identify examples of dynamic risk management strategies that are undertaken by corporates. We have provided one such example in the appendix for which hedge accounting would not currently be practical under IAS 39 or IFRS 9.

We would encourage you to meet with representatives of the 100 Group and individual corporates to discuss this example further and seek further information and examples on which to base your deliberations. I would be happy to put you in touch with interested member companies. We also suggest that you engage with the Association of Corporate Treasurers.

Yours sincerely



Russ Houlden
Chairman
Financial Reporting Committee
The 100 Group of Finance Directors

APPENDIX

RESPONSES TO SPECIFIC QUESTIONS

We have responded only to those questions that we consider are relevant to dynamic risk management in the context of corporates. We have not responded to any of the questions that deal with the detailed application of the PRA model to the hedging of interest rate risk within banks.

Q15 Scope

- (a) Do you think that the PRA should be applied to all managed portfolios included in an entity's dynamic risk management (i.e. a scope focussed on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (i.e. scope focussed 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 IFRS9 would provide a faithful representation of dynamic risk management? Why or why not?

The PRA should be restricted to circumstances in which an entity has undertaken risk mitigation through hedging as we believe the primary objective of hedge accounting is to reduce the accounting measurement mismatches which can exist where effective economic hedging is in place. A PRA solution focussed on DRM more broadly would only lead to additional volatility within the financial statements as a result of additional accounting measurement mismatches being introduced. We do not believe that this would be useful in assessing an entity's performance or risks.

We believe this would be a case of trying to do too much with the financial statements where only so much information can be contained in a single figure. The communication of the extent and effectiveness of an entity's DRM is better served through narrative and disclosures. In addition, it is clear from the DP that in many cases the accounting will not be able to reflect the full extent of the economics behind entities' DRM strategies due to recognition limitations, which would lead, at best, to an incomplete representation of an entities' DRM. Finally, there is a risk that trying to reflect broader DRM in the financial statements will lead to the accounts becoming increasingly more complex and difficult for users to understand.

We are of the view that a PRA solution limited to risk mitigation could be a useful addition to the existing hedge accounting options in IFRS 9, enabling corporates to more effectively communicate their financial position and performance, and more faithfully represent their risk management activities.

Q16 Mandatory or optional application of the PRA

- (c) 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?
- (d) 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?

We strongly advocate that any PRA model should be optional in its application, consistent with the general hedge accounting model in IFRS 9. We think that it sensible that companies

be able to choose the most practical expedient within the framework to report their risk management activities in a cost-effective manner to reduce the accounting measurement mismatches which can occur. In addition, due to the variety of risk mitigation strategies that exist and risk appetites of different companies, it is unrealistic to believe that a PRA solution could be developed which be applicable in all circumstances on a cost-effective basis.

Q25 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.

Accounting for dynamic risk management must be available for all entities that manage risk on this basis and would include other non-banking entities. To do otherwise would separate out one industry for specific accounting treatment.

With regard to corporates, the hedging of interest rate risks can generally be dealt with under existing and forthcoming financial instruments accounting standards. This is particularly the case now that IFRS 9 permits a synthetic position (i.e. the borrowing plus a related swap) to be designated as the hedged item. That said, an effective PRA solution might provide corporates with a useful alternative to deal with hedging at a macro level rather than as a series of closed and rigid hedge relationships.

However, it is necessary to consider a more general additional DP that covers risk mitigation activities as used by corporates. This would focus more on risk mitigation activities over future transactions such as foreign exchange or commodity price risk management.

For such activities, it is not clear in the current discussion paper how such arrangements would be accounted for. In particular we would note that a PRA approach which is similar to fair value hedge accounting in its application (i.e. adjusting the hedged items for the FV of the risk being hedged) is not always relevant for corporates in this area. For example, assets/liabilities could not be recognised for future foreign exchange transactions, as recognising an asset for unperformed executory contracts would violate basic accounting concepts. An alternative PRA model which is similar to cash flow hedge accounting in its application (i.e. the fair value movement on the hedging instrument are recognised through the OCI to the extent hedging is effective) may be more appropriate. Another matter for consideration is that the IAS 39 'highly probable' criterion may not be relevant and too restrictive to enable proper reflection of the risk management activity undertaken. The probability of the level of future transactions, for example, is likely to be taken into account in the risk management activity itself, as is the case in the example below.

An alternative PRA model which is similar to cash flow hedge accounting in its application for risk management activities is worth examining further and would provide a basis for companies to appropriately reflect their risk management activities in their accounts, while maintaining consistency with the general model.

EXAMPLE FACT PATTERN

A corporate hedges its transactional foreign exchange risk on a portfolio basis. The risk arises due to future (both firm and forecast) CU denominated receipts exceeding CU denominated payments and extends over a significant period. The net CU position reflects a structural foreign exchange risk implicit in the operating base. The net CU position is hedged back into its respective currencies of cost via a portfolio hedging policy.

The objectives of the portfolio hedging policy are to:

- Minimise the effect of exchange rate fluctuations on the Group's profitability, cash flow and competitiveness;
- Dampen the movements in realised exchange rates from one financial year to the next (i.e. the exchange rate on hedging instruments settled in the year);
- Provide increasing certainty of future cash and profit for forecasting purposes;
- Allow for volatility in forecast net exposure; and
- Recognise that some exchange rates are more attractive than others and allow the volume of cover taken to be increased at these favourable levels.

There is a maximum and minimum band between which cover may be taken – i.e. the volume of forward purchased/sold currency permitted. The band is calculated on a progressive basis that weights volume requirements so that a higher percentage is covered in the nearer years, reflecting the greater forecasting certainty.

The following table details the percentage of total cover permitted in any year (rolling 12 month basis) based on forecast volume requirements for that year.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Minimum	60%	50%	40%	30%	20%	10%	0%	0%	0%	0%
Maximum	100%	90%	80%	70%	60%	50%	40%	40%	40%	40%

Cover must be maintained within the maximum and minimum levels over the 10 year rolling period.

The following hedging instruments may be used:

- Forwards and synthetic forwards;
- Purchased options; and
- Written options.

The forecasts comprise many thousands of transactions, with varying levels of probability, which is dealt with in the risk management policy by the reducing level of mitigation that is allowed. The forecast transactions change over time in quantum, timing and probability. Hedge accounting for a group of items under IFRS 9 is not considered practicable as:

- It would be difficult to define which of the transactions included in the portfolio are 'highly probable' as required by 6.3.1, or to manage the changes in this probability over time;
- The conditions of 6.6.3 could not be achieved on a cost effective basis without amending the risk management policy, which does not take a layered approach.
- Many of the forecast transactions are individually significant, so these transactions would have to be individually monitored.