

To,
The Secretary,
Accounting Standards Board
The Institute of Chartered Accountants of India
ICAI Bhawan Post Box No. 7100
Indraprastha Marg New Delhi - 110002

Subject: Comments on Exposure Draft – Risk Mitigation Accounting – Proposed amendments to IFRS 9 and IFRS 7

Respected Sir,

The Northern India Regional Council of The Institute of Chartered Accountants of India (NIRC of ICAI) appreciates the opportunity to comment on the Exposure Draft *Risk Mitigation Accounting – Proposed amendments to IFRS 9 and IFRS 7*.

We broadly welcome the International Accounting Standards Board's (IASB) efforts to develop an accounting model which better reflects the manner in which entities, particularly financial institutions, actually manage repricing risk on a dynamic and portfolio basis.

In our view, one of the important strengths of the proposed model is that it recognises that repricing risk may be managed at a portfolio level rather than solely on an instrument-by-instrument basis. This is particularly relevant for banks and other financial institutions where assets and liabilities are originated, settled, repriced and replaced continuously.

At the same time, we believe that the proposed model may involve significant operational and system-related challenges. Some of these challenges may not be apparent from the accounting requirements alone because the model requires entities to establish a reasonably sophisticated link between their risk management systems, treasury systems, behavioural assumptions, derivative systems and financial reporting systems.

Our comments on the individual questions are set out below:

Question 1 – Objective and scope of risk mitigation accounting

Response

We agree, in principle, with the proposed objective of risk mitigation accounting, namely that the financial statements should represent the economic effect of an entity's risk management activities where repricing risk is managed on a net basis.

We also agree that application of risk mitigation accounting should be voluntary rather than mandatory. Entities have different risk management strategies, systems and levels of sophistication and a single mandatory model may not be suitable for all entities.

We also agree that an entity applying the model should formally document how it will apply risk mitigation accounting.

However, we suggest that the IASB should clarify that formal documentation is not intended to create a requirement to document every individual risk management decision or transaction. The risk management strategy may remain substantially unchanged while the underlying portfolios, interest rates, volumes and derivative positions may change on a daily basis.

Therefore, the documentation requirement should primarily cover the framework, policies, processes, controls, assumptions and methodology followed by the entity rather than requiring contemporaneous documentation of every individual action.

This distinction is important because otherwise entities may end up maintaining a parallel accounting documentation exercise which is different from their actual risk management process.

Additional point

We also suggest that the IASB clarify whether an entity can use the same risk management information that is already produced for Asset-Liability Management Committee (ALCO), Asset Liability Management, treasury risk management, interest rate risk management and regulatory purposes.

In our view, the accounting model should, as far as possible, be capable of operating using the information already used by management for risk management purposes. This would make the model more faithful to actual risk management and would also reduce unnecessary duplication.

We also suggest that the IASB clarify whether risk limits already used within an entity's interest rate risk management framework, including measures such as sensitivity of net interest income or economic value, may be considered sufficient for the purposes of paragraph 7.1.4, even where such limits are not expressed directly by reference to a single mitigated market rate. This would help ensure that the proposed model can operate within existing risk management frameworks rather than requiring entities to establish a separate set of accounting-specific risk limits.

Question 2 – Underlying portfolios

Response

We generally agree with the proposed approach of applying risk mitigation accounting to underlying portfolios rather than individual financial instruments. This is an important feature of the proposed model because repricing risk is often managed at a portfolio level and not by matching every individual loan or liability with a particular derivative.

We also agree with the proposed eligibility of financial assets measured at amortised cost or financial assets measured at fair value through other comprehensive income (FVOCI), financial liabilities measured at amortised cost and certain future transactions. However, we believe that the treatment of future transactions requires particular attention.

The Exposure Draft permits expected reinvestments, expected refinancing, firm commitments and highly probable forecast transactions to be included. This is useful because dynamic risk management necessarily considers expected future transactions. However, there may be significant judgement involved in determining whether a forecast transaction is sufficiently reliable to be included.

For example, a financial institution may expect a certain level of loan growth during the next six months based on its business plan. Actual loan growth may subsequently be significantly different. Similar issues may arise with expected refinancing, deposit renewals and prepayments.

We therefore suggest that the IASB provide additional guidance on:

- the level of evidence required before a forecast transaction can be included;
- how frequently the forecast should be reassessed;
- treatment of material changes in forecasts;
- whether historical experience can be used to support behavioural assumptions; and
- how changes in forecasts should affect the benchmark derivatives.

The Exposure Draft's application guidance recognises that customer deposits may behave differently when viewed at a portfolio level. We support this principle.

However, we recommend that the IASB provide more explicit guidance around behavioural modelling of such instruments, particularly:

- core and non-core deposits;
- expected withdrawal behaviour;
- deposit stability;
- customer optionality;
- behavioural maturity;
- changes in customer behaviour following significant changes in market interest rates.

This is important because the economic substance of repricing risk may differ materially from contractual maturity.

Question 3 – Determining the net repricing risk exposure

Response

We agree with the proposal that net repricing risk exposure should be determined by aggregating exposures into repricing time bands and that the methodology should be consistent with how the entity actually makes risk management decisions.

The requirement that the accounting methodology should be consistent with the entity's risk management decisions is appropriate because otherwise the accounting model could result in an artificial representation of risk which is different from the risk actually managed by the entity. The Exposure Draft specifically proposes consistency in both the aggregation methodology and the measure used to quantify the exposure.

However, we suggest that the IASB should avoid prescribing excessively rigid time bands. Different financial institutions may manage repricing risk using different buckets, for example:

- overnight to one month;
- one to three months;
- three to six months;
- six months to one year;
- one to three years; and
- more than three years.

Another entity may use considerably more granular buckets.

The accounting requirements should therefore allow entities to use the same time bands that are genuinely used by management, provided the methodology is consistently applied and appropriately disclosed.

A further practical issue

The Exposure Draft requires the net repricing risk exposure to be determined with sufficient frequency so that changes in the underlying portfolios are reflected on a timely basis.

We suggest that the IASB clarify that this does **not necessarily mean that the accounting calculation has to be performed daily.**

The frequency should be based on the entity's risk management process and the nature and volatility of its exposure. Otherwise, there could be a significant systems burden without necessarily improving the quality of financial reporting.

We also suggest that the IASB include at least one worked example where the entity's risk management process measures repricing exposure using cash-flow or gap-based information rather than a fair-value sensitivity measure. This would be particularly useful for entities whose internal and regulatory interest rate risk management is based on repricing gaps across defined time bands.

Question 4 – Designated derivatives

Response

We agree with the proposal that only derivatives used for managing repricing risk in accordance with the entity's risk management strategy should qualify as designated derivatives. We also agree with the restriction regarding derivatives with external parties.

However, we suggest that the IASB provide greater clarity on situations where a derivative is entered into for multiple risk management purposes.

For example, an interest rate swap may simultaneously affect interest rate risk, liquidity risk and other financial risks. In practice, treasury functions may not manage each component of the derivative separately.

The standard should therefore provide further clarity on how the portion of a derivative to be designated should be determined where the derivative is used for more than one risk management purpose.

We also suggest that the IASB consider whether the prohibition on derivatives already designated under Chapter 6 could create situations where an entity has economically integrated risk management but is required to maintain two separate accounting models.

A further practical issue may arise where treasury activities are centralised within a group or where a treasury function manages risks transferred to it from different business units. The external derivatives may be entered into on a net basis and therefore may not correspond directly to any one internal transfer of risk. The IASB may consider providing an illustrative example showing how such external derivatives would be identified and designated when applying the model at the consolidated level.

The objective should be to avoid situations where accounting requirements themselves influence treasury's choice of hedging instrument or the manner in which risk management is documented.

Question 5 – Risk mitigation objective and benchmark derivatives

Response

We broadly agree with the proposal. The use of benchmark derivatives is understandable because it provides a mechanism for comparing the actual derivatives used by the entity with the amount of repricing risk which the entity intends to mitigate. However, this area could become one of the most technically difficult aspects of implementation.

A benchmark derivative is a theoretical derivative constructed by the entity. Therefore, the result of risk mitigation accounting may depend significantly on assumptions used in constructing that benchmark derivative.

We suggest that the IASB provide more guidance on the following matters:

1. What constitutes a reasonable benchmark derivative methodology;
2. How frequently the benchmark derivative should be reconstructed;
3. Whether the methodology can be based on observable market instruments;
4. How interpolation should be performed where the exact maturity is not available in the market;
5. Treatment of non-standard repricing dates;
6. Treatment of prepayments and early settlements;
7. Treatment of negative interest rates, where relevant; and
8. Treatment of situations where market liquidity in the relevant derivative is limited.

The IASB should provide clear examples explaining how benchmark derivatives are constructed, calibrated to an initial fair value of zero, updated when portfolios change and how different benchmark rates and basis risk are dealt with. It should be made clear that benchmark derivatives are accounting constructs and do not represent actual contracts.

A practical suggestion

The IASB may consider allowing an entity to establish a documented benchmark derivative methodology which is approved at the beginning of the reporting period. The methodology should not need to be reconsidered for every change in the underlying portfolio, although the benchmark derivatives themselves would continue to be adjusted, where required by the proposed requirements, for changes in the net repricing risk exposure.

This would provide consistency and auditability without requiring the entity to reconstruct the methodology from scratch for every reporting period.

The IASB may also clarify that the risk mitigation objective should be established based on the entity's documented risk management strategy at the relevant point in time and should not be determined retrospectively by reference to the derivatives ultimately held. This would provide greater discipline around the determination of the objective and reduce the risk of hindsight affecting the accounting outcome.

Question 6 – Recognising and measuring the risk mitigation adjustment

Response

We agree with the basic principle of recognising the risk mitigation adjustment based on the lower of the cumulative gain or loss on designated derivatives and the cumulative change in the fair value of benchmark derivatives.

We also agree with the proposal that the accumulated amount should be recognised in profit or loss in the same periods in which the related repricing differences affect profit or loss.

This approach addresses the accounting mismatch which can otherwise arise when derivatives are measured at fair value through profit or loss while the economic effects of repricing of the underlying instruments are recognised over a different period.

The Exposure Draft specifically identifies this timing mismatch as one of the reasons for introducing the model.

Area requiring further consideration

We believe that the **"lower of" test** and subsequent write-down mechanism require additional guidance.

The Exposure Draft requires the entity to assess at each reporting date whether the accumulated risk mitigation adjustment may not be fully realised and, where appropriate, immediately recognise an excess in profit or loss.

This may produce volatility in profit or loss in circumstances where the underlying risk management strategy continues to be valid but the exposure temporarily changes.

For example, a temporary increase in prepayments may reduce the net repricing risk exposure and result in a reduction or write-down of the accumulated risk mitigation adjustment. If prepayment behaviour subsequently returns to its earlier pattern and the underlying exposure is rebuilt, the proposed non-reversal requirement could nevertheless result in the previously recognised amount remaining in profit or loss. The IASB may therefore consider providing further guidance on such circumstances, including whether a limited reversal could be appropriate where there is clear and objective evidence that the specific circumstances giving rise to the excess have subsequently reversed.

Another example can be, an unexpected reduction in loan volumes or a faster-than-expected repayment of loans could reduce the net repricing risk exposure. This could result in a reduction of the risk mitigation adjustment even though management continues to expect the portfolio to rebuild over the relevant period.

We therefore suggest that the IASB provide additional guidance distinguishing between:

- a temporary change in the underlying portfolio, and
- a fundamental change in the entity's risk management strategy.

We therefore suggest that the IASB provide additional guidance on how temporary or short-term changes in the underlying portfolio should be assessed for the purposes of the risk mitigation adjustment. In particular, the IASB may clarify how an entity should distinguish between a temporary change in portfolio exposure and a change which indicates that the accumulated risk mitigation adjustment may no longer be recoverable over the mitigated time horizon.

We also suggest that the IASB clarify the appropriate presentation in profit or loss of amounts recycled from the risk mitigation adjustment. For financial institutions, it would be particularly useful to clarify whether such amounts are expected to form part of net interest income, with separate disclosure of the risk mitigation adjustment, or whether they should be presented separately from net interest income. Consistent presentation would improve comparability across entities.

Question 7 – Discontinuation of risk mitigation accounting

Response

We agree with the basic principle that risk mitigation accounting should be discontinued prospectively when there is a genuine change in the risk management strategy.

We particularly support the clarification that ordinary changes in the entity's exposure should not by themselves result in discontinuation. The Exposure Draft appropriately distinguishes changes in risk exposure from changes in the underlying risk management strategy.

However, we suggest that the IASB provide some examples of what would constitute a change in risk management strategy.

For example, the following may occur in practice:

- change in the target mitigated rate;
- change in the ALCO policy relating to the management of repricing risk;
- change from a fixed-rate to a floating-rate strategy;
- change in the proportion of risk being hedged;
- change in the time horizon;
- temporary suspension or change in derivative transactions due to market conditions;
- change in the mix of instruments used for risk mitigation.

The IASB may also provide guidance on changes to behavioural assumptions used in the risk management process. For example, an entity may periodically recalibrate its assumptions regarding the stability or repricing behaviour of deposits without changing the mitigated rate, risk measure or underlying risk management strategy. It would be useful to clarify whether such routine recalibration should be treated differently from a genuine change in risk management strategy.

Given the judgement involved in distinguishing a change in strategy from routine risk management activity, the IASB may also emphasise the importance of applying the assessment consistently over time and maintaining appropriate documentation of the basis for the conclusion.

Not all such changes would necessarily represent a change in the entity's risk management strategy. The IASB may therefore provide examples to distinguish changes in risk management activities undertaken in the ordinary course from a genuine change in the underlying risk management strategy.

Question 8 – Effective date and withdrawal of IAS 39

Response

We understand the IASB's objective in proposing the withdrawal of the remaining IAS 39 hedge accounting requirements. However, we believe that the withdrawal should be approached carefully.

Entities currently applying IAS 39 portfolio hedge accounting may have developed systems, models, controls and documentation over a considerable period. They may also have incurred significant costs and committed substantial resources, including by engaging external consultants and incurring recurring annual consultancy fees for maintaining and supporting the existing framework.

Also, implementation will require substantial changes to risk data systems, treasury systems, general ledger interfaces, valuation processes, model governance, internal controls, disclosures, audit procedures and staff training.

Accordingly, we suggest that the withdrawal date should provide adequate implementation time after the final standard is issued, rather than being linked only to the date of issuance.

Suggested approach

We would suggest that the IASB consider providing a minimum implementation period covering at least two annual reporting cycles, particularly for entities with significant dynamic risk management activities.

A phased implementation or an optional early adoption approach could also be considered.

The objective should be to ensure that entities do not have to choose between continuing an old model without sufficient support and implementing a new model before their systems are ready.

Question 9 – Transition

Response

We broadly agree with prospective application of the proposed requirements. However, transition is likely to be one of the most important practical issues for entities currently applying hedge accounting.

We therefore suggest that the IASB provide a practical transition mechanism rather than requiring entities to recreate historical risk mitigation adjustments under the new model

In particular, entities should not be required to reconstruct historical benchmark derivatives for periods before the transition date merely for the purpose of establishing opening balances.

Additional suggestion

The IASB may consider permitting entities to determine the opening risk mitigation adjustment using the fair value of relevant existing derivatives and the net repricing risk exposure as at the transition date, together with an appropriate benchmark methodology, subject to adequate documentation.

This would significantly reduce implementation costs without compromising the information provided to users.

We also support the proposal allowing an entity to revoke an earlier FVTPL designation where the relevant instruments will now form part of the underlying portfolios.

However, the standard should clarify whether such revocation is:

- instrument-by-instrument;
- portfolio-by-portfolio; or
- required for all eligible instruments meeting the relevant conditions.

The transition provisions should also clearly address the interaction between existing hedge adjustments under IAS 39/IFRS 9 and the new risk mitigation adjustment.

Question 10 – Disclosure requirements

Response

We agree that appropriate disclosure is important because the proposed model may result in significant amounts being recognised as a risk mitigation adjustment and may otherwise be difficult for users to understand. We support separate presentation of the risk mitigation adjustment in the statement of financial position and the amount recognised in profit or loss. The Exposure Draft proposes disclosures addressing these matters.

However, we suggest that the IASB should be cautious about making the disclosure requirements excessively detailed.

There should be a clear distinction between:

- ❖ information useful to users of financial statements, and
- ❖ information which is primarily useful to auditors or internal risk management personnel.

For example, requiring disclosure of highly granular repricing bands, internal risk limits, detailed behavioural assumptions or individual derivative positions may result in large amounts of information without necessarily improving users' understanding.

We also note that disclosures relating to risk management strategy, mitigated rates, repricing time bands, behavioural assumptions and derivative positions, when considered together, could reveal commercially sensitive information about an entity's asset-liability management strategy. The IASB may therefore consider permitting entities, where the relevant information is already available in regulatory or other public disclosures, to cross-refer to such information rather than reproduce substantially the same information in the financial statements.

We therefore recommend a **materiality and proportionality principle** for the disclosures.

One useful disclosure

In our view, one particularly useful disclosure would be a simple reconciliation such as:

Opening risk mitigation adjustment

+/- changes during the period

+/- amounts recognised in profit or loss

+/- adjustments arising from changes in exposure

= Closing risk mitigation adjustment

Such a reconciliation may be more useful to users than several pages of narrative description.

For Entities not applying risk mitigation accounting

We also have a concern regarding proposed paragraph 33A that if an entity meets the characteristics in paragraph 7.1.4 but voluntarily chooses not to apply risk mitigation accounting, requiring a qualitative explanation is reasonable. However, the disclosure should remain limited to information that is relevant to understanding how the entity manages repricing risk. It should not become a requirement to provide an extensive explanation of why the entity has chosen not to apply risk mitigation accounting.

Question 11 – Risk management strategy of insurance entities

Response

From a financial reporting perspective, we believe that the IASB's consideration of insurance entities is important. Insurance entities can have long-duration assets and liabilities, and the timing and amount of cash flows may be affected by interest rates over a substantially longer period than in many other businesses.

The exposure of insurance entities to repricing risk can differ from that of banks and other financial institutions. The IASB should study the inclusion of insurance contract liabilities, the interaction with insurance finance income or expense under IFRS 17, policyholder behaviour assumptions, participating and unit-linked contracts and the possibility of double reflection of the same risk.

In particular, the interaction with the risk mitigation provisions already available under IFRS 17 should be considered carefully to ensure that the same economic risk is not reflected through overlapping accounting mechanisms.

We recommend that, before extending the model to insurance entities, the IASB undertake sufficient field testing and develop appropriate sector-specific implementation guidance.

Additional observations

In addition to the specific questions above, we would like to bring the following matters to the attention of the IASB.

1. Use of a risk management documentation framework

The IASB may consider introducing the concept of a risk management documentation framework. This would link existing treasury and accounting information and could contain the documented risk management strategy, mitigated rate, mitigated time horizon, risk limits, composition of underlying portfolios, method for expected repricing dates, designated derivatives, risk mitigation objective, significant assumptions, changes during the period and management approval.

2. Avoid creating a new "shadow hedge accounting" model

There is a possibility that entities may end up maintaining:

1. their normal treasury risk management model;
2. IFRS 9 hedge accounting records;
3. risk mitigation accounting records; and
4. separate benchmark derivative calculations.

This could become operationally burdensome. The final standard should therefore encourage entities to use one underlying risk management dataset, with accounting adjustments derived from that dataset.

3. Materiality should apply throughout the model

The proposed requirements contain several areas involving estimates and judgements. We recommend that the IASB make it clear that materiality applies not only to disclosures but also to the level of operational precision required in determining repricing exposures. For example, an entity should not be required to establish highly granular repricing bands where such granularity would not affect the financial statements materially.

Also, a small entity with a simple portfolio should not be required to develop the same system complexity as a large international bank. The IASB could also consider whether implementation guidance can distinguish between simple contractual portfolios, portfolios requiring moderate behavioural assumptions and complex portfolios involving multiple rates, options and modelling techniques.

4. Implementation guidance before mandatory application

The IASB should publish implementation guidance or illustrative examples before the mandatory effective date covering fixed-rate loans and deposits, demand deposits, prepayments, floating-rate instruments, future reinvestments and refinancing, multiple mitigated rates, different currencies, cross-currency swaps, partial designation, excess adjustments, discontinuation and transition from IAS 39.

Overall conclusion

NIRC of ICAI supports the IASB's objective of developing a risk mitigation accounting model that better reflects dynamic risk management activities.

The proposed model represents a significant step towards reducing the accounting mismatch which can arise when entities manage repricing risk on a portfolio basis but accounting requirements operate largely at an individual instrument or closed-portfolio level.

At the same time, we believe that the final requirements should give adequate attention to operational practicality, behavioural assumptions, forecast transactions, benchmark derivatives, transition arrangements and proportionality of disclosures.

In particular, we recommend that the IASB undertake field testing with a representative group of banks, NBFCs, insurance entities and other financial institutions before finalising the requirements. The field testing should not be limited to whether the accounting result can be calculated; it should also consider whether the information can be obtained reliably from existing risk management and treasury systems without disproportionate cost.

We believe that a successful risk mitigation accounting model should achieve three things simultaneously:

- 1) reflect the actual risk management strategy of the entity;
- 2) avoid creating significant accounting mismatches; and
- 3) remain capable of being implemented through normal risk management and financial reporting systems.

Subject to the above observations and suggestions, we support the overall direction of the Exposure Draft.

Yours faithfully,

**For Northern India Regional Council of
The Institute of Chartered Accountants of India**

Chairman / Vice-Chairman

Northern India Regional Council

The Institute of Chartered Accountants of India