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Hans Hoogervorst
Chairman of the
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Berlin, 20 October 2014

Dear Hans,

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

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the Discussion Paper DP/2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (hereafter referred to as 'the DP'). We appreciate the opportunity to comment on this DP.

The ASCG welcomes the efforts to develop a solution for accounting for macro hedging activities. Whilst we believe that the Discussion Paper contains an appropriate description of how large banks, in particular, are carrying out their dynamic risk management activities, we do not think that a reflection of such activities should be the key driver for the project. We agree that there are two objectives that the IASB should tackle concurrently – though not necessarily in one and the same project:

- On the one hand, preparers have repeatedly stated that they incur accounting-induced volatility given their dynamic risk management, which cannot be depicted under the static accounting model provided under IAS 39 (and IFRS 9). Hence, there is a need to address the accounting consequences that arise from entities managing risk on a dynamic basis. In our opinion, this should be the focal point of this project. When addressing accounting anomalies that result from the general classification and measurement regime of IFRS 9, any model being developed should complement the other already existing accounting approaches or methods (e.g. general hedge accounting, fair value option), as it seems unlikely that the IASB will find a one-size-fits-all solution accommodating each and every entity.
- On the other hand, users of financial statements have demanded better information about the impact of hedging activities on the financial statements, especially on the perform-

ance of these entities. This type of information is probably more prone to being addressed through presentation and disclosure or even outside the financial statements than through recognition and measurement.

Additional points worth noting upfront:

- We consider the aim of reflecting the dynamic risk management ('DRM') in financial statements being too far-reaching and hardly achievable against the accounting principles and constraints set by IFRSs and the conceptual framework. In particular, the definition of assets or liabilities and their recognition criteria would most likely not be met and, thus, require thorough consideration;
- Some elements of the PRA as laid out in the DP are worth being considered further; this particularly applies to the PRA in its narrow scope alternative with a focus on risk mitigation. We note that many of the options or alternatives presented in the DP are not free options or alternatives, but would flow directly from the decision on the scope. Among others, this concerns the population of eligible exposures, the question of optional or mandatory application, or the date of inclusion in/removal from the portfolio, to name but a few;
- Lastly, we note that the proposals are heavily concentrated on one sector and one type of risk. Our preliminary outreach has revealed that other industries (esp. the insurance and the utility sector) should be looked at in the course of the project, even though the appetite of most corporates seems to be limited. Similarly, feedback from our financial instruments working group has confirmed that interest rate risk seems to be the key risk factor for which an accounting approach is warranted. Nonetheless, we suggest the IASB reach out to other industries to confirm our results.

Please find our detailed comments on the proposals of the DP in the appendix to this letter. Our comments are provided in the order that the questions were raised. However, we believe that the DP could have been structured in a more logical way. In particular, the scoping question is a basic issue (but only arises in sec. 5 of the DP) that should have been asked at the beginning, and many of our major comments relate to, or depend on, the scope. Thus, some comments interrelate with each other, even though they are spread over the comment letter. We have tried to accommodate this by using cross-references. Lastly, in some areas we have narrowed down our comments due to the fact that we have a strong preference for a limited scope that affects several other issues. In particular, we have considered some aspects only under our preferred scope, or not even considered yet since any further consideration is only useful once the IASB has decided upon a clearer direction for the PRA.

If you would like to discuss our views further, please do not hesitate to contact me or Andreas Barckow.

Yours sincerely,

Liesel Knorr
President

Appendix A – Answers to the questions of the Discussion Paper

Section 1 Background and introduction to the portfolio revaluation approach (PRA)

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?

Yes, we think that there is a need for a specific accounting approach to represent the impact of DRM activities on the financial statements as this is not yet covered sufficiently by the current general hedge accounting requirements. However, we do not think that any such accounting approach should aim at representing the (entire) DRM in the financial statements.

In general, we think that accounting principles on their own do not allow for fully reflecting the DRM of an entity and are not intended to do so, as risk management and accounting are fundamentally different in nature – e.g. the unit of account considered ([net] cash flows vs. assets and liabilities) and the (non-)consideration of internal derivatives, to name but two. Further, financial statements are not designed to portray DRM activities. If additional information was added to other parts of financial reporting, such as management commentary, a more comprehensive depiction of risk management might be achievable.

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?

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

ad (a) With respect to interest rate risk in the banking sector, we acknowledge that the PRA addresses the main issues that arise in many banks, especially the large institutions. In particular, challenges stemming from core demand deposits, prepayments, or behaviouralisation arise in nearly all banks; hence, the PRA would address the most pressing areas. Other issues in conjunction with the Equity Model Book (EMB) or sub-benchmark rate instruments do arise, though they are not that widespread.

ad (b) Since the DP proposes several variations of the PRA, it is impossible to assess generally whether the PRA appropriately addresses the issues identified. Consider, for example, the focus of the PRA: If the PRA were to be developed further, we believe that a focus on risk mitigation would be the only appropriate way forward. Such a "narrow" focus would influence many other aspects of the PRA. As another example, we point to the list of exposures that are suggested for inclusion in the portfolio under the PRA. We consider some exposures necessary to be included, others not. For details, we refer to our answers on the specific questions raised in the DP.

Section 2 Overview

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?

The description of DRM in sec. 2 is rather short, so it is difficult to judge whether it is accurate and complete. Generally speaking though, we broadly agree with the description. What appears to be missing, however, is a discussion of the relationship between DRM and the accounting consequences that flow from it – in other words the link between macro hedging and macro hedge accounting.

In addition, and as mentioned in our introduction, DRM is not uniform within the banking sector (in particular with regard to the scope, inter-segment risk transfers and – most importantly – valuation methods) and even less uniform for different risks or sectors. As we consider reflecting DRM not being an appropriate objective of this (or any) accounting approach, we do not see overly much merit in changing or broadening this description.

Section 3 The managed portfolio

Question 4 – Pipeline transactions, EMB and behaviouralisation (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. (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*. (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*.

As a general remark, we note that setting a boundary for which items should be included in the PRA is difficult and maybe arbitrary. This is mainly due to those transactions that are either not yet contracted, or are contracted but not yet recognised. Since accounting and risk management have different perspectives owing to their different objectives, the inclusion of any such items depends on the perspective taken: Forecast transactions, pipeline transactions, firm commitments, etc. could more reasonably be included in the PRA from a risk management perspective than from an accounting perspective.

ad (a) We generally support the inclusion of pipeline transactions as they are relevant to the risk position as well as to DRM activities in general. However, we note conceptual concerns as these items are not contractual items, so they are not (yet) recognised in the financial statements.

In addition, the general difficulty of setting a boundary as mentioned before would particularly arise in respect of pipeline transactions.

ad (b) We partially support the inclusion of the EMB as, on the one hand, it is relevant when determining the risk exposure as part of the DRM of some banks. However, it is not that widespread within the financial sector in our jurisdiction and does not seem that relevant to other industries. On the other hand, including the EMB in a revaluation portfolio would contradict to general accounting principles since it would lead to equity being (re-)measured after initial recognition.

ad (c) We would prefer that cash flows were based on behavioural assumptions (rather than on contractual terms) if and when risks are managed on a behaviouralised basis. This particularly includes expectations on prepayments, but also bottom layer considerations.

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.

See our answer to Question 4.

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?

As mentioned above, we believe that cash flow profiles that are based on behavioural assumptions as being in line with the nature and intention of the PRA. Thus, we support including prepayments and the impact of other assumptions of customer behaviour in the revaluation of the portfolio under the PRA. However, we have not yet developed a definitive view on how these features could be considered under the PRA.

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.

We have not yet developed a view on which approach should be preferred and whether it should be mandatory or optional.

Question 8 – Risk limits

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

As a consequence resulting from our scope preference, we think that risk limits are irrelevant under a PRA that is focused on risk mitigation. Under such a scope, the PRA would already be restricted to those exposures that are actually risk mitigated (rather than risk managed), so risk limits do not seem to serve any additional purpose.

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?

ad (a) We support the inclusion of core demand deposits in the PRA as they are highly relevant for determining the open net risk position and are generally considered by banks as part of their DRM activities. We believe that their inclusion in a PRA approach is more easily justifiable than some of the other items considered as these items are already recognised, so their inclusion in the PRA would rather be a matter of acknowledging and choosing a (different) unit of account and measurement as and when core deposit become part of a risk mitigated portfolio.

ad (b) We believe that guidance would be required so as to safeguard the approach and limit potential abuse. However, we acknowledge the fine line in developing such guidance as it should not be drafted such that it effectively hinders entities in faithfully portraying what they are doing in risk management.

Question 10 – Sub-benchmark rate managed risk instruments

(a) Do you think that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if it is consistent with an entity's dynamic risk management app roach (ie Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (ie Approaches 1+2 in Section 3.10) for calculating the revaluation adjustment for sub-benchmark instruments provide an appropriate reflection of the risk attached to sub-benchmark instruments? Why or why not?

(b) If sub-benchmark variable interest rate financial instruments have an embedded floor that is not included in dynamic risk management because it remains with the business unit, do you think that it is appropriate not to reflect the floor within the managed portfolio? Why or why not?

ad (a)+(b) We are aware of some top rated financial institutions in our jurisdiction that are hedging sub-benchmark rate instruments as they are able to refinance below the benchmark interest rate. Further, given the historically low interest environment that is likely to sustain for some years, this issue has the potential of becoming even more prominent and widespread than it is today. Lastly, we note that this is one of the two issues where in the European Union a carve-out exists, which we hope being addressed in this project. Thus, we support the IASB considering this issue further.

Section 4 Revaluing the managed portfolio

Question 11 – Revaluation of the managed exposures

(a) Do you think that the revaluation calculations outlined in this Section provide a faithful representation of dynamic risk management? Why or why not?

(b) When the dynamic risk management objective is to manage net interest income with respect to the funding curve of a bank, do you think that it is appropriate for the managed risk to be the funding rate? Why or why not? If not, what changes do you suggest, and why?

ad (a)+(b) Answering these questions would mainly depend on whether the scope was focused on DRM or on risk mitigation. Given our preference for a focus on risk mitigation, the objective of providing a faithful representation of DRM would not arise.

Generally speaking, we believe that under any revaluation approach the entire portfolio (i.e., all exposures it comprises) should be remeasured with respect to the mitigated risk. This is in line with current practice under fair value hedge accounting where the hedged instrument is remeasured with respect to the designated risk. We have not determined which particular methodology under the PRA would serve this purpose best. Please find some additional comments in our answer to the following questions (Q12-14).

Question 12 – Transfer pricing transactions

(a) Do you think that transfer pricing transactions would provide a good representation of the managed risk in the managed portfolio for the purposes of applying the PRA? To what extent do you think that the risk transferred to ALM via transfer pricing is representative of the risk that exists in the managed portfolio (see paras. 4.2.23–4.2.24)?

(b) If the managed risk is a funding rate and is represented via transfer pricing transactions, which of the approaches discussed in para. 4.2.21 do you think provides the most faithful representation of dynamic risk management? If you consider none of the approaches to be appropriate, what alternatives do you suggest? In your answer please consider both representational faithfulness and operational feasibility.

(c) Do you think restrictions are required on the eligibility of the indexes and spreads that can be used in transfer pricing as a basis for applying the PRA? Why or why not? If not, what changes do you recommend, and why.

(d) If transfer pricing were to be used as a practical expedient, how would you resolve the issues identified in paras. 4.3.1–4.3.4 concerning ongoing linkage?

Question 13 – Selection of funding index

(a) Do you think that it is acceptable to identify a single funding index for all managed portfolios if funding is based on more than one funding index? Why or why not? If yes, please explain the circumstances under which this would be appropriate.

(b) Do you think that criteria for selecting a suitable funding index or indexes are necessary? Why or why not? If yes, what would those criteria be, and why?

Question 14 – Pricing index

(a) Please provide one or more example(s) of dynamic risk management undertaken for portfolios with respect to a pricing index.

(b) How is the pricing index determined for these portfolios? Do you think that this pricing index would be an appropriate basis for applying the PRA if used in dynamic risk management? Why or why not? If not, what criteria should be required? Please explain your reasons.

(c) Do you think that the application of the PRA would provide useful information about these dynamic risk management activities when the pricing index is used in dynamic risk management? Why or why not?

In addition to our general comment above (Q11), we are not yet convinced whether the idea of using transfer prices or (market funding or pricing) indices is appropriate. We note that the assessment largely depends on the valuation curves used, and practice is not uniform in this regard. Hence, we are not sure whether transfer pricing as explained in the DP is an appropriate means for revaluation in all circumstances, since it is basically an instrument of disaggregating the (interest) margin between the business units involved. If this was directly driving the valuation of the managed or mitigated risk for the portfolio, the use of transfer pricing could potentially be arbitrary and would require certain guidance in order not to impair comparability.

Since funding and pricing indices are directly or indirectly connected with the transfer pricing rate, we do not believe that using these indices is appropriate, since funding and pricing indices may contain other elements than just a core interest element, especially business incentives. These incentives would have to be neutralised should such indices be used for the approach.

On the other hand, we deem internal derivatives worth being considered in the context of revaluing the portfolio. Given our preference for a focus on risk mitigation, we think that when internal derivatives are used as risk mitigating instruments, they represent the (revaluation of the) mitigated risk. If no internal derivatives are used, there is either no risk mitigation, or the risk mitigation is conducted through external instruments, which would be included in the net position anyway.

Section 5 Scope

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?

(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?

(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?

(d) Would the answers provided in questions (a)–(c) change when considering risks other than interest rate risk (for example, commodity price risk, FX risk)? If yes, how would those answers change, and why? If not, why not?

ad (a) We strongly prefer a scope that is focused on risk mitigation, which is a direct consequence of our opinion that an objective of reflecting DRM in financial statements is neither appropriate nor achievable. Instead, addressing those accounting mismatches that (still) arise under the classification and measurement regime of IFRS 9, despite and considering and potentially applying general hedge accounting, appears a more appropriate objective for the PRA. Hence, the PRA should not focus on DRM as a whole (i.e. the "full PRA"), but on risk mitigation only (i.e. the "partial PRA").

ad (b) Generally, we are convinced that the scope strongly depends on the objective of the PRA. If, as proposed by the DP, the PRA aimed at a better reflection of DRM in the financial statements, the full PRA would be appropriate. If, as is our preference, the objective was to address accounting mismatches, the partial PRA would be appropriate.

Under a full PRA we strongly believe that all DRM activities would have to be included in the PRA: those that are used for risk analysis only (without any risk mitigation occurring) as well as those for which risk mitigation is sought. Under a full PRA it would not matter whether exposures are risk managed or intentionally left open; neither would it matter whether how effective the entity was in carrying out its DRM activities – the approach would simply reflect everything. This would be particularly relevant for those items that IFRS 9 foresees as being subsequently measured at amortised cost but that risk management has determined of leaving unhedged, as these items would equally be remeasured to P&L and, thus be an overlay to the measurement and classification regime of IFRS 9.

Conversely, under a partial PRA, it would be essential to distinguish between the two dimensions mentioned above (risk mitigated or not, and effective or not): It is only the former of the two that matters, i.e. the PRA must only reflect the effects of those items that risk management actually decided to include in risk mitigation efforts. In contrast, the second dimension reflecting the effectiveness of any such risk mitigation activities can be seen in two ways: In a narrow sense, one would merely consider those transactions that are a means of effective risk mitigation; under a wider view, one would also consider exposures within the risk mitigated portfolio that are intentionally left open (e.g. for reasons of efficiency, particularly large portfolios containing a large number of small-ticket items, such as retail loans).

Further, we believe that there should be no hierarchy between that the general hedge accounting requirements and a PRA; rather, they should both be available to an entity, which should decide based on its facts and circumstances how its risk management activities are portrayed in the most appropriate fashion. This being said, we believe that safeguards are required to ensure that risk exposures are not double-counted, are unintentionally applied under both the PRA and the general hedge accounting model. This issue may be particularly relevant for groups with multiple layers of entities that are disbursed around the globe and for which regional risk management operations exist.

ad (c) If the full PRA was applied, we would have major concerns about its compatibility with general accounting principles and the conceptual framework. E.g., it seems difficult to imagine how the revaluation adjustment would comply with the asset/liability definitions and with the principle of not remeasuring equity after initial recognition.

If the partial PRA was applied, our concerns would be fewer. However, under such focus other feasibility issues would arise. E.g., the delineation of those exposures that are in the focus and those that are outside requires clear criteria, including an answer as to whether sub-portfolios or proportions of portfolios should be determined for setting this line.

In either case, though, the key challenge appears to be how one can depict the dynamic element in the PRA. This is not only a question relating to sub-portfolios or proportions and, thus, the partial PRA. This question does encompass addressing issues such as tracking the exposures, amortisation of revaluation adjustments, etc.

ad (d) Our scope preference would not change if the PRA was extended to cover other risks, too. We comment on the possibility of the PRA being applied to other risks in our answer on Q25.

Question 16 – Mandatory or optional application of the PRA

(a) 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?

(b) 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?

ad (a) Since we prefer a scope focused on risk mitigation, we have no view on this. However, from a conceptual point of view it seems rather obvious that if the scope was focused on the (entire) DRM, there would be no room for optionality. If the aim is to portray the DRM in its entirety, any exposure that is part of DRM must be reflected in the revaluation adjustment under the PRA.

ad (b) Under a restricted scope, we would clearly support an optional application of the PRA. This is based on the following arguments. Firstly, if the PRA was mandatory, there would be a need for a strong (and automatic) trigger that determined the inclusion of any potential exposure in the net position, in respect of timing and population. This argument is similarly valid for the exclusion from the net position. We are not yet aware of any such robust and neutral trigger. Secondly, we consider the interaction with the general hedge accounting requirements important. As said above, since exposures could be accounted for under both the general hedge accounting and under the PRA, entities should be left with discretion as to how they believe they could best reflect the risk mitigation having taken place. We note though that guidance would be needed to avoid a potential double-counting if risk management activities take place at different levels within an entity or group.

Question 17 – Other eligibility criteria

(a) Do you think that if the scope of the application of the PRA were focused on dynamic risk management, then no additional criterion would be required to qualify for applying the PRA? Why or why not?
   (i) Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.
   (ii) If the application of the PRA were optional, but with a focus on dynamic risk management, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

(b) Do you think that if the scope of the application of the PRA were to be focused on risk mitigation, additional eligibility criteria would be needed regarding what is considered as risk mitigation through hedging under dynamic risk management? Why or why not? If your answer is yes, please explain what eligibility criteria you would suggest and why.
   (i) Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.
   (ii) If the application of the PRA were optional, but with a focus on risk mitigation, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

ad (a) Since we prefer a scope focused on risk mitigation, we have not developed any view on this issue.

ad (b) Under the restricted scope, we would only support a criterion that was robust and not arbitrary. Any such criterion needs to determine which exposures are risk mitigated (and are, thus, included in the net position) as well as at which point in time the exposure shall be included in, or excluded from, the net position. Any such criterion needs to determine the population and timing for inclusion unambiguously, so that optional application of the PRA would be supported. If so, the option of applying the PRA would not be a question of "what and when", but only of "yes or no".

Although we do not yet have an answer as to which criterion would serve that purpose best, we refer to our opinion that internal derivatives might play a role in this context. As far as internal derivatives exist, they could be considered as representing risk mitigation and the (revaluation of the) mitigated risk. However, this might not be the only criterion as it is not applicable in circumstances where risk mitigation is undertaken through means other than internal derivatives.

Section 6 Presentation and disclosures

Question 18 – Presentation alternatives

(a) Which presentation alternative would you prefer in the statement of financial position, and why?
(b) Which presentation alternative would you prefer in the statement of comprehensive income, and why?
(c) Please provide details of any alternative presentation in the statement of financial position and/or in the statement of comprehensive income that you think would result in a better representation of dynamic risk management activities. Please explain why you prefer this presentation taking into consideration the usefulness of the information and operational feasibility.

ad (a) We prefer alternative 3, i.e. a "single net line item". This alternative best reflects the net effect and, thus, accommodates the purpose of the PRA most.

We would not support alternative 2 (an "aggregate adjustment") as this would result in disaggregating the net effect into two sub-items, which seems arbitrary. We consider the revaluation adjustment of the net position ("portfolio"), without derivatives, representing one partial amount, and the effect from changes in all risk management instruments ("derivatives") representing another partial amount, with both adding up to the entire net effect of risk management. As this constitutes a disaggregation required by accounting principles, but irrelevant for risk management purposes, we would not support another disaggregation of the economic net effect from risk management.

We do not consider alternative 1 being feasible at all under the current accounting framework, since the entire revaluation adjustment comprises revaluation effects relating to items that are not (yet) recognised. Hence, it cannot be allocated to any line item in the statement of financial position.

ad (b) We prefer neither alternative. We would consider it appropriate if presentation separated interest income originated by the interest cash flows from revaluation-induced effects originated by DRM activities with respect to interest risk. At best, both effects could be presented next to each other or would add up in a sub-total of interest income. However, due to the PRA lacking a clear or a convincing objective, we are not clear yet as to what objective-should determine income presentation. Given this, we do not support stabilising (net) interest revenue generally.

ad (c) We have no additional proposals.

Question 19 – Presentation of internal derivatives

(a) If an entity uses internal derivatives as part of its dynamic risk management, the DP considers whether they should be eligible for inclusion in the application of the PRA. This would lead to a gross presentation of internal derivatives in the statement of comprehensive income. Do you think that a gross presentation enhances the usefulness of information provided on an entity's dynamic risk management and trading activities? Why or why not?

(b) Do you think that the described treatment of internal derivatives enhances the operational feasibility of the PRA? Why or why not?

(c) Do you think that additional conditions should be required in order for internal derivatives to be included in the application of the PRA? If yes, which ones, and why?

ad (a) We support the idea of a gross presentation of internal derivatives. This would allow portraying the effects of using internal derivatives, in particular by allocating these effects to different line items, thus, to different business activities. We note, though, that in some situations the net effect might not add up to zero. This might result from IT system-related circumstances, in particular from time lags when derivatives are recorded in the system, especially in groups operating around the globe.

ad (b) We are not aware of a description of internal derivatives' "treatment" in order to enhance the operational feasibility of the PRA. We acknowledge the description in the DP (sec. 6.2) covering how internal derivatives are used within DRM, which seems broadly appropriate, and how they might be presented, which we commented on under (a) above.

ad (c) We have not yet discussed this in detail. We think that some details only deserve further consideration once the IASB has decided upon a clearer direction for the PRA. However, as mentioned before, we think that internal derivatives might play a role in the context of eligibility of items to be included in the PRA under a scope focused on risk mitigation, and also in the context of revaluing the portfolio.

Question 20 – Disclosures

(a) Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views.

(b) If you think that an identified theme would not provide useful information, please identify that theme and explain why.

(c) What additional disclosures, if any, do you think would result in useful information about an entity's dynamic risk management? Please explain why you think these disclosures would be useful.

Question 21 – Scope of disclosures

(a) Do you think that the scope of the disclosures should be the same as the scope of the application of the PRA? Why or why not?

(b) If you do not think that the scope of the disclosures should be the same as the scope of the application of the PRA, what do you think would be an appropriate scope for the disclosures, and why?

At this stage of the project, we have not yet discussed the area of disclosures. We think that this area would go very much into details that only deserve further consideration once the IASB has decided upon a clearer direction for the PRA.

Section 7 Other considerations

Question 22 – Date of inclusion of exposures in a managed portfolio

Do you think that the PRA should allow for the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract? Why or why not?

(a) If yes, under which circumstances do you think it would be appropriate, and why?

(b) How would you propose to account for any non-zero Day 1 revaluations? Please explain your reasons and comment on any operational implications.

Question 23 – Removal of exposures from a managed portfolio

(a) Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?

(b) Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from a managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?

(c) If exposures are removed from a managed portfolio prior to maturity, how would you propose to account for the recognised revaluation adjustment, and why? Please explain your reasons, including commenting on the usefulness of information provided to users of financial statements.

We think that the inclusion in and exclusion from the portfolio should be treated similarly, either equally at the point in time when the items are recognised/derecognised or equally deviating from such point in time.

The answer to both questions very much depends on the scope of the PRA. Subject to limited exceptions, we assume that once an item/exposure arises (either by contract or otherwise), it will become part of DRM at that very same moment. It should be noted that exposures do not only arise when the entity first becomes a party of a contract – as reads Q22 –, but maybe even before. Consequently, under a scope that is focused on DRM, we think that the only appropriate timing would be to include/exclude the exposure in/from the PRA at the same moment as the exposure arises or ceases to exist (e.g. the entity becomes a party to the contract or is released from the contract, respectively).

However, under a scope focused on risk mitigation (which we prefer), the answer to the timing question might be different. The reason for this is that some exposures for which DRM is undertaken are subject to risk mitigation, others are not. Those exposures that are risk mitigated, might be so once they are included in DRM or at a later point in time. Hence, under a scope that is focused on risk mitigation we deem it more appropriate for the PRA to include exposures in the portfolio once risk mitigation is undertaken – which might be the same moment when the exposure occurs (e.g. the entity becomes a party to the contract), but not necessarily. The same logic applies with respect to its removal.

We note the operational issues attached, though. Firstly, inclusion in and exclusion from the portfolio at a point in time different from their inclusion in and exclusion from the DRM would require a clear criterion or trigger that precisely determines the moment of inclusion/exclusion. Secondly, the issue of amortising any upfront amounts would occur. Thus, further consideration is required to address the operational challenges.

Question 24 – Dynamic risk management of foreign currency instruments

(a) Do you think that it is possible to apply the PRA to the dynamic risk management of FX risk in conjunction with interest rate risk that is being dynamically managed?

(b) Please provide an overview of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not.

We refer to our answer to Q25. We do not understand why the proposals in sec. 7.3 of the DP (that Q24 refers to) are separate from those in sec. 8 (that Q25 refers to).

Section 8 Application of the PRA to other risks

Question 25 – 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.

ad (a) Generally speaking, we believe that the PRA should be applicable across industries and/or other risks. However, at a first glance, it seems that the PRA as described in the DP cannot easily be applied to other risks and/or other sectors. Based on the feedback received to date, the PRA does not seem to be even applicable straightforward to all financial institutions with a DRM on interest rate risk, which is due to differences in the banks' business models and their respective strategies under a DRM.

We also acknowledge that the insurance sector would probably not be able to similarly apply the PRA to their risk management for interest risks, given their particular asset liability structure, which is generally different from that in most banks. Moreover, given that the revisions to IFRS 4 are still under consideration by the IASB, it is difficult to judge how a PRA might be applicable to insurance entities. We suggest the IASB closely monitor the developments in that project and take these into consideration when developing the PRA further.

With respect to sectors other than the banking and insurance sectors, we have been reported only limited situations for DRM of interest rate risk: Financial asset/liability management may be something to think about more broadly, management of leasing contracts may be another. Moreover, most of our outreach regarding potential fact patterns relate to risks other than interest rate, in particular commodity and FX.

ad (b) Generally, we do not consider the risk management for other risk factors comparable to interest rate risk management, as most risks affect only one side of the balance sheet.

As regards FX risk, the risk exposures and their management might be the most similar to interest rate risk. Management of net positions is generally the case and occurs frequently. However, from an accounting perspective, FX risk is not comparable to interest rate risk, since IAS 21 *The Effects of Changes in Foreign Exchange Rates* comes into play. Under IAS 21, changes in FX rates would lead to recording gains and losses of risk mitigation instruments as well as of exposures they are mitigating in P&L. The exception to this would be anticipated and firmly committed exposures, for which we see general accounting being applied with no complaints reported. Hence, we do not currently see the need to apply the PRA to FX risk. However, we suggest the IASB reach out to entities to confirm our preliminary findings.

As regards commodity risks, there are major differences between their management and the interest rate risk management.

- Firstly, we are aware of fact patterns where commodity risk is often not identical with respect to sales and purchases. Assume an entity that sells electric power and purchases different fuels and, in addition, electric power: The commodity risks are obviously not, or only in part, identical. Therefore, risk management does not, or only in part, address a net exposure or a net position. Rather, risk management for commodity risk often addresses separate gross positions.
- Secondly, there are also fact patterns where there is no risk mitigation of the full net exposure. Instead, entities manage the full risk exposure from purchases, while there are no comparable risk exposures from sales due to the fact that sales prices (partly) vary with commodity price changes. Thus, risk management comprises either a gross position or a net position with partial risk mitigation only.
- Thirdly, most commodity risk exposures comprise cash flow risks. This is in contrast to (usually fixed) interest rate risk exposures. In addition, it is not obvious how a measurement oriented approach like the PRA may accommodate to cash flow risks.

Overall, it should be noted that the DP does not provide clear indications of how to align the basic concept of the PRA, which appears very bank-specific, to other risks or other industries. We are aware that many entities other than banks indicate that they have not understood the PRA sufficiently in order to be in a position to estimate whether it can be applied or not.

Finally, we are aware that most entities from industries other than the banking and insurance sector are very well accommodated by the new general hedge accounting provisions in IFRS 9. They mostly consider this set of requirements being sufficient for accounting for their risk management or hedging strategies. Thus, there is only a limited, if any, appetite for a further approach.

Section 9 Alternative approach – PRA through other comprehensive income

Question 26 – PRA through OCI

Do you think that an approach incorporating the use of OCI in the manner described in paras. 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?

With one noticeable exception referred to below, our general leaning is that such an approach should not be considered further. This is based on the following reasons:

- Firstly, it is current practice that profit and loss (P&L) is used for fair value hedges, whereas other comprehensive income (OCI) is used for cash flow hedges. Since we consider the PRA being an approach relying on revaluation (and, thus, measurement of risks), it is closer to the concept of fair value hedges, which supports a P&L treatment. We note that a PRA with use of the OCI would have accounting mechanics different from those for cash flow hedges, since the PRA would recognise both the portfolio revaluation amount as well as measurement effects from risk management instruments (derivatives) in OCI – with offsetting effects –, while cash flow hedge accounting relies on accrual accounting – with no such offsetting. Further, we are aware that applying hedge accounting to equity instruments measured at FV through OCI also involves OCI recognition.
- Secondly, if the PRA through OCI was to be applied, one outcome of the PRA would no longer be achieved, which is that interest income and revaluation effects (caused by DRM) can be presented together. Thus, since interest income/expense is presented in the P&L, the revaluation adjustment from the PRA should be presented in the P&L as well.
- Lastly, the nature and purpose of OCI has been under discussion for years and with no clear direction so far. Hence, for the time being we do not support a PRA (or any potential alternative approach) that incorporates the use of OCI.

However, some entities – in particular the insurance sector – expect to have a large population of financial instruments measured under IFRS 9 at FV through OCI. This might constitute a fact pattern that could warrant further consideration of the alternative of a PRA through OCI. We suggest the IASB look into this further as the new approach is developed.