EFRAG
European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 10 October 2014 to commentletters@efrag.org

1 July 2014

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

30. Sitzung IFRS-FA am 02.09.2014
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Dear Sir/Madam,

Re: DP Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging,* issued by the IASB on 17 April 2014 (the 'DP').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG commends the IASB's effort in comprehensively analysing banks' risk management practices and developing new thinking in how to best reflect the effects of such practices on an entity's financial position and performance, having regard for practical difficulties. We note that dynamic risk management is undertaken for open portfolios, in which new exposures are frequently added and existing exposures expire.

In macro hedging, hedging instruments are not designated to hedge specific underlying assets or liabilities. Therefore, it is difficult to apply the existing hedge accounting guidance in IAS 39 or IFRS 9 to macro hedging given the restrictions on eligible hedged items. The existing hedge accounting guidance is only applicable to closed portfolios, as is acknowledged by the IASB in the Basis for Conclusions to IFRS 9. Therefore, a new hedge accounting model for open portfolios, which are managed on a net risk basis, is needed.

However, the IASB has expanded the scope of the project by considering the accounting for dynamic risk management, through revaluation of all portfolios that are dynamically managed, rather than focusing on finding a hedge accounting solution for open portfolios which was the original objective when the project was decoupled from phase III of IFRS 9 on general hedge accounting. We disagree with a scope that focuses on dynamic risk management as we do not believe that revaluing all portfolios that are dynamically managed, regardless of whether or not they have been risk-mitigated through hedging, is decision-useful as it would ignore the amortised cost measurement attribute for financial instruments in the banking book. If further information is required regarding the susceptibility of an entity to risks associated with future market movements then we believe that such extension can only be dealt with through expanded disclosures, not by selection of a measurement basis which is not aligned with the underlying business model.

We therefore urge the IASB to continue developing the model as a hedging solution in accordance with the original objective which is to address the accounting mismatch between the fair value of hedging derivatives and the amortised cost measurement of hedged items. Our responses to the questions in the DP, provided in the Annex to this letter, are given from the perspective of a hedge accounting model - what the DP describes as ‘a scope focused on risk mitigation’ - as we do not support a widened scope including the accounting for dynamic risk management in general. Relying on a scope focused on risk mitigation has the effect of limiting any revaluation to hedged (or risk mitigated) positions rather than the entire dynamically managed position.

However EFRAG is concerned that the suggested approach in the DP that is restricted to mitigated risk (the ‘portfolio revaluation approach’ or ‘PRA’) may trigger significant difficulties with respect to operationality, such as adding or removing exposures to a net position, dealing with changes in behavioural assumptions and identifying situations of overhedging. EFRAG would welcome suggestions from our constituents as to possible ways to mitigate those operational difficulties in practice and still reach an acceptable level of reliability.[1]

If the scope of the project reverted to finding a macro hedge accounting solution that is both operational and sufficiently reliable, EFRAG believes that the most appropriate way to account for these dynamic hedges would be to recognise the changes from revaluing the net open position for the risks actually hedged in profit or loss so as to offset or reduce the volatility generated by the changes in fair value of the hedging instruments.

EFRAG observes that determining the position to be hedged to be acceptable for accounting purposes and able to resolve the mismatch issue requires keeping the model closely aligned with risk management practice, i.e. considering pipeline and forecast transactions, equity model book and behaviouralisation of core deposits and prepayment options. As doing so in a current value hedge accounting model leads to accounting for adjustments in value of items which are not, and should not, be reflected in the statement of financial position, EFRAG is seeking views from constituents as to the understandability of such a model. ERAG would also be interested in hearing from constituents whether the concepts explored in the DP could be applied to a macro cash flow hedging model and if so how that might work.

Furthermore, EFRAG assesses that presentation of the net effects of risk mitigation on the performance of an entity when applying the actual net interest approach enhances the relevance and comparability of an entity’s performance in the income statement. The same is true for the disaggregation of accruals of interest income and expense on the one hand and the net effect of changes in value of hedging instruments and of hedged net open positions on the other hand. EFRAG believes that a net presentation in the Statement of Financial Position is to be favoured as it limits the effects of the model on the presentation of an entity’s financial position.

Finally, EFRAG is of the opinion that an impact assessment is needed during further development of the approach and before release of an Exposure Draft. This would have the purpose of identifying the effects the model will have on the Statements of Financial Position and Comprehensive Income of entities as well as identifying any implementation issues. We believe that, based on initial feedback received, a macro hedge accounting model could be of particular interest to industries such as insurance,

[1] EFRAG intends to assess the answers from its constituents in drafting its final comment letter. The questions themselves will not be part of our final comment letter to the IASB.

utility, pharmaceutical and manufacturing and to other risks, such as commodity price risk and foreign exchange risk in addition to banks and interest rate risk.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Sebastian Harushimana, Benjamin Reilly or me.

Yours faithfully,

Françoise Flores
EFRAG Chairman

Annex

PREAMBLE

1 *In our view, the scope of the project should be limited to risk mitigation. Therefore in answering the questions in the DP we have moved Question 15 immediately after Question 2 so as to explain our reasoning for the mitigated risk option. The order of the remaining questions is retained but our answers are determined by this choice of scope. We note some issues that have not been addressed by the DP in our answer to Question 2 and at the end of this Annex.*

Questions to constituents

2 The DP is developing significant new thinking in this project. As well as the specific questions throughout the Annex, EFRAG would appreciate your overall view as to the usefulness of the proposals. Do you find the resulting information of the PRA understandable and reliable if the scope were to be based on dynamic risk management? Please explain.

3 Do you find the resulting information of the PRA understandable and reliable if the scope were to be based on risk mitigation? Please explain.

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?

Notes to constituents

4 The DP explains that many entities manage risks, such as interest rate risk, on a portfolio basis rather than on an individual contract basis. Such dynamic risk management involves continuous changes as the risks that entities face change over time. For this reason entities rely on open portfolios when managing interest rate risk dynamically.

5 Under the current hedge accounting requirements it is difficult to accommodate such dynamic risk management as current hedge accounting requirements are based upon a one-to-one designation between the hedged item and the hedging instrument. Because of this the IASB has developed a new approach to faithfully represent dynamic risk management.

EFRAG's response

No, we disagree. In our view there is a need to address macro hedge accounting rather than dynamic risk management. The objective of a future macro hedge accounting standard should therefore be limited to addressing risk mitigation. In the context of interest rate risk management in banks, the particular difficulty that arises is due to the mixed measurement model used to represent the results of the banking book and hedging instruments in risk management. It is therefore this difficulty that the proposals should address.

EFRAG also notes that it is not possible for any system of measurement to represent adequately an entity's susceptibility to future risks (i.e. its risk profile) and management thereof. This must therefore be dealt with by appropriate disclosures.

Question 1

6 EFRAG acknowledges that current accounting requirements do not allow entities to reflect the effect of their dynamic risk management in accounting. The current absence of an accounting solution results in a situation whereby entities need to use a patchwork of accounting techniques which may not always faithfully reflect the effects of dynamic risk management actions.

7 In particular, EFRAG notes that the mixed measurement model does not present the effect of the economic offset when derivatives, measured at fair value, are used for hedging positions that are measured at amortised cost. This has the risk that the performance of an entity is affected by an accounting mismatch as the performance presented misrepresents the effects of risk management within the financial statements.

8 We are therefore of the opinion that the objective of a future macro hedge accounting standard should be limited to eliminating accounting mismatches and consequently its scope should be limited to risk mitigation. The DP explores wider objectives that are not necessarily appropriate as they create unacceptable side effects such as increasing volatility in profit or loss unconnected with the entity's performance or business model without achieving the goal of portraying a faithful representation of the performance of the risk mitigation activities.

9 Hence, in EFRAG's view, the specific accounting approach to be developed should not be to 'represent dynamic risk management in entities financial statements'.

10 We do acknowledge that the business practice for dealing with open portfolios of hedged items is not appropriately reflected in current accounting requirements. This business practice relies on a risk management approach that is exercised dynamically. Since market conditions change, risk management within banks adapts its hedging actions in order to fulfil the common strategy of protecting net interest income. Dynamic risk management is also used within other sectors, but there the strategy is not necessarily identical to the one in the banking sector.

11 The risk management approach of some banks is not to manage fair values or current values but is aimed at protecting net interest income irrespective of the profile of future interest rates. Thus, the interest cash flow profile generating the portfolio revaluation adjustment is actually what is being dynamically managed not the resulting discounted calculation of the identified cash flows. This is further discussed in our answer to Question 2.

12 Some banks do not aim to protect the level of net interest income, but aim to lock-in an economic net interest margin on new loans made, including the cost of funding of items classified as equity. Such an approach is frequently taken by banks that extend funding to lending business units on a marginal cost basis, and the transfer prices therefore include an explicit marginal cost of equity, even if that cost of equity is not reflected in the Statement(s) of Comprehensive Income. The cost of equity may change over the lifetime of the assets and therefore the cost of equity may be modelled as a variable rate exposure. EFRAG is concerned that the proposals with respect to the equity model book and core demand deposits assume that these are modelled as fixed rate liabilities, which is consistent with protecting net interest income but is not consistent with the approach for those banks who aim to lock-in an economic net interest margin. The proposals contained in the DP do not appear to have been developed with these banks in mind. EFRAG is of the opinion that the final standard should be applicable to all macro hedging practices.

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 the PRA would address the issues identified? Why or why not?

Notes to constituents

13 The DP notes that the measurement and/or recognition of exposures is done differently in accounting compared to risk management. For example loan commitments to buy or sell commodities are not usually recognised for accounting purposes at the time an entity enters into a contract. Such contracts are however considered from a risk management perspective.

14 Portfolio hedge accounting requirements for interest rate risk within IAS 39 captures hedge accounting relationships on a static basis, i.e. it does not take into account that new exposures are added and existing exposures are removed or replaced on a continuous basis. Dynamically managed risk portfolios are thus usually open portfolios.

15 The DP explains that while demand deposits have a contractual maturity of one day, in practice customers hold on to these deposits for a longer period of time. Risk management takes this longer period into account when designating demand deposits in a hedge relationship.

16 Additionally the DP explains that risk management considers all items which represent an exposure to a certain risk to the entity irrespective of the accounting recognition and measurement requirements for those items. Banks may thus consider that they are exposed to interest rate risk from fixed interest rate exposures that have not been contracted yet, such as pipeline transactions.

17 The DP explains that as a consequence of these shortcomings many entities find it difficult to faithfully present the outcome of their dynamic risk management activities in their financial statements. Some entities have stopped hedge *accounting completely, some entities apply it selectively only and some entities use proxy hedging techniques. The lack of a solution in the current accounting framework has therefore resulted in a patchwork presentation that may not always represent the effect of dynamic risk management.*

EFRAG's response

EFRAG agrees that the DP has identified and discussed many of the main issues. We note it has focussed at this stage on interest rate risk management and therefore has not really explored the nature of other risks and the way they may be managed.

Questions 2 (a) and 2 (b)

18 EFRAG welcomes that the DP identifies and discusses some issues which prevent banks from applying an appropriate hedge accounting solution: in particular the sub-LIBOR issue, the reliance of banks on core deposits, the use of the equity model book and the use of bottom layers.

19 In addition to these important issues discussed in the DP we identify below other issues worthy of consideration.

Accounting for dynamic risk management on accrual basis

20 The DP does not recognise that some banks account for their dynamic management of interest rate risk on an accrual basis and not on a revaluation basis. The revaluation adjustment can represent different risk profiles depending on the time buckets the cash flows are assigned to and the discount factors being used. A different interest profile over time implies that risk mitigation cannot be based on a constant number and static characteristics of risk management instruments to achieve offset. As a consequence, some banks choose to manage their interest rate risk profiles on a cash flow basis rather than on a valuation basis. In doing so, those banks recognise the interest cash flows and the corresponding interest income from risk management instruments in profit or loss as rights to it arise, i.e. as they are accrued.

Measurement of derivatives and impact on offset with the revaluation adjustment

21 EFRAG notes that the market practice for measuring derivatives has changed. This change in market practice may lead to an offset between the portfolio revaluation adjustment and the external derivative(s) that is less than perfect. Although this is due to a cause independent of the portfolio revaluation approach, it would affect its outcome.

22 For example, assume that the business unit grants a loan that is not collateralised. The corresponding revaluation adjustment is calculated using an interest rate curve taking the absence of collateral into account. We further assume ALM transfers the interest rate risk of the loan to the trading function with an interest rate swap. The trading function externalises the position and collateralises the interest rate swap. As a consequence, the external derivative of the trading function may not fully offset the revaluation adjustment from the loan in profit or loss.

23 Before the financial crisis the standard market practice in valuing derivatives was based on a single interest curve. This single curve was used to price and hedge interest rate derivatives on a given currency. This approach is no longer consistent with current market practice for the following reasons:

(a) Pricing of external derivatives takes into account differences in tenors resulting in different tenor-specific interest rates (tenor basis spread);

(b) Currency basis spreads have become important;

(c) Adjustments for credit risk valuation (credit risk on the counterparty) and debt risk valuation (own credit risk) are taken into account;

(d) Collateralised derivative positions are discounted at the overnight interest rate curve. Non-collateralised derivative positions will be discounted differently; and

(e) The use of day count conventions to calculate interest e.g. 30/360 or actual/actual.

24 Derivatives are therefore now measured using multiple interest rate curves. This could lead to 'noise' in offsetting the fair value of the external derivative with the revaluation adjustment to be recognised in profit or loss as trading result.

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 (i.e. a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (i.e. 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?

Notes to constituents

25 Section 5 of the DP discusses two potential scope alternatives, and in particular whether the focus should be on dynamic risk management or whether the focus should be on risk mitigation.

26 Dynamic risk management has three key elements: risk identification, analysis and mitigation. Under a focus on dynamic risk management the presence of any one of these three elements would be sufficient for an exposure (from a portfolio of underlying instruments) to be included in the portfolio revaluation approach.

27 For example, a bank with retail and corporate banking business lines may only dynamically manage interest rate risk in the retail banking business. A focus on dynamic risk management would mean all interest rate exposures in the retail *banking business (composed of numerous portfolios and sub-portfolios) would be included in the portfolio revaluation approach, regardless of whether any net position has been hedged.*

28 The DP states that this means the financial statements would provide a complete picture of an entity's managed net open risk position and risk management instruments because both of these would be revalued (the net open risk position by reference to the managed risk and risk management instruments at fair value), irrespective of whether they have been hedged. Unhedged exposures would be revalued with no offsetting effect from risk management instruments. This is stated to be consistent with the economic position.

29 Some who support a focus of dynamic risk management believe it would enable users of financial statements to understand the profits and risks of an entity by profit source. Financial statements would also reflect the impact of risk management activities, including the decision to hedge or not to hedge, directly in the primary statements without relying on additional disclosure.

30 The DP acknowledges that the revaluation of open positions that are not hedged will generate volatility in the income statement, which may not be relevant in understanding dynamic risk management activity and may also impair comparability. Some argue that the only economic difference between entities that undertake dynamic risk management and those that do not is the act of hedging. For example, entities with an amortised cost portfolio for which dynamic risk management is not undertaken would not reflect volatility from open positions. In contrast, those entities that did undertake dynamic risk management but not risk mitigation through hedging would report a more volatile profit or loss.

31 The DP proposes a second alternative approach for the scope that focuses on risk mitigation. A focus on risk mitigation captures dynamic risk management only when all three elements of dynamic risk management are present (risk identification, analysis and mitigation through hedging). Therefore a focus on risk mitigation would mean the portfolio revaluation approach would only apply to those portfolios that have been hedged.

32 The DP states that supporters of this scope believe that applying the PRA to unhedged open risk positions does not provide useful information about dynamic risk management activities and a decision not to hedge net open risk positions should not lead to volatility in net income.

33 The DP identifies two approaches within the scope of a focus on risk mitigation, which are what it calls a sub-portfolio approach and the proportional approach.

34 Under the sub-portfolio approach application of the portfolio revaluation approach would be limited to the sub-portfolios that are managed dynamically for which risk mitigation or hedging activities have been undertaken.

35 Under the proportional approach, the portfolio revaluation approach would be applied in a proportion that reflects the hedging activity from dynamic risk management.

36 The DP notes that applying the revaluation approach only to items that have been hedged creates a challenge in isolating those hedged items under the proportional or the sub-portfolio approach. The DP argues that this would require significant tracking effort to distinguish hedged from unhedged items since risk exposures within open portfolios are changing continuously.

EFRAG does not believe the PRA should be applied to all managed portfolios. As outlined in our response to Question 1, EFRAG is of the opinion that a macro hedge accounting solution should ensure that the reported performance on an entity is not distorted by the accounting mismatch arising from accounting for hedging instruments at fair value and hedged items at amortised cost. Providing a representation of 100% of the interest rate risk included in managed portfolios would not meet the objective of eliminating the accounting mismatch, and in fact would result in reconsidering the amortised cost attribute for a number of financial instruments being hedged. For this reason EFRAG supports a scope focussed on risk mitigation, which would mitigate the effects of the accounting mismatch.

Question 15 (a)

37 EFRAG supports a scope focussed on dynamic risk mitigation and does not believe a focus on dynamic risk management, as defined in the DP, is appropriate.

38 A model bringing an overlay of current value on all managed portfolios would, de facto, contradict the conclusion reached in IFRS 9 *Financial Instruments* that the major part of banking books' financial instruments are best measured at amortised cost and that such measurement results in decision-useful information.

39 Furthermore, a scope based on dynamic risk management would result in the revaluation of all net open risk positions which goes far beyond the objective of the project which is to eliminate the misrepresentation resulting from the accounting mismatch between the fair value measurement of the hedging instruments and the amortised cost measurement of the hedged items. Revaluing all open net risk positions would not assist in understanding the performance of the entity and would introduce irrelevant, and potentially significant volatility in net income which would not be decision-useful as negating the amortised cost measurement attribute. Given that one of the key reasons for dynamically managing interest rate risk exposure is to reduce volatility unrelated to business performance, revaluing all open net positions would not be a fair representation of the effects of risk mitigation. Retaining the amortised cost for unhedged positions would be consistent with the measurement attribute of such positions. The intent of the project should not be the implicit recognition that the measurement model for loans is inappropriate but to address an accounting mismatch.

40 A scope focussed on risk mitigation, on the other hand, reflects one of the goals of dynamic risk management in protecting net interest income.

Question 15 (b)

41 EFRAG does not believe that information presented, if the scope was based on dynamic risk management (as defined in the DP), would provide useful information. Although the approach may reflect the extent to which risk management has decided to close open net risk positions included in dynamic risk management, it would provide limited information useful for predicting future net cash inflows (providing information to enable this being an objective of financial reporting as defined in the Conceptual Framework for Financial Reporting), i.e. projecting future net interest income. This is because:

(a) some exposures are notional exposures (the equity model book and core deposits) which, as EFRAG understands, are included in risk management to the extent they fund income producing assets;

(b) a focus on dynamic risk management would reflect the extent to which identified exposures have not been mitigated: this in itself does not provide insights into future cash flows, as the revaluation does not provide more than a value at a point in time. It would not provide any information on how well the entity has identified and measured risk exposures, including those measured using behavioural techniques. Such information can only be conveyed through appropriate disclosures which are required whatever measurement basis is used;

(c) it would substantially eliminate the amortised cost basis of accounting by providing for revaluation of such instruments thereby negating the decision-usefulness achieved by such measurement attribute;

(d) analysis of net interest income may be made difficult by the volatility generated by the revaluation of the entire net open positions; and

(e) tenor and any basis risk that is not included in dynamic risk management are not included in the macro hedge accounting model.

Question 15 (c)

42 EFRAG believes that the PRA as proposed by the IASB presents operational challenges regardless of the scope chosen.

43 The scope based on dynamic risk management would require tracking individual exposures since, for example, the model requires the reversal to the income statement of the revaluation adjustments related to risk exposures that are expired or disposed of. The behavioural cash flows under dynamic risk management would also require some tracking to reflect changes in customer behaviours or changes in assumptions taken in layering approaches. Another example of tracking mentioned in the DP is the need to amortise day one revaluation adjustments if risk exposures were allowed to be transferred to dynamic risk management after they have been originated. Also, when catch-up revaluation adjustments arise from changes in behavioural estimates, tracking would be required.

44 A scope focussed on risk mitigation as defined in the DP would also require tracking effort given the need to reflect, in profit or loss, revaluation adjustments related to extinguished exposures that were being hedged and to track the hedged items. We elaborate on this further in our answers to Questions 6, 7, 22 and 23.

Question 15 (d)

45 EFRAG's answers to questions 15(a) to 15(c) are equally valid for other managed risks. Therefore, we encourage the IASB to develop the application of the model to other risks and industries before the ED is published.

All questions below are answered based upon our preference for a risk mitigation approach.

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?

Notes to constituents

46 *The DP describes a portfolio revaluation approach for banks with respect to interest rate risk which is being managed on a dynamic basis.*

47 *The DP describes dynamic risk management as usually having the following characteristics:*

(a) *Risk management is undertaken for open portfolios, to which new exposures are frequently added and existing exposures expire; and*

(b) *As the risk profile of the open portfolio(s) changes, risk management is conducted on a timely basis in reaction to the changed net risk position.*

48 *In addition to these main characteristics the DP notes that dynamic risk management may show some of the following characteristics:*

(a) *In the context of interest rate risk management the objective may be to keep the net interest income from the open portfolio(s) within a targeted sensitivity to changes in market rates;*

(b) *Risk management may be based on open portfolios that include exposures based on estimates in terms of volume and/or timing of the cash flows; and*

(c) *Only risk arising from external exposures is included within the managed portfolio.*

EFRAG's response

EFRAG agrees that many of the characteristics accurately depict dynamic risk management within banks. However, it is unclear whether these characteristics also cover dynamic risk management in other sectors.

Question 3

49 EFRAG agrees that many of the characteristics describing dynamic interest rate risk management accurately reflect dynamic interest rate risk management within banks. However, EFRAG believes that some of these characteristics do not reflect dynamic risk management strategies in all banks as well as in other sectors. EFRAG recommends that the IASB investigate whether the portfolio revaluation approach for hedging net interest rate risk could be applied by all banks as well as by other industries, such as insurance, and for other risks.

50 For example, insurance companies manage their portfolios of assets and liabilities by duration and cash flows. The investment strategy is, to a large extent, liability driven. The main source of risk for life insurance liabilities is the interest rate risk exposure due to minimum guaranteed returns to policyholders. Traditional life insurance products provide long-term guaranteed benefits, which generate exposure to declining interest rates, as insurers earn lower returns on their reinvestments of premiums and maturing financial assets. In life insurance, assets

typically have shorter maturities than the liabilities they support – in some jurisdictions, liabilities have expected cash flows of up to 80-100 years. This duration gap is managed on a portfolio basis. It is partly narrowed by the use of derivatives.

51 Under current IFRSs, the economic asset and liability management tools lead to accounting mismatches, as derivatives are measured at fair value and insurance liabilities are currently measured at cost in some countries. Macro hedge accounting solutions are therefore needed to reflect the dynamic risk management of insurance companies, in particular to manage the interest rate risk exposure.

Question 4 – Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

(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 for Financial Reporting (the Conceptual Framework)*.

EMB

(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 account operational feasibility, usefulness of the information provided in the financial statements and consistency with the *Conceptual Framework*.

Behaviouralisation

(c) For the purposes of applying the PRA, should the cash flows be based on a behaviouralised rather than 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*.

Notes to constituents

52 Pipeline transactions: According to the DP, 'pipeline transactions' are forecast volumes of drawdowns on fixed-rate products at advertised rates. The DP notes that pipeline transactions may pose conceptual challenges in that including them in the portfolio revaluation approach amounts to recognising adjustments in the statement of financial position of items that are not yet assets and liabilities.

53 However the risk exposure in pipeline transactions may be viewed as being economically the same as writing short term put options to customers to enter into a fixed rate product at a predetermined rate, because the issuer may feel it has to have no reasonable alternative but to accept customers' transactions on the basis of the advertised offer. Whether pipeline transactions may result in a constructive obligation that satisfies the definition of a liability under the conceptual framework will depend on facts and circumstances.

54 With regard to forecast transactions other than pipeline transactions, the DP does not propose to include them in the portfolio revaluation approach as they do not *represent an existing revaluation risk. Instead, the DP notes that cash flow hedges are the most appropriate hedge accounting to be applied to forecast transactions if their certainty satisfies the 'highly probable' criterion in IFRS 9.*

55 *Equity model book: The DP explains that some banks disaggregate the return on their own equity into a base return similar to interest, i.e. compensation to their equity holders for providing funding, and a residual return over and above the base return. The base return is then replicated by considering a hypothetical portfolio of products that represent an interest rate risk similar to the base return. This is called a replication portfolio and is known as the 'Equity model book' when included in the dynamic risk management of interest rate risk. No actual interest expense would be paid (or recognised in the statement of comprehensive income) with respect to the EMB replication portfolio, but including the EMB within the managed portfolio allows the bank to manage its interest rate risk in such a way that the target base return for equity holders is protected.*

56 *Behaviouralisation: Mortgages with a fixed interest have a contractual life but can generally be prepaid at any time by the borrower upon the payment of a penalty to the bank. The DP explains that for risk management purposes the interest rate risk of prepayable open portfolios is determined taking into account behavioural expectations on the prepayments. Similarly, banks manage interest rate risk for demand deposits on a behavioural basis by identifying a core element of the demand deposit portfolio. This core element is assumed to have a longer term interest rate profile.*

EFRAG's response

Dynamic risk management employs risk management instruments which, for accounting purposes, are measured on a different basis than the risk-mitigated items. EFRAG considers that any approach that aims to represent faithfully the impact on performance of dynamic risk management actions should aim at limiting accounting mismatches to the extent feasible.

EFRAG therefore believes that to reach the maximum offset between the revaluation adjustment and the changes in value of hedging instruments in the PRA applied to risk mitigation only, a hedge accounting model would have to incorporate all items that contribute to the identification of the managed risk exposure that serves as a basis for the identification of hedged positions. EFRAG agrees that pipeline transactions, the equity model book and core deposits be included. EFRAG asks its constituents whether forecast transactions should also be included.

Question 4 (a)

57 EFRAG agrees with the view that exposure from pipeline transactions are eligible for inclusion for hedge accounting purposes. Pipeline transactions are forecast volumes by banks of draw-downs on fixed-rate products at advertised rates. Although these forecast volumes do not yet contain a contractual commitment by any party, EFRAG agrees that, once the terms and conditions are advertised, an exposure to interest rate risk is borne by the bank based on the commitment to enter into transactions on the basis of a general public offer to all customers (a past event). This is the case where the issuer has historically honoured its commitments under the advertised offer to the extent that the issuer now finds no realistic alternative but to accept applications made on the basis of the offer. This is similar to the proposal in the ED *Insurance Contracts* defining the boundary of

insurance contracts based on the existence of a substantive obligation to provide coverage.

58 EFRAG acknowledges that the revaluation approach is different from a general cash flow hedge in that it focuses on the part of value change of underlying items attributable to a specific risk, such as an interest rate risk, while the cash flow hedge focuses on the exposure to cash flow variability. Therefore, including pipeline transactions in the revaluation approach would presume the existence of revaluation risk for exposures with no revaluation risk from an accounting perspective. It would result in recognising items of income and expenses that are not derived from changes in recognised assets and liabilities. Furthermore, EFRAG notes that the revaluation approach for pipeline transactions is different from the fair value hedge of a firm commitment, which is based on a fixed interest rate risk of contractual rights.

59 However, on the basis that those transactions are considered by the issuer as binding on the basis of a general public offer to all customers, EFRAG supports the inclusion of pipeline transactions as hedgeable items under the revaluation approach.

60 Many banks include forecast transactions (new production) within their dynamic risk management portfolio, including banks which specifically match funding. If the PRA is to faithfully represent dynamic risk management forecast transactions should be included in the scope.

61 Before deciding on the inclusion of forecast transactions (new production) however[2], EFRAG wishes to ask its constituents whether such transactions should be included as part of an approach based on risk mitigation. Including forecast transactions would reflect assumptions made by risk management. In addition, removing the estimated interest exposure to new production from the overall net interest position would increase complexity.

62 In contrast, 'new production' is different from pipeline transactions in the sense that there are no terms offered (no past event) and no risk exposure exists at present. Further, including future new production provides a considerable degree of freedom, and the assumptions made would be difficult to challenge as they relate to future commercial decisions based on an assessment of future macro-economic factors.

Questions to constituents
63 Do you think that forecast transactions should be included in a portfolio revaluation approach based on risk mitigation? Please explain why or why not.

Question 4 (b)

64 EFRAG acknowledges that some banks include the impact of equity model book exposures when dynamically hedging interest rate risk. EFRAG notes that if equity model book exposures were excluded non-existing volatility would be depicted in

[2] In its comment letter to the IASB EFRAG will present the view it will have formed after due consideration of all input received.

net interest income. Such volatility would follow from defining a net risk position based on assets alone without including (part of) the funding used to finance those assets. Such volatility is not consistent with the overall objective of the risk mitigation approach, which is to portray the effects of risk management activities that are carried out with the objective of protecting net interest income, but would arise merely because some of an entity's assets are funded by equity rather than liabilities. For these reasons the equity model book should be eligible as a hedged item if it was considered by an entity as such in its interest rate risk management.

65 EFRAG does not believe that the revaluation of the equity model book has a meaning in itself because:

(a) the inclusion of exposures from equity are notional exposures to simplify risk management rather than a reflection of a real economic exposure of the reporting entity (similar to the core deposits issue); and

(b) there is no accounting cost related to equity reflected in the financial statements.

66 EFRAG also notes that inclusion of the equity model book lead to an inconsistency with the Conceptual Framework for Financial Reporting, but believes that it is appropriate in this case given the role of a hedge accounting model that seeks to reduce the impact of accounting mismatches.

Questions to constituents
67 In our answers to Questions 4 (a) and 4 (b) above, we support reporting elements of valuations and changes thereto of items which are not recognised in the Statement of Financial Position. In your view, what would be the effects of such requirements on the understandability of financial statements? Please explain.

Question 4 (c)

68 EFRAG agrees with the use of behavioural assumptions as a means to estimate the cash flows to be included in the portfolio revaluation approach, because:

(a) Relying on risk management for defining behavioural cash flows increases operational feasibility, as the identification of the cash flows is done already within the entity; and

(b) Doing so also increases the relevance and hence the usefulness of the information provided in the financial statements as using another basis (such as contractual cash flows) would misrepresent the efforts from dynamic risk management to hedge the risks related to the portfolios.

69 The Discussion Paper related to the Conceptual Framework discusses how cash-flow measures other than estimates of current prices could be considered as consistent with the Conceptual Framework. Behavioural estimates are nothing more than estimations when and to what extent cash flows will occur. Therefore EFRAG is of the opinion they are in line with the Conceptual Framework definition.

70 EFRAG notes that, where changes in behavioural assumptions affect the Statement of Comprehensive Income, it would be very easy to change the assumptions to reflect a particular outcome and hence lead to earnings management. Therefore, EFRAG thinks additional safeguards such as internal

controls are necessary when including behavioural assumptions as part of the portfolio revaluation approach in order to avoid overly simplistic or general assumptions. Such safeguards could be similar to what is foreseen in insurance accounting for surrender options.

71 EFRAG does not believe that guidance would be helpful in describing how behavioural assumptions ought to be developed. Practices differ from entity to entity and estimations require extensive judgement: there is no single behavioural outcome for all entities. For example: one bank may estimate its core deposits to have a maturity of five years, while another bank may estimate the maturity to be six years.

72 In order to address any diversity in practice, disclosures could help users understand the assumptions being used by the entity and the internal control procedures that overlay risk management.

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.

Notes to constituents

73 Mortgages with fixed interest have a contractual life but can generally be prepaid at any time by the borrower upon the payment of a penalty to the bank. However, that penalty may in some jurisdictions not fully compensate the bank for differences between the original interest rate on the prepaid loan and current interest rates. In some countries or for some products within certain countries prepayments could be made without any penalty at all.

74 The DP notes that risk management is applied to interest rate risk from managed portfolios of prepayable instruments after applying behavioural expectations about prepayments and not based on the contractual lives of the exposures. Consequently, changes in the economic value of inherent prepayment options impact the revaluation adjustment. Different methods exist to determine the impact: an entity can modify the cash flows when prepayment risk is managed using behavioural estimates, or it can revalue the inherent prepayment option if prepayment risk is managed using options.

75 If prepayable portfolios are managed in a behavioural way, including such behavioural cash flows in the managed portfolio would reflect risk management. When prepayment options change, it would affect the revaluation adjustment as calculated according to the portfolio revaluation approach, because managed exposures would be updated to reflect current expectations.

76 When interest options are used the DP notes firstly that it would be uncommon that a bank would manage its entire interest rate risk exposure using only options. Thus risk management instrument with and without optionality are being used to manage interest rate risk. Secondly, the DP notes that options may be used as risk management instruments to protect only the net open risk position from changes in the downside risk, because risk management wants to be able to benefit from favourable changes in interest rates. This is referred to as one-sided risk.

77 The DP further notes that one-sided risk is unlikely to be determined at a constant level as dynamic risk management is undertaken continuously. As a result risk management instruments would have been entered into with different terms, including different strike rates. This would make it operationally difficult to restrict the managed risk as one-sided risk.

EFRAG's response

Risk management instruments with optionality which are used in a risk mitigation approach should be considered as a protection against a decrease in interest income. Any profits resulting from the use of risk management instruments with optionality are not the result of trading and remain part of interest income.

Question 5

78 The objective of macro hedging within banks includes securing the desired level of net interest income. Unexpected prepayments will generally take place in an environment of declining market interest rates as customers will want to take advantage of lower interest rates to replace their existing – more expensive – loan with a less costly one.

79 EFRAG considers that banks may rely on risk management instruments with optionality to protect themselves against the potential loss of interest income when loans are being prepaid in a declining market rate environment. There is no need to protect the upside of the interest rate margin as this would result in an additional profit. Even if such an unexpected profit were to occur, EFRAG does not consider this to be a trading position. Consequently, EFRAG is of the opinion that the use of such risk management instruments with optionality can contribute to the results from dynamic risk management and should be fully regarded as genuine hedging instruments.

80 EFRAG considers that revenues should be labelled as trading only when the entity takes an open position on both sides of the margin.

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?

Notes to constituents

81 The portfolio revaluation approach requires that changes in the behaviouralisation of cash flows that are included within managed portfolios are reflected when calculating the revaluation adjustment from those portfolios. Changes in the revaluation adjustment, consistent with other changes in revaluation, would be recognised in profit or loss.

EFRAG's response

EFRAG asks help from its constituents in determining how (changes in) hedging instruments and the underlying hedged net position are being identified and recognised for accounting purposes.

Changes in expected customer behaviour are not to be included in the revaluation adjustment until risk management decides to hedge these changes. Consequently, EFRAG agrees that they should be recognised in profit or loss when they are being hedged and included in the revaluation adjustment.

Question 6

82 EFRAG considers that when changes in expected customer behaviour occur, or more generally, when a change in the net position occurs, and if such changes are material enough to require a change to the hedging instruments, an entity which applies dynamic risk mitigation may respond to this in different ways.

83 A first approach is to add or remove layers of risk management instruments. For example adding additional risk management instruments may be used to address an overhedged situation. One could argue that it would be necessary to identify on the one hand, that part of the net position which is risk mitigated by the 'old' risk management instruments and, on the other hand, that part of the net position which is risk mitigated by the 'newly added' risk management instruments. However, such an approach would involve tracking. A second approach is to add or remove risk exposures to/from a net position in order to keep the net position 'stable'. Also, one could argue that it would be necessary to differentiate between the 'old' part of the net position and the 'newly added' part of the net position. This approach would also require tracking.

84 An additional complexity is that, in contrast to the accounting requirements, dynamic risk management may not view hedged items and hedging instruments as artificial opposites with changes in value offsetting each other. Instead both may be comingled as part of one overall risk position.

85 EFRAG does currently not know how under such circumstances (changes in) hedging instruments and the hedged net position could be identified and accounted for.

Questions to constituents

86 Under a dynamic risk mitigation approach, how would you identify and recognise hedging instruments and the according hedged net position for accounting purposes? Please explain.

87 Under a dynamic risk mitigation approach, how would you identify and recognise changes in hedging instruments and the offsetting hedged net position for accounting purposes? Please explain.

88 When changes in expected customer behaviour occur these might not necessarily be hedged by the entity. In this case, EFRAG sees no reason why these changes should affect the performance from risk mitigation in profit or loss. Once risk management decides to hedge the changes in expected customer behaviour, for

example because the change has become material, EFRAG supports their inclusion in the revaluation adjustment.

89 However, EFRAG is concerned that permitting changes in behavioural assumptions to affect the Statement(s) of Comprehensive Income could lead to earnings management as discussed in our answer to Question 4 (c).

90 EFRAG is of the opinion that reliance on a bottom layer that has been 100% hedged could help to resolve the issues related to continuous changes as described above (see our answer to Question 7). When an entity uses a bottom layer approach only, this bottom layer would be considered to fall within the scope of the PRA based on risk mitigation. This solution would avoid any tracking and amortisation issues, unless the prepayments became so significant that the bottom layer was breached. Such a breach should be recognised immediately in profit or loss as it represents ineffectiveness.

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 believe 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.

Notes to constituents

91 The DP notes that risk management of pre-payable portfolios is often done making use of a bottom layer approach. Under such an approach, risk management divides a pre-payable portfolio into two layers, a bottom layer and a top layer. Risk management additionally assumes that all prepayments of loans in the portfolio take place in the top layer and subsequently only hedges the bottom layer of the portfolio. In doing so risk management ignores the possibility that there may be prepayments in that bottom layer and hedges only the re-pricing risk of that layer. As prepayments would influence the effectiveness of the hedge relationship, hedging a bottom layer only will reduce the possibility of an ineffective hedge relationship.

92 Open portfolios are not composed of homogenous financial instruments as new financial instruments can be added with terms based on different market conditions. As the portfolio is not homogenous, it will be difficult for entities to determine which exposures within the portfolio compose the bottom layer. Consequently, the DP states that it is not possible to include a bottom layer approach without introducing tracking and amortisations.

93 The DP notes that a similar conclusion occurs when the portfolio revaluation was based on a proportion of the exposures in a portfolio and the hedged proportion were to increase. The increase in the hedged proportion would require tracking and amortisation and thus would result in an increase in operational complexity.

EFRAG's response

EFRAG believes that a bottom layer approach and a proportional approach both lead to operational complexity and will require tracking although relying on a bottom layer may be less burdensome. Therefore EFRAG supports reliance on a bottom layer approach. EFRAG wishes to ask its constituents how they would deal with the operational complexity of both approaches.

Question 7

94 EFRAG supports an approach based on risk mitigation as explained in our answer to Question 15. EFRAG does not believe that any approach will eliminate tracking, as cash flows relevant to the managed risk will need to be identified, included in risk management, and removed from risk management as the bank's exposures change.

95 One may argue that when a bottom layer of a portfolio of prepayable assets is part of a net position and only a proportion of the net position is being risk mitigated, it may be difficult to identify whether the full bottom layer is included in that hedge or not. EFRAG agrees that such situations would create operational complexity because, in this example, the proportional approach of the net position overrides the bottom layer approach applied to a part of the net position, i.e. a portfolio of prepayable assets, and will thus require tracking.

96 Under a scope based on risk mitigation, EFRAG considers a bottom layer of a portfolio of prepayable assets as a specific application of a proportional approach. EFRAG supports the reliance on a bottom layer as it is in line with risk management practice and, when used in isolation, i.e. not in the situation described in the previous paragraph, it could avoid operational complexity except when it is breached. As such reliance on a bottom layer approach could thus be less operationally burdensome than reliance on a proportional approach.

97 If an entity used a bottom layer approach, only this bottom layer would be considered to fall within the scope of the PRA based on risk mitigation. This solution would avoid any tracking and amortisation issues unless the prepayments become so significant that the bottom layer is breached. Such a breach should be recognised immediately in the profit or loss as it represents ineffectiveness.

98 When a bottom layer is breached this leads to a situation whereby the entity is overhedged. EFRAG notes that in such cases any lack of offset should be recognised in profit or loss immediately as such a situation could be seen as taking a position on the underlying risk. However, when dynamically risk mitigating, entities may address a situation of overhedging in different ways. Some entities may choose to remove a layer of risk management instruments to the hedged position, others may choose to add similar risk exposures to the net position being hedged. Both situations would require tracking to reflect the changes occurred as explained in paragraph 83 above.

99 When an entity uses a proportional approach, changes in the proportion being hedged would require tracking and increase the complexity of the model.

Questions to constituents

100 Do you agree that the operational challenges of dealing with a bottom layer would be less than dealing with a proportional approach? Please explain how you would deal with the operational complexity of both approaches.

101 Please describe how you would identify and deal with an overhedged situation of a dynamically risk mitigated net position?

Question 8 – Risk limits

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

Notes to constituents

102 Risk limits are entity specific thresholds set for risk levels that entities are willing to accept.

103 As long as a net open position remains within an entity's risk limit, the entity would conclude there is no need to hedge that net open position because that level of risk is accepted by the entity. Only when the net open position exceeds the risk limit, the net open position would be hedged. For the accounting it would mean that there should be no volatility in profit or loss as long as the net open position remains within the risk limits set by the management. Thus, the wider the risk limits are, i.e. the greater the risk tolerance of the entity, the less volatility profit or loss would show.

104 The IASB does not support the introduction of risk limits in the new model.

EFRAG's response

EFRAG acknowledges that entities apply internal risk limits in their hedging strategy and does not agree with the introduction of externally imposed risk limits. We believe that qualitative disclosures should be used to provide transparency on the use of risk limits.

Question 8

105 EFRAG recognises that risk management does not only consider *how* to mitigate risk positions but also *the extent to which* a risk position needs to be mitigated. EFRAG considers that the use of internal risk limits as defined by the asset and liability management function is subject to internal control processes and regulatory oversight. EFRAG sees therefore no reason why accounting should impose additional risk limits on the risk management activity.

106 Qualitative disclosures could be used to provide insight for users on the use of risk limits.

Question 9 – Core demand deposits

(a) Do you believe 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 believe that guidance would be necessary for entities to determine the behaviouralised profile of core demand deposits? Why or why not?

Notes to constituents

107 Banks often view core demand deposits as creating interest rate risk even if they pay no or negligible interest. Core demand deposits may include demand deposits, such as current account balances, savings accounts and other accounts that behave in a similar manner. While these deposits can be withdrawn at little or *short notice, typically they are left as a deposit for a long and generally predictable time despite the low interest paid.*

108 *Even though the total balance from all such customer deposits may vary, a bank typically determines a level of core demand deposits that it believes will be maintained for a particular time frame, and hence will behave for that time frame like a term fixed interest rate exposure from an interest rate risk perspective. The bank cannot determine which customer deposits will make up the core demand deposits. Existing and new deposits are fungible for dynamic interest rate risk management purposes as new deposits will usually be on the same terms as any withdrawn deposits that they replace.*

109 *These deposits behave more like a fixed interest rate portfolio than the contractual terms specify. Banks model this aspect of customer behaviour by assuming that there is a deemed exposure to interest rate risk arising from such deposits.*

110 *When managing interest rate risk, banks treat core demand deposits differently to the rest of the demand deposit balance. Given the assumed stable nature of the core demand deposits, banks treat them as fixed interest rate funding and impute a fixed market interest rate and term for dynamic risk management purposes.*

111 *The IASB's preliminary view is that the PRA should incorporate this element of dynamic risk management in the accounting. Under the PRA the deemed interest rate profile of the core demand deposit portfolio is considered as part of the managed portfolio.*

112 *As selecting an appropriate term and volume for core demand deposits involves judgement, information that reflects the deemed interest rate risk profile from these deposits may be useful to users of financial statements. Additional disclosures on key assumptions (for example, expected or behavioural maturity) may be helpful for users of financial statements to understand the effect of considering such exposures and their relevance in dynamic risk management. In addition, it may be appropriate to consider whether guidance is required to determine the behaviouralised profile of core demand deposits for the purposes of inclusion in the PRA.*

EFRAG's response

EFRAG believes that behaviouralised exposures from core demand deposit portfolios should be eligible for inclusion in hedge accounting.

Selection and identification of a core demand deposit portfolio requires extensive judgement rather than the application of accounting concepts with associated guidance. EFRAG therefore believes appropriate disclosures are necessary for users to understand both the inclusion of exposures from core demand deposit portfolios and how these have been hedged.

Question 9(a)

113 In defining the net position being hedged a bank has a net long fixed interest rate position (which incorporates exposures from loans, borrowings and risk management instruments). Including the notional exposures from core deposits simplifies risk management in that it enables the objective to be a neutral position with respect to the hedged risk. EFRAG therefore supports its inclusion in the net position.

Question 9(b)

114 EFRAG agrees with the DP that the selection and identification of a core demand deposit portfolio requires extensive judgement. EFRAG does not believe that guidance would be necessary for entities to determine the behavioural profile of core demand deposits because this would be inconsistent with reflecting the effects of risk mitigation.

115 If banks are dynamically hedging core demand deposits then they already have methodologies in place. Given that due to the extent and nature of judgements required for determining a core demand deposit portfolio there can be very little comparability, EFRAG believes any marginal benefit would not be worth the associated cost. Disclosures should instead be included to enable users of financial statements to understand how the bank views core demand deposits, including the methodology around estimation, how these methods have changed and the impact of changes in estimates and policies.

116 This is important because the revaluation of the notional core demand deposit exposures could have a material impact on reported performance. Unless there are sufficient disclosures around changes in estimates it may be difficult to understand to what extent reported performance is driven solely by changes in an entity's estimates.

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 approach (i.e. Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (i.e. Approaches 1 and 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 provide an appropriate reflection of the risk attached to sub-benchmark instruments? Why or why not?

(b) If sub-benchmark variable 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?

Notes to constituents

117 Some financial instruments are priced at an interest rate based on a benchmark index less a margin. These are often referred to as 'sub-benchmark instruments' (or 'sub-LIBOR'). It is common for only the benchmark interest rate risk from these financial instruments to be included within dynamic risk management.

118 When sub-benchmark financial instruments pay a variable interest rate that is linked to the benchmark, they generally include an embedded floor so that the coupon cannot be negative. Typically, risk managers do not include the interest rate risk from the embedded floor within their managed portfolio.

119 However, the embedded floor has an economic effect on the bank's interest rate risk profile. For example, if a bank funded its fixed interest rate asset portfolio with a portfolio of sub-LIBOR deposits and wished to achieve a stable net interest income, it might transact an interest rate swap, paying a fixed interest rate and receiving LIBOR. Such a strategy would lock in a stable net interest income, unless LIBOR fell below the level of the (negative) margin. In that case, if the *portfolio has a floor, the stable net interest income would no longer be achieved. Therefore, when accounting for recognised variable rate sub-benchmark financial instruments as part of the managed portfolio, the effect of the embedded floor needs to be considered.*

120 Transfer pricing transactions raise other complications in addition to not reflecting the embedded floor in contractual sub-benchmark exposures. The difficulty is that the deemed cash flows that arise from transfer pricing transactions (for example, 1-month LIBOR) are greater than the actual cash flows that occur on the external exposure that is part of the managed portfolio (for example, 1-month LIBOR – 0.2%).

121 Some believe that it would not be appropriate for any accounting approach for dynamic risk management of sub-benchmark instruments to ignore the effect that the embedded floor has on a strategy to stabilise the net interest income. However, others believe that if the purpose of the accounting approach is to represent dynamic risk management, then the embedded floor is not relevant if it is not included within dynamic risk management.

122 The current hedge accounting requirements in IFRS do not allow the designation of a benchmark component as a hedged risk when the total cash flows on a hedged item are less than the benchmark. If sub-benchmark instruments are allowed to be included in the portfolio revaluation approach then two issues would have to be addressed:

(a) *Deemed cash flows could exceed actual customer cash flows; and*

(b) *Many variable rate instruments have an embedded floor.*

123 The IASB has identified three potential ways of dealing with the first issue within the portfolio revaluation approach:

	Approach 1	***Approach 2***	***Approach 3***
	Full customer deposit discounted at benchmark index	***Full customer deposit discounted at benchmark index with static margin***	***Risk included in ALM (transfer pricing)***
Cash flows (numerator)	*Customer contractual cash flows (for example, LIBOR – 0.2%)*	*Customer contractual cash flows (for example, LIBOR – 0.2%)*	*Benchmark pricing cash flows (for example, LIBOR)*
Initial discount rate (denominator)	*Initial benchmark index (for example, LIBOR)*	*Initial customer deposit rate (for example, LIBOR – 0.2%)*	*Initial benchmark index (for example, LIBOR)*
Subsequent discount rate (denominator)	*Current benchmark index (for example, LIBOR)*	*Adjusted for benchmark changes but margin kept static (for example, LIBOR – 0.2%)*	*Current benchmark index (for example, LIBOR)*
Day 1 revaluation difference	*Difference between the present value and the implied par value*	*Nil*	*Nil*

Interest recognition (assuming actual net interest approach)	*Actual coupon on customer deposit accrued, including the effect of the negative margin (and any embedded floor) (for example, LIBOR – 0.2%)*	*Actual coupon on customer deposit accrued, including the effect of the negative margin (and any embedded floor) (for example, LIBOR – 0.2%)*	*Actual coupon on customer deposit accrued, including the effect of the negative margin (and any embedded floor) (for example, LIBOR – 0.2%)*
Revaluation effect from dynamic risk management	*Clean revaluation of contractual cash flows with respect to changes in benchmark index plus amortisation/accretion of Day 1 revaluation difference*	*Clean revaluation of contractual cash flows with respect to changes in benchmark index (discount rate includes static negative margin)*	*Clean revaluation of benchmark cash flows with respect to changes in benchmark index*

124 *All three approaches present the same interest income profile in profit or loss, i.e. actual coupon payable on the customer deposits. The differences arise when determining the revaluation adjustment. Using Approaches 1 and 2, the cash flows included within the revaluation would be based on the actual deposit rate, whereas Approach 3 would only revalue the benchmark cash flows, consistently with the dynamic risk management approach. Consequently, the revaluation adjustments from Approaches 1 and 2 will include changes in the discounting effect both on the benchmark cash flows and on the negative margin. In addition, the revaluation effect from Approach 1 will include the unwind of the Day 1 revaluation effect. However, this will be offset by the amortisation of the Day 1 revaluation difference over time.*

125 *None of these three approaches recognise the effect of the embedded floor which should be included in revaluation adjustment in order for the risks to be reflected in the accounting for dynamic risk management. The DP suggests this could be achieved by being included in transfer pricing.*

EFRAG's response

EFRAG supports approach 3 as it is consistent with the approach based on risk mitigation in that hedged cash flows are those relating to risk exposures that are both managed and hedged by ALM (even if in excess of the actual risk exposures with external parties) and as it does not cause inappropriate day 1 revaluation gains and losses.

EFRAG thinks embedded floors should be included in the approach based on hedging activities to the extent they are included in the net risk position being hedged by ALM. If they are not included in the net position being hedged by ALM they should not be included in the portfolio revaluation.

Question 10 (a)

126 EFRAG supports Approach 3 as it:

(a) Is consistent with the approach based on risk mitigation in that hedged cash flows are those relating to risk exposures that are both managed and hedged by ALM (even if in excess of the actual risk exposures with external parties); and

(b) Does not cause inappropriate day 1 revaluation gains or losses.

127 EFRAG notes that ALM undertakes hedging activities with the objective of protecting net interest income based on risk exposures that it is dynamically managing. These risk exposures may be transferred from business units using a benchmark funding yield, even if the actual risk exposure with the external party consists of a benchmark yield less a spread, i.e. a sub-benchmark risk exposure. ALM would generally hedge that benchmark risk exposure even if it is higher than the actual exposure at the business unit level. EFRAG also notes that ALM may sometimes not be aware of that actual risk at the business unit level, which makes it difficult for ALM to hedge the actual customer margin, either in relation to borrowing or lending.

128 EFRAG observes that excluding sub-benchmark instruments from the portfolio revaluation approach would lead to a similar solution as with IAS 39 where institutions need to use a patchwork of hedge accounting solutions in order to assimilate the economically hedged position. Hence, EFRAG believes sub-benchmark instruments should be included in the portfolio revaluation approach to the extent that they are hedged.

Question 10 (b)

129 EFRAG believes that embedded floors in variable rate exposures should be included to the extent they are being hedged by ALM. EFRAG notes that generally, embedded floors included within sub-benchmark instruments are not separately transferred to ALM, even though those embedded floors may have an impact on the actual cash flows when benchmark yield falls below the floor. Since EFRAG supports the application of the PRA approach based on risk mitigation, cash flows that are not relevant to the hedged risk (such as actual customer margin) are excluded from the revaluation of the net position.

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?

Notes to constituents

130 The DP proposes that the interest rate risk exposures are revalued using present value techniques. The revaluation adjustment represents the measurement of one particular risk, making it consistent with risk management, which is undertaken on a 'by risk' basis. The resulting revaluation adjustment is not identical to a fair value approach which would include all risks.

131 The revaluation adjustment is calculated as the present value of those parts of the cash flows that represent the managed interest rate risk (numerator) discounted at the current rate for that risk (denominator):

(a) *the numerator is a set of cash flows whose determination depends on whether it relates to fixed-rate or variable-rate exposures:*

(i) *for fixed-rate exposures it is based on the interest rate level (that corresponds to the risk that the entity manages) at the time when the financial instrument first gave rise to the interest rate risk exposure. This numerator remains fixed at its initial level.*

(ii) *for variable-rate exposures it is based on the level of the relevant current interest rate (that corresponds to the risk that the entity manages) at the time of calculating the present value. This numerator is updated by projecting future variable contractual interest cash flows using the forward curve and the most recent fixing for the current interest period (if applicable).*

(b) *The denominator is always updated (i.e. for both fixed and variable-rate exposures). It is the rate that is current at the time that the present value is calculated. Changes in the rates that do not form part of the risk that the entity dynamically manages, such as credit risk and instrument liquidity will not form part of the revaluation adjustment. Such risks are typically managed separately, hence accounting for these risks would be unaffected by the portfolio revaluation approach.*

132 In describing the calculation of the denominator the DP notes that pricing of external customer lending may be based on a particular benchmark rate, which will then be adjusted to include customer-specific lending margins. The customer lending is internally funded by ALM, represented by an internal transfer pricing deal. This transfer pricing deal not only represents the internal funding from ALM but also represents the transfer of interest rate risk positions to ALM for inclusion in dynamic risk management.

133 The DP notes that it would not be appropriate for the risk position from the loan portfolio to be identified with respect to the pricing index as that is not assumed to be the risk that is being dynamically managed. Given the risk management objective, the relevant rate that is to be used for the purposes of the portfolio revaluation is the funding index as represented by the funding benchmark interest curve of the bank.

134 If the managed risk is the funding index, any changes in the counterparty credit risk and the differential between the pricing and the funding index are not relevant to reflect the risk management and thus will not be reflected in the revaluation adjustment.

EFRAG's response

EFRAG supports the revaluation adjustment resulting from the PRA approach limited to mitigated risk, as it would appear as an effective offset of the changes in value of hedging instruments and, hence, help eliminate effects of accounting mismatches on profit or loss.

EFRAG is of the opinion that a macro hedge accounting solution should reflect the effects of risk mitigation faithfully. As customer margins are not being hedged they should not be included in the hedged position.

Question 11 (a)

135 EFRAG thinks that the calculation of the revaluation adjustment is an appropriate way to overcome the accounting mismatch between hedged items at amortised

cost and the fair value of the hedging derivatives. The revaluation adjustment allows an effective offset of the changes in value of hedging instruments.

Question 11 (b)

136 EFRAG is of the opinion that a macro hedge accounting solution should reflect the effects of hedging activities faithfully. Dynamic interest rate risk management within banks is carried out with the objective of securing the level of net interest income. What is not included in the hedged risk is the customer margin, either in relation to borrowing or lending. Requiring a special treatment for the margin earned from borrowing activities is not consistent with either the overall focus on risk management activities, or the exclusion of the margin earned from lending activities. Therefore, EFRAG believes that it is appropriate to include the funding rate in the PRA to the extent that it is being used to estimate future cash flows which are to be hedge accounted for.

137 EFRAG notes that this approach:

(a) allows a hedge accounting solution to include core demand deposits as entities would be able to rely on the benchmark interest rate to hedge them;

(b) provides a hedge accounting solution for only a part of the full interest margin, i.e. the transformation margin; and

(c) ignores the fact that an entity is able to earn a margin based on its credit standing which is better than the benchmark as this margin is not being dynamically hedged.

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 purpose 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 paragraphs 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 paragraph 4.2.21 do you believe 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 paragraphs 4.3.1-4.3.4 concerning ongoing linkage?

Notes to constituents

138 The DP suggests that transfer pricing processes could be an operational expedient to reflect the interest rate risk in managed portfolios for the purposes of applying the portfolio revaluation approach. The DP discusses several alternatives for this:

(a) *Alternative A: only transfer pricing that purely reflects the market funding index within the portfolio revaluation approach can be used to represent the managed risk within exposures and excludes any internal or own credit related spreads.*

(b) *Alternative B would be to permit the use of transfer prices without restriction to identify the cash flows used for revaluation purposes (i.e. numerator), but to require that the discount rates be derived only from the (unadjusted) relevant benchmark funding index. However, such a treatment would lead to a day-one revaluation effect. That difference would need to be either taken to profit or loss immediately or amortised in some way, increasing operational complexity.*

(c) *Alternative C would be to use the full transfer prices to identify the cash flows used for revaluation purposes. However all spreads other than the market funding index within the transfer price would be adapted to determine the discount rate at the original spread that was used in the pricing of the transfer pricing deal.*

139 An additional point discussed by the DP is the extent to which the risk transferred to ALM via transfer pricing is representative of the risk that exists in the managed exposure. For example if the managed exposure is composed of sub-LIBOR instruments but the managed risk transferred to ALM via the transfer pricing mechanism is LIBOR.

140 Finally the DP discusses whether transfer pricing transactions would continue to be a good proxy for the managed risk in the managed portfolio over time, in order to be used in application of the portfolio revaluation approach. I.e. whether the internal transfer price can remain fixed for a longer time independent of changes in the net position or whether the internal transfer price needs to be determined on a marginal basis.

EFRAG's response

EFRAG recognises that limiting the application of the PRA to hedged items that are under dynamic risk management, i.e. under ALM for many banks, inevitably raises the issue of identifying those risk exposures and distinguishing them from risk exposures that remain under business units, which are not dynamically hedged and are thus outside the scope of the PRA. In the interest of avoiding requirements that are operationally burdensome, EFRAG accepts the use of internal transactions as proxies for risk exposures in portfolios that are being managed and hedged by ALM.

However, EFRAG believes that if such a practical expedient is to be permitted, sufficient discipline and safeguards are needed to provide for audit trails back to the original transactions. Strong internal controls might serve this purpose. Furthermore, EFRAG believes that incentives that influence transfer pricing transactions introduce bias in the measurement of the hedged position and should be eliminated when applying the PRA; this should be operationally feasible where strong internal controls and procedures exist.

Question 12 (a)

141 EFRAG recognises that limiting the application of the PRA to hedged items that are under dynamic risk management, i.e. under ALM for many banks, inevitably raises the issue of identifying those risk exposures and distinguishing them from

risk exposures that remain under business units, which are not dynamically hedged and are thus outside the scope of the PRA. In the interest of avoiding requirements that are operationally burdensome, EFRAG accepts the use of internal transactions as proxies for risk exposures in portfolios that are being managed and hedged by ALM.

142 However, EFRAG believes that if such a practical expedient is to be permitted, sufficient discipline and safeguards are needed to provide evidence of the existence of those risk exposures in the form of audit trails back to the original transactions. Strong internal controls might serve this purpose. Furthermore, EFRAG believes that incentives and other spreads that influence transfer pricing transactions introduce bias in the measurement of the hedged position and should be eliminated when applying the PRA. EFRAG notes that the identification and the elimination of such incentives and spreads should be operationally feasible where strong internal controls and procedures exist.

143 EFRAG believes that transfer pricing mechanisms have the potential to be an appropriate way of identifying the risks that have been transferred to ALM, but only to the extent to which these transfer prices appropriately reflect the hedged risk. EFRAG understands that ALM functions in some banks are able to specifically identify within each transaction with business units the part of the price which relates to the managed and then hedged risk. However, where this is not the case, there would be a minimum requirement to establish internal controls and procedures to ensure transfer prices being used as proxy to the managed and then hedged risk are adjusted to exclude incentives and other spreads before their inclusion into the PRA.

Questions to constituents

144 When transfer pricing transactions are used to transfer risk exposures to ALM, how would you identify that the risk transferred is appropriately reflecting the hedged risk permitting an audit trail? Please explain.

Question 12 (b)

145 To the extent that the managed risk is a funding rate, is reflected via transfer pricing and is being used to estimate future cash flows which are to be hedge accounted for, EFRAG supports using the market funding index discussed in paragraph 4.2.21 of the DP as it excludes all transfer pricing spreads. As explained in our response to question 10 above, EFRAG accepts the use of the benchmark funding index provided it is being managed and hedged by ALM, even if this is higher than the actual risk included in the managed portfolios.

Question 12 (c)

146 EFRAG is not in favour of restrictions, other than those on incentives and other spreads as explained above, on the eligibility of indexes that can be used in transfer pricing as a basis for identifying the exposures for inclusion in an approach based on hedge accounting. Creating restrictions would oblige entities to change their funds transfer pricing system in order to be able to implement a macro hedge accounting approach.

Question 12 (d)

147 EFRAG believes that the use of transfer pricing is appropriate only to the extent that it adequately identifies the hedged exposures. If ongoing linkages are such

that transfer pricing no longer adequately identifies the continuing managed and hedged exposures then transfer pricing is not a suitable proxy. Where strong internal controls and procedures exist, it will be easier for ALM to be informed when hedged risk exposures have expired requiring a reversal of the related revaluation adjustment. As much as there is a need to evidence the existence of external transactions that led to internal transactions, there will be a need to identify which of those transactions have been settled or changed. EFRAG acknowledges that additional disclosures will also be needed to provide more information on how internal transactions are monitored against external transactions that led to them.

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 should those criteria be, and why?

Notes to constituents

148 The DP notes that banks raise funding from a variety of sources and manage the resulting interest rate risk without necessarily matching particular assets with particular liabilities. As a result, in most cases using the funding index when managing interest rate risk is not straightforward. The DP describes that in these cases asset and liability management makes an assessment of the funding index to be used. Alternatively, asset and liability management may assign the funding rate to particular portfolios via transfer pricing transactions.

149 The portfolio revaluation approach could work with more than one funding index.

EFRAG's response

EFRAG holds the view that entities should be able to choose the funding index (or indices) that best reflect(s) their risk mitigation within the boundaries of internal risk management controls. EFRAG does not agree with mandatory criteria for selecting suitable funding indices.

Question 13 (a)

150 EFRAG is of the opinion that funding rates can be chosen on the basis of different parameters such as the nature of the funding, i.e. equity or liability, the time for which funding is sought, i.e. short or long-term, the moment at which the funding is acquired and the currency it is acquired in.

151 Not allowing entities to choose the funding index (or indices) would oblige entities to use a funding index which does not reflect how they have financed transactions, thereby misrepresenting the net result of those transactions in the financial statements.

152 EFRAG notes that institutions may use different methods for defining funds transfer prices. Additionally, managed portfolios are open portfolios, whereby new items are added and old items disappear frequently. For such portfolios, entities may choose to determine the funds transfer price of the managed portfolio on the average funding rate of all the items in the portfolio at a given moment in time.

Further, institutions may choose to assign an incremental funding rate to new items being added to the open portfolio. In both cases, an institution needs to rely on more than one funding index. The choice to use one, or more than one, funding index is related to the internal risk management system. Consequently, EFRAG agrees that institutions should be able to use more than one funding index within a managed portfolio. Entities should also be able to select a single funding index even if funding is based on more than one funding index if they consider that that is the best reflection of their risk mitigation activities.

Question 13 (b)

153 The choice of an institution to fund itself either on the long term or the short term or by using equity or liabilities is part of the overall strategic internal risk management system and should not be steered by accounting. Consequently, EFRAG thinks that entities should be free in their choice of a suitable funding index or indexes, albeit within the boundaries of internal risk management controls.

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 believe 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 risk management activities when the pricing index is used in dynamic risk management? Why or why not?

Notes to constituents

154 The DP notes that there may be circumstances that banks manage their interest rate risk based on a pricing index, i.e. the basis for determining pricing when lending to customers and not a funding index. In those cases it would be appropriate to select the pricing index for purposes of applying the portfolio revaluation approach.

155 Risks other than the pricing index, for example credit risk would be excluded from the portfolio revaluation approach.

156 Finally, the DP points out that for some risk management strategies the funding and pricing index will be the same.

EFRAG's response

EFRAG requests information from its constituents in identifying situations whereby net positions are being identified and subsequently hedged based upon a pricing index. EFRAG asks its constituents to provide information on risk management undertaken based on a pricing index.

All questions

157 EFRAG has currently no information about situations whereby net positions are identified and subsequently hedged based upon a pricing index. EFRAG will therefore respond to these questions based upon the input from constituents.

Questions to constituents

158 Could you provide information of dynamic risk management undertaken based on a pricing index? In doing so please provide the following information:

(a) Which components of the margin stay with the business unit, which components of the margin are being transferred to the asset and liability management function and being dynamically hedged? Please explain.

(b) How does the asset and liability management function mitigate the risk assigned to the entity or product specific components of the margin? Please explain.

(c) Do you rely on external derivatives to hedge these risks? If so, please explain how these derivatives offset with the hedged item determined relying on a pricing index.

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 the risk mitigation? Why or why not?

Notes to constituents

159 The decision on which scope should be applied has an effect on this question. In the absence of mandatory application an entity engaging in dynamic risk management could elect any one of four accounting alternatives given the interaction with hedge accounting in IFRS 9 and IAS 39.

160 It is possible that, given a free choice, many entities would choose the alternative that presents the least volatility in profit or loss. Comparability is also reduced when options are available.

161 The DP argues that regardless of the scope application chosen, making the portfolio revaluation approach optional will require additional guidance regarding when and how an entity can start or stop the application of the model. It also states that such guidance could bring in the amortisation and tracking requirements which could compromise operational simplicity.

EFRAG's response

EFRAG believes that the scope should be based on risk mitigation and consequently should remain optional. Such an option would allow entities to

make a choice between applying the general hedge accounting model to certain risk exposures and using the option to apply the macro hedge accounting model to the remaining dynamically hedged items.

Questions 16 (a) and (b)

162 EFRAG believes that the scope should be based on risk mitigation and consequently should remain optional.

163 If the approach would become mandatory we believe this would create cross-cutting issues with IFRS 9 *Financial Instruments* which are discussed in paragraphs 260 and 261 of this Annex.

164 Mandatory application would create problems for entities who seek to combine interactively both the macro hedge accounting approach and the general hedge accounting provisions of IFRS 9. For example, an entity that holds both fixed and floating rate portfolios may choose to apply the macro hedge accounting to the hedged fixed rate portfolios and the cash flow hedge accounting to the hedged floating rate portfolios, or an entity may choose to apply general hedge accounting provisions to specific significant individual items and apply macro hedge accounting to the remaining hedged portfolios under dynamic risk management. A mandatory application would deprive the entity of the possibility to reflect the effects of its hedging strategies in the financial statements.

165 EFRAG believes that there should be no hierarchy between the macro hedge and the general hedge accounting models; however both models should not be applied to the same risk exposure simultaneously. We do not believe mandatory application would ensure comparability, since dynamic hedging strategies are different from one entity to another, which inevitably leads to the lack of comparability that cannot be overcome by a mandatory application of the model.

166 However, EFRAG considers that once an entity has chosen to apply the model to a particular hedged position, it should not be permitted to stop applying the model until the hedged position ceases to exist.

167 In addition EFRAG notes that natural economic hedges should remain untouched by the approach. EFRAG considers no hedge accounting is needed for economic hedges where both sides of the economic hedge are recognised on the same measurement basis, as in those cases no accounting mismatch arises.

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' or '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.

Notes to constituents

168 The DP does not propose any requirement for use of the portfolio revaluation approach other than the risk being managed dynamically. However, the DP states that additional criteria might be needed if the scope of the model is items that are dynamically managed and that have actually been hedged or if the model is made optional.

EFRAG's response

EFRAG supports an approach based on risk mitigation. EFRAG is of the opinion that the following eligibility criteria should be considered in developing the approach: i) being dynamically managed, and ii) the general hedge accounting model under IFRS 9 is not applied to the hedge relationship.

All questions

169 EFRAG has considered the following additional criteria in responding to this question:

(a) Being dynamically managed;

(b) Effectiveness testing; and

(c) The general hedge accounting model under IFRS 9 is not applied to the hedge relationship.

170 EFRAG agrees that the criterion 'being dynamically managed' should be an eligibility criterion for application of the portfolio revaluation approach.

171 EFRAG is of the opinion that effectiveness testing should not be considered as an additional criterion in the application of the portfolio revaluation approach. Such a

criterion would bring back a large part of the complexity in designation and de-designation of risk management instruments required by IAS 39 and IFRS 9.

172 EFRAG believes that entities should be able to rely on IFRS 9 general hedge accounting when they do not dynamically hedge their financial risk exposures or hedge non-financial risk exposures. Hence, such hedge relationships should not be part of the scope of the macro hedge accounting solution. On the other hand, EFRAG is of the opinion that the same risk component should not be hedged twice, i.e. once as part of a macro hedge relationship and once as part of a static hedge relationship by applying IFRS 9. Even if such a principle seems straightforward, we think that its application in a group may not be easy. For example, a subsidiary may apply a static hedge relationship to a particular risk component. The asset and liability management function at group level may be unaware of this and include the same risk component in a dynamical hedge relationship. EFRAG wishes to learn from its constituents how such situations are being addressed in the separate and consolidated financial statements.

Questions to constituents

173 Assume a situation where hedging activities are set up at subsidiary level and on consolidated level. In addition assume no documentation exists at group level about all hedging activities within the group. Please explain how you would avoid designating risk components more than once as hedged items.

174 Do you agree that the general hedge accounting model and the macro hedge accounting model should not be applied to the same risk exposure simultaneously? Please explain why or why not.

175 The DP assumes that all entities have a centrally organised asset and liability management function. EFRAG notes that not all entities are organised this way, which may affect how the net position is being determined and, thus, how it can be hedged.

176 For the reasons mentioned above, EFRAG thinks that two eligibility criteria should be retained, i.e. being dynamically managed and the general hedge accounting model under IFRS 9 is not applied to the hedge relationship.

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 believe 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.

Notes to constituents

Presentation in the Statement of Financial Position

177 *The DP considers the following alternatives for presentation in the Statement of Financial Position:*

(a) *Line-by-line statement of financial position gross up: The carrying amounts of the exposures included within the managed portfolio would be adjusted to reflect the revaluation for the managed risk;*

(b) *Separate lines for aggregate adjustments to assets and liabilities: Separate line items would be presented for both the revaluation adjustments for the revalued exposures that are assets and those that are liabilities; and*

(c) *Single net statement of financial position line: The net revaluation adjustment for the whole managed portfolio is reported in a single line in the Statement of Financial Position.*

Presentation in Statement of Comprehensive Income and disclosures

178 *The DP considers two alternatives for presentation in the Statement of Comprehensive Income. In both alternatives a single profit or loss line item would represent both the revaluation adjustments of the revalued portfolio(s) and the fair value changes in hedging instruments. Both alternatives differ in distinguishing between net interest income and the revaluation effect.*

(a) *Stable net interest income approach: This approach assumes that a bank's risk management objective is to fully stabilise net interest income against changes in benchmark interest rates irrespective of the entity's actual risk management. Reported net interest income is recognised on the assumption that this objective has been achieved. The revaluation profit or loss then provides information on how good the bank has been at achieving that objective for both realised and future net interest income.*

(b) *Actual net interest income approach: All net effects from risk management instruments are reported in a new interest line on the face of the income statement within net interest income called 'net interest income from risk management instruments'. Under this approach there is no change to the existing income presentation for managed exposures. Interest is recognised using the effective interest method, irrespective of whether exposures were included within the macro hedging activity or not.*

EFRAG's response

EFRAG believes that presenting the revaluation adjustment in a separate single net line item in the Statement of Financial Position is the best way to limit the effect of hedge accounting applied to dynamic risk management. EFRAG believes that the actual net interest income approach in the Statement of Comprehensive Income provides the best information for users.

Question 18 (a)

179 EFRAG believes that presenting the revaluation adjustment in a separate single net line item in the Statement of Financial Position is the best way to reflect hedge accounting activities, because dynamic risk management addresses net portfolios of assets and liabilities. Hedge accounting activities do not address the risk of assets alone or liabilities alone. Using separate lines for aggregated adjustments to assets and liabilities would not provide a good representation of the dynamic risk management undertaken. Additionally, it would require entities assigning the revaluation adjustment to assets and liabilities separately which involves tracking.

Question 18 (b)

180 EFRAG is of the opinion that the actual net interest income approach provides the best information for users for the following reasons.

181 The actual net interest income approach enables net interest income accrued over the reporting period to be distinguished from mismatches in anticipated future net interest income. By separating the two, the impact of hedge accounting is recognised without touching upon the recognition of actual interest income.

182 The stable net interest income approach is based on the assumption that net interest income is stable over time which is an artificial assumption. Changing market conditions or risk management failures lead to changes in net interest income. The stable net interest income approach would thus lead to a misrepresentation in the profit or loss account.

Question 18 (c)

183 EFRAG is not in favour of an alternative presentation in the Statement of Financial Position or the Statement of Comprehensive Income.

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 believe 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?

Notes to constituents

184 One objective of the portfolio revaluation is to improve information in the financial statements regarding risk management. For this purpose, the risk management activity and the trading activity will be separately presented in the financial statements. Consequently, the DP explains that back-to-back internal derivatives will need to be grossed up in the income statement in order to demonstrate the effect of risk management. The profit or loss from all internal derivatives will be eliminated so there would be no net impact on profit or loss.

185 The DP does not require that internal derivatives are externalised in order to apply the revaluation approach. As some IASB constituents are concerned about the potential effect on profit or loss caused by revaluing the managed exposures, the DP discusses an alternative.

186 In paragraph A4.2.15 the DP describes that an entity should demonstrate that the risk transferred from asset and liability management through internal derivatives has been substantially passed on to external counterparties, before the gross-up in the profit or loss of internal derivatives could be permitted. The externalisation criterion could be based on an instrument-by-instrument approach. In paragraph A4.2.17 the DP describes that the risk transferred through internal derivatives could be deemed to be substantially externalised as long as predefined risk limits are not breached.

EFRAG's response

EFRAG supports the grossing up of internal derivatives in the Statement of Comprehensive Income as a practical expedient which does not affect the quality of financial reporting. We note that the offset between the legs of the internal derivative(s) may not always be perfect.

Question 19 (a)

187 EFRAG recognises that grossing up internal derivatives in the profit or loss account is a practical expedient. EFRAG supports it as it does not affect the quality of financial reporting. However, we note that entities do not solely rely on derivatives to transfer interest rate risk from ALM to the trading function and that any eventual standard would need to reflect these different ways of transferring interest rate risk out of ALM.

188 EFRAG understands that in some entities valuations may not always be the same in ALM and trading, for example caused by differences in functional currencies. There may be differences in valuations between internal derivatives and those transacted with the market, as IFRS 13 *Fair Value Measurement* requires that the fair value incorporates, for example, credit risk. This means that, even if the trading function externalises all risk passed to it by ALM, some 'noise' will remain.

Question 19 (b)

189 To be answered based upon input from constituents.

190 One may argue that the transfer of risk from ALM to trading could be used as a proxy for the mitigated risk. EFRAG notes that this would entail no independent revaluation of the risk mitigated positions, but would assume that, as ALM had chosen to transfer risk, this was done on an appropriate basis (for example following an internal risk assessment and risk appetite process).

Question 19 (c)

191 EFRAG notes that as a possible solution the DP describes that the risk transferred through internal derivatives could be deemed to be substantially externalised as long as predefined risk limits are not breached. EFRAG would like to learn from its constituents if this could be used as a condition for including internal derivatives in the portfolio revaluation approach.

Questions to constituents

192 Would it be acceptable for different valuation methodologies to be used in ALM and trading such that, for the same internal derivative, the assets and liabilities did not net to zero? Please explain.

193 Do you think that the treatment of internal derivatives as proposed by the DP enhances operational feasibility? Please explain.

194 Do you think it would be possible to use the transfer of risk from ALM as an appropriate proxy for the mitigated risk? If yes would this require the existence of a documentation process, i.e. an audit trail, demonstrating which risks are being transferred? Please explain.

195 Do you think that additional conditions should be required for internal derivatives to be included in the portfolio revaluation approach? Please explain.

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 an identified theme would not provide useful information, please identify that theme and explain why.

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

Notes to constituents

196 *The IASB identifies different disclosure themes regarding macro hedging which refer to qualitative and/or quantitative information on:*

(a) *the objectives and policies for dynamic risk management, including the identification of risks within exposures;*

(b) *the net open risk position(s) and its impact on the application of the portfolio revaluation approach;*

(c) *application of the portfolio revaluation approach; and*

(d) *the impact of dynamic risk management on the current and future performance of an entity.*

<u>Objectives and policies for dynamic risk management, including the identification of risks within exposures</u>

197 *The DP explains that a qualitative description is required of the different types of exposures and risks considered within the dynamic risk management. The disclosures should help users understand how the managed risk is determined throughout the portfolio and how that links into the risk management objective.*

198 *For each type of exposure managed dynamically, information is required on the basis upon which the risk is measured and analysed. This could include information about whether the managed risk is monitored based on the contractual terms of the exposure, or if risks are considered differently, such as from a behavioural perspective.*

199 *Qualitative information is to be disclosed on the dynamic risk management policies and performance objectives. This includes a high-level description of the dynamic risk management processes, including the role of risk limits and the extent to which risk management instruments are transacted with external or internal counterparties.*

<u>The net open risk position and its impact on the application of the portfolio revaluation approach</u>

200 *The DP requires qualitative disclosures on how the net open risk position is calculated. This refers to a description of the method used for measurement of risk and an explanation of the methodology used to calculate the revaluation adjustments, including any changes to the techniques during the period and an explanation of the reasons for the changes.*

201 Additionally, the DP requires information on estimation techniques used for risk management and accounting purposes. In particular, information about any reliance on subjective or judgemental inputs would have to be provided.

202 The DP requires quantitative information on the net open risk position, and the portfolio revaluation adjustment recognised at the reporting date. As some of this information can be commercially sensitive, the DP requests input on the extent to which these disclosures should be provided.

203 The DP requires quantitative disclosures enabling users to understand the extent to which the managed risk position is not based on the contractual terms of the exposures.

204 It is also discussed whether it would be useful to provide a breakdown of the portfolio revaluation adjustments by class of financial instrument and if so whether this should be provided in the statement of financial position or in the notes.

205 Finally, as disclosures would be based on data at the end of the reporting period, it is asked whether information on positions throughout the year would not be more representative.

The application of the portfolio revaluation approach

206 A description of an entity's accounting policy for the application of the portfolio revaluation approach would be required by IAS 1 Presentation of Financial Statements.

207 The DP requires that information is provided enabling users to understand the extent to which the accounting represents risk management, and how dynamic risk management is reflected in the financial statements. Differences between accounting and risk management should be made transparent.

208 Qualitative disclosures may be required if the final model includes an element of choice about the scope of the revaluation approach. When certain aspects of risk management activity are ineligible for inclusion within the scope of the portfolio revaluation approach, additional disclosures on those activities or exposures may be required.

The impact of dynamic risk management on the current and future performance of the entity

209 The DP explains that these disclosures aim at providing a better understanding of the importance of risk management on reported results in the current and future periods. The disclosures required relate to the alternatives for income statement presentation.

210 Following the DP, users may be interested in information on the sensitivity of future net interest income to changes in interest rates after risk management. As this information may be considered sensitive, the DP asks for suggestions how to provide this information.

211 Finally, the DP notes that users may like to understand the drivers of profit or loss from the portfolio revaluation approach. For example information may be provided on the sensitivity of both reported net interest income and the revaluation effect in the period. This could include a sensitivity disclosure for changes in the managed risk and key assumptions.

EFRAG's response

EFRAG believes that most of the requested disclosures provide a good start for providing information to users on an approach that is based on risk mitigation. Nevertheless, EFRAG thinks that only some disclosure themes are essential and makes its own proposal. If a comprehensive disclosure package for the approach is considered we believe that there is a risk of duplication of disclosure requirements. Therefore, we advocate disclosing information about risks and ways in which they are mitigated together. Finally EFRAG disagrees with some of the proposed disclosures.

Question 20 (a), 20 (b)

Overall comments

212 EFRAG believes that the four identified disclosure themes provide a good start for providing information to users on the portfolio revaluation approach. However, in our view, only the following disclosure themes are essential and should replace those proposed in the DP:

(a) A description of the (interest rate) risk exposure of an entity being risk mitigated and how it is mitigated; and

(b) Information needed to understand the effects of hedge accounting in the financial reporting of an entity.

213 EFRAG believes that the IASB should focus on disclosures which explicitly enhance the understanding of entities' use of an approach based on risk mitigation. EFRAG recommends the IASB to carry out a holistic review of the present disclosure requirements regarding financial assets and liabilities. In doing so we believe that the IASB will find it useful to also look at information that is already provided by banks as part of the regulatory disclosure requirements. Learning from those disclosure requirements would, in our view, minimise duplication of disclosure requirements for financial reporting purposes for regulated entities.

214 On the second disclosure theme in paragraph 212, we agree that IFRS 7 *Financial Instruments: Disclosures* currently does not provide sufficient information and could be complemented with information regarding the effects of hedge accounting. In addition, we believe that disclosures should provide information on the effects of hedge accounting in future reporting periods.

215 If the IASB decides to develop a comprehensive disclosure package for the approach based on risk mitigation regardless of already existing disclosures, we believe that there is a risk of duplicating disclosure requirements. We see merit in disclosing information about risks and ways in which they are mitigated together. This is regardless of whether the entity has chosen to use the approach based on risk mitigation or not. Otherwise, the disclosures risk being on a piecemeal basis depending on each entity's choice between different accounting solutions (i.e. fair value option, fair value hedges, cash-flow hedges and economic hedges).

EFRAG's comments on the disclosure themes proposed by the DP

216 Were the IASB to retain the four disclosure themes as developed in the DP, our comments on these themes would be as follows.

217 The first disclosure theme requires information on the objectives and policies for the performance of risk management. EFRAG agrees that this information would be useful for the following reasons:

(a) The identification of risks is different to the identification of contractual cash flows, the latter being more familiar to users of financial statements. Risks could be identified within pipeline trades and behavioural exposures, which are concepts that may be new for users of financial statements; and

(b) The objective of risk management is not to eliminate risk completely (i.e. without risk there would be little performance), but rather to reduce it and protect the performance of the entity. This crucial difference should be understandable for users of financial statements.

218 Alternatively the content related to this disclosure theme could be presented in the Management Commentary. If information was already available elsewhere EFRAG thinks entities should be allowed to rely on cross-referencing to fulfil the disclosure requirements.

219 The second disclosure theme requires information on the risk position and its impact on application of an approach based on risk mitigation. Although EFRAG considers the information useful, we are of the opinion that, for regulated institutions, much of it is already available through regulatory reporting requirements. Therefore cross-referencing should be permitted in these cases.

220 EFRAG does not think that a breakdown by class of financial instruments is useful as this would bring back the designation rules of IAS 39 and IFRS 9 for disclosure purposes and hence remove much of the attractiveness of the model.

221 By definition, dynamic risk management evolves continuously, and EFRAG believes that disclosures on how exposures have evolved during the reporting period could potentially be of use. The nature and extent of any such disclosures should be consistent with overall disclosures of financial risks and be appropriately targeted.

222 The third disclosure theme requires information on the application of an approach based on risk mitigation. EFRAG agrees that this information would be useful for the following reasons:

(a) The accounting policy could provide a useful insight into the reasons why and to which extent an approach based on risk mitigation has been applied;

(b) An implementation of an approach based on risk mitigation would require overcoming conceptual differences between accounting and risk management. Some of the differences may be difficult to incorporate such as the identification of risk in future transactions. However, that does not imply that an entity will or should stop managing such risks. For this reason EFRAG is of the opinion that disclosing such information could be useful; and

(c) The choice of the indices used for determining risk cash flows and discounting them is an important element in representing risk management in accounting. Also it enhances comparability between entities. When entities rely on different indices to measure their risk, the outcomes are, by definition, not comparable. For this reason, EFRAG is of the opinion that this information is useful for users.

223 The fourth disclosure theme requires information on the impact of dynamic risk management on the current and future performance of the entity. EFRAG agrees that this information would be useful for the following reasons:

(a) EFRAG favours the actual net interest income approach as this not only provides information on the actual interest margin, but also provides information of the net interest income before and after dynamic risk management. In other words it provides information on the success of the risk management undertaken;

(b) EFRAG is of the opinion that users could benefit from information on the sensitivity of an entity's net interest income to future changes in interest rates after dynamic risk management. EFRAG notes that net interest income may change because of a change in business undertaken (i.e. more or less interest bearing products are sold), and/or by the change in market interest rates.

Question 20 (c)

224 EFRAG proposes the following specific disclosures:

(a) Behavioural assumptions (see our answer to Question 4 (c));

(b) Changes in behavioural assumptions (see our answer to Question 4 (c));

(c) Risk limits (see our answer to Question 8);

(d) Core demand deposits (see our answer to Question 9); and

(e) The use of transfer prices (see our answer to Question 12 (d)).

Question 21 – Scope of disclosures

(a) Do you think that the scope of 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 believe would be an appropriate scope for the disclosures, and why?

Notes to constituents

225 Generally, the scope of disclosures follows that of the scope of the application of the relevant accounting standard. As an alternative, the DP notes that the disclosures about an entity's total exposure to a dynamically managed risk could be used to provide meaningful information on dynamic risk management in the financial statements, even when the scope of the application of the portfolio revaluation approach is narrower.

EFRAG's response

EFRAG supports an approach based on risk mitigation and believes the disclosures should be aligned with this approach.

Question 21 (a) and (b)

226 EFRAG is of the opinion that the scope of the disclosures should depend on the objective of the approach. EFRAG supports an approach based on risk mitigation and believes the disclosures should be aligned with this approach as this would benefit the usefulness of the information provided.

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

(a) 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 the contract? Why or why not? If yes, under which circumstances do you believe 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.

Notes for constituents

227 The DP states that the portfolio revaluation approach has been developed on the basis that managed risk exposures may only be included within the portfolio to be revalued when the entity first becomes a party to the contract, except for pipeline transactions. The DP argues that this to avoid day-one gains or losses that may arise when revaluing risk exposures for the first time after they have been contracted to.

228 For example, day-one gains or losses may arise where an interest rate exposure is included in the dynamic risk managed portfolio at a later stage, because the relevant reference interest rate at the moment of inclusion into the managed portfolio will have changed when compared to the time the entity became a party to the contract. This results in a day-one revaluation adjustment, which arguably could have been already recognised gradually in profit or loss had the interest risk exposure been included in the managed portfolio as from day one.

229 The DP notes that recognising this revaluation adjustment in profit or loss in one go may create volatility that is inconsistent with risk management objectives, but also notes that deferring it to be amortised in future periods requires tracking that is operationally burdensome.

EFRAG's response

The exposures included in dynamic risk management are constantly changing, and the requirements should reflect that. Any non-zero day-one revaluations should be included in profit or loss and should be appropriately disclosed.

Question 22 (a)

230 By their very nature, exposures in an open portfolio are constantly changing. Similarly, an entity's choices of risks to include within dynamic risk management may change on an ongoing basis (for example including exposures from different business units or product lines). EFRAG does not agree that exposures should only be included within the hedged portfolio when the entity first becomes a party to the contract. It may happen that an entity initially decides to maintain a particular risk exposure within the business unit because that risk is deemed not significant enough to warrant dynamic risk management. Due to changes in the economic or market environments in which the entity is operating, the initial risk may later become significant and be transferred from business unit to risk

management where it is hedged dynamically. Excluding such risk exposures from the hedged portfolio would mean not accounting for exposures that have been risk mitigated.

Question 22 (b)

231 EFRAG acknowledges that including risk exposures into the hedged portfolio at any time may result in non-zero day- one valuations, which may not be offset by the fair value of the related hedging instruments as its fair value may be nil at inception. EFRAG believes that these day- one revaluation adjustments should be recognised in profit or loss. While this avoids the operational complexity related to amortisation of the non-zero day-one valuations, tracking would nevertheless be required in order to ensure that the revaluation adjustment only reflects risk mitigated exposures.

232 This could possibly be addressed by defining the unit of account according to what is effectively being hedged as discussed in paragraphs 268 to 269 of this Annex. However, EFRAG has currently insufficient information on this issue to conclude and asks its constituents for help (see our answer to Question 23).

233 Any resulting volatility from including non-zero day-one valuations is a result of the risk management decision and should be clearly disclosed in the notes to the financial statements together with the reasons why risk management decided to include such risk exposures in the hedged portfolio at a later stage.

Question 23 – Removal of exposures from the 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 the 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 the 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.

Notes to constituents

234 The DP notes that if risk exposures are permitted to be removed from the revalued portfolio prior to their maturity or earlier derecognition, an issue arises as to what to do with revaluation adjustment to that point related to the removed risk exposures. The DP also notes that either the revaluation adjustment can be amortised, which is operationally burdensome due to tracking, or be immediately recognised to profit or loss, which does not represent an economic gain or loss since the risk exposures continue to exist. Therefore, careful consideration is required in determining the circumstances, other than derecognition, under which removal from the revalued portfolio should be allowed, if at all.

EFRAG's response

The exposures included in dynamic risk management are constantly changing, and the requirements should reflect that. Removing risk exposures from a hedged portfolio prior to maturity or earlier derecognition should be allowed so as to allow the portfolio to continue to reflect mitigated risk. The corresponding portion of the revaluation adjustment should be recognised in profit or loss.

Question 23 (a)

235 By their very nature, exposures in an open portfolio are constantly changing. In most cases risk exposures are included within a risk mitigated portfolio with the intention to stay there until derecognition. Sometimes, changes in the entity's overall risk profile or changes in dynamic risk management strategy may entail transferring certain risk exposures back to business units and thus that no longer will be hedged. That is why it should be permissible to remove risk exposures from the hedged portfolio prior to maturity or earlier derecognition. Doing otherwise would mean that the portfolio would no longer represent the mitigated risk.

Question 23 (b)

236 An entity may initially leave a particular risk exposure with the business unit and subsequently decide to transfer the risk exposure to dynamic risk management where it is risk-mitigated. This transfer may be due either to changes in the economic environment or a simple change in risk management strategy to include the risk exposure previously managed by the business unit into the portfolio managed by dynamic risk management.

Question 23 (c)

237 When an entity decides to remove a risk exposure from a risk mitigated portfolio the revaluation asset or liability related to that risk exposure will be reversed to profit or loss. This simply works by revaluing the managed portfolio for the remaining exposures and recognising any difference with total revaluation to that point, which relates to the exposures removed from the revalued portfolio, in profit or loss. While this avoids the operational complexity related to amortisation of removed exposures, tracking would nevertheless be required in order to ensure that the revaluation adjustment only reflects risk-mitigated exposures. In particular when the net risk position is only partially hedged, one needs to determine how much of the hedged position relates to removed exposure.

238 This could possibly be addressed by defining the unit of account according to what is effectively being hedged as discussed in paragraphs 268 to 269 of this Annex. However EFRAG has currently insufficient information on this issue to conclude and asks its constituents for help.

Question to constituents

239 What solution(s) would you suggest in dealing with the tracking requirements related to an approach based on risk mitigation? Please explain.

240 However, EFRAG also notes that a similar situation exists with general hedge accounting where hedging reserves are reclassified in profit or loss for portions that represent hedge ineffectiveness or when the hedge is discontinued, while the underlying risks continue to exist. Therefore, EFRAG would recommend that appropriate disclosure, including the reason for the removal and the impact on

profit or loss, should be made where risk exposures are removed from the managed portfolio and the resulting revaluation gain or loss is recognised in profit or loss.

Question 24 – Risk management of foreign currency instruments

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

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

Notes to constituents

241 The DP describes several ways in which entities may treat foreign exchange risk exposures for which the interest rate risk is being dynamically managed.

(a) *Scenario A: An entity may manage its business in its functional currency, converting all foreign currency exposures into synthetic functional currency exposures; or*

(b) *Scenario B: An entity may manage the interest rate risk from its foreign currency exposures separately from the interest rate risk from its functional currency exposures; or*

(c) *Scenario C: An entity lends and raises funds in a foreign currency. In case an excess or insufficient foreign currency funding arises, it is managed using cross-currency derivatives on a portfolio basis. The interest rate risk for each of those foreign currency portfolios is dynamically managed in that foreign currency.*

242 To address scenario A, two potential approaches are discussed. Firstly, the accounting for the foreign currency debt and the cross-currency swaps are done in accordance with IFRS 9. The portfolio revaluation approach would be applied to the interest rate risk of the aggregated functional currency exposures. Secondly, the portfolio revaluation approach would address the foreign currency debt. Cross-currency swaps and interest rate swaps would be measured at fair value through profit or loss. Fair value changes in the swaps would partially offset the revaluation of the foreign currency debt.

243 To address scenario B, the portfolio revaluation approach would be applied to all the foreign currency lending and funding exposures. Fair value movements from hedging instruments for the interest rate risk in the foreign currency portfolio would offset the revaluation of the portfolio for reasons of interest rate risk. Additionally, a presentational issue arises for which the interaction of the revaluation approach and IAS 21 The Effects of Changes in Foreign Exchange Rates should be considered. In order to present the offsetting effects between the fair value changes of the hedging derivatives and the revaluation adjustment both should be presented in the same line in profit or loss.

244 To address scenario C, the portfolio revaluation approach would be applied to both interest rate risk and foreign exchange risk, similarly as for approach 2 in scenario A.

EFRAG's response

EFRAG's final answer will be based on input from constituents.

Question 24 (a) and 24 (b)

245 EFRAG's final answer will be based on input from constituents.

Questions to constituents

246 Do you think it is possible to apply an approach based risk mitigation to foreign currency risk and interest rate risk in conjunction? Please explain.

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 believe 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.

Notes to constituents

247 The DP currently focuses on explaining the portfolio revaluation approach for dynamic risk management activity using the example of dynamic interest rate risk management undertaken by banks. However, it is the IASB's intention to develop an accounting model for dynamic risk management activities that would accommodate different types of risks, e.g. commodity price risk, foreign currency exchange risk, etc., that may be managed dynamically on the basis of an open portfolio.

248 In addition to applying the model to different types of risk that are dynamically managed, the IASB intends to apply the model to industries other than the banking industry, e.g. energy and utility industry, retail industry, manufacturing industry, etc., provided the entities apply dynamic risk management.

249 However, despite the similarity in rationale, the DP identifies some key differences between banks' risk management of interest rate risk and the dynamic management of other risks that may warrant additional consideration:

(a) *applying the revaluation approach to foreign currency risk may be seen to be superseded by IAS 21 which already requires translation of these exposures;*

(b) *commodity risk positions would often include inventory considered as a fixed-priced asset for the purposes of the revaluation approach;*

(c) *where purchases and sales contracts have significantly different degrees of sensitivity to the particular commodity price, additional thought is required* *about whether the revaluation of those exposures with respect to changes in the same commodity price provides useful information given the difference in price sensitivity;*

(d) *exposures to buy or sell non-financial instruments may be dynamically managed on a full fair value basis, rather than focusing on a particular pricing sensitivity of managed risks. If those non-financial instruments satisfy the own use criterion, the fair value option for own use contracts given by IFRS 9 may be more appropriate while the revaluation approach could be applied to those non-financial instruments contracts that fail the own use criterion;*

(e) *situations may occur when not all of the contracts that are risk managed together meet the own use criteria. In this case the fair value option would not be available for all of those contracts and the portfolio revaluation approach could be preferred; and*

(f) *the portfolio revaluation approach requires an ability to revalue the managed exposures by risk, which may require significant implementation effort for non-banking entities.*

EFRAG's response

EFRAG's final answer will be based on input from constituents.

Questions 25 (a) and (b)

250 EFRAG's final answer will be based on input from constituents.

Questions to constituents

251 Do you think that an approach based on risk mitigation could be applied to other risk types? Please explain why or why not. If yes, please describe each fact pattern you think it should be applied to.

Question 26 – PRA through OCI

Do you think that an approach incorporating the use of OCI in the manner described in paragraphs 9.1-9.8 should be considered? Why or why not? If you think the use of OCI should be incorporated in the portfolio revaluation approach, how could the conceptual and practical difficulties identified with this alternative approach be overcome?

Notes to constituents

252 The DP notes that the application of the portfolio revaluation approach will result in volatility in profit or loss if the scope is all items that are dynamically managed and risk management has intentionally left unhedged open risk positions. The DP therefore questions whether recognising volatility arising from unhedged positions relating to future flows in current profit or loss provides the most useful information to users of financial statements.

253 Therefore, the DP explores an alternative approach of presenting the portfolio revaluation approach through other comprehensive income (OCI). Under this *approach, both the net revaluation adjustment from managed exposures and the changes in the clean fair value of risk management instruments would be recognised in OCI rather than profit or loss.*

254 The benefit of this alternative approach is that profit or loss would be comparable between entities that undertake dynamic rick management and those entities that do not. This alternative can also be seen as enhancing the usefulness of the information provided about how an entity has, for example, transformed net interest income in the current period, while maintaining in OCI the wider information on dynamic risk management activities relating to future net interest income.

255 However, the DP notes several hurdles that need to be considered before this alternative approach is viable:

(a) *this alternative breaks the assumption that the IASB applied in developing the portfolio revaluation approach that all risk management instruments such as derivatives are measured at fair value through profit or loss;*

(b) *the proposed gross up presentation for internal derivatives may need to be reconsidered since internal derivatives would no longer net to zero in profit or loss since one side would be in profit or loss and the other in OCI;*

(c) *natural recycling from OCI into profit or loss will not occur if managed exposures are sold or risk management instruments are terminated; and*

(d) *consistency with the proposals being developed in the conceptual framework discussion paper on the purpose of OCI.*

EFRAG's response

EFRAG does not support the use of OCI as proposed by the DP. We do not believe the use of OCI as proposed by the DP would make the underlying scope more acceptable. There is no disconnect expected between the revaluation adjustment and the fair value of the hedging instruments other than ineffectiveness and basis risk of the hedging instruments. In both cases, EFRAG sees no reason why recognition in profit or loss should be deferred.

If a cash flow hedging model is developed using some or all of the principles proposed in the DP then EFRAG considers the use of OCI is appropriate.

Question 26

256 EFRAG has considered whether the use of OCI could usefully contribute to the PRA applied to risk mitigation only. As such a model is aiming at offsetting the revaluation adjustment of the hedged position with the changes in value of the hedging instruments, there is no disconnect expected other than ineffectiveness and basis risk of hedging instruments. In both cases, EFRAG sees no reason why recognition in profit or loss should be deferred. Consequently, we do not support the use of OCI as proposed by the DP.

257 We also do not agree that relying on other comprehensive income would make the underlying scope more acceptable as we do not agree that the information provided would be relevant as outlined in our answer to Question 15. We do believe, however, that there is merit in exploring a cash flow hedge accounting model that is very closely aligned with how risk is mitigated in practice. This would

use OCI in much the same way as the macro cash flow hedging model in IAS 39 but remove the constraints in the current model.

Questions to constituents

258 Do you think that the concepts and ideas behind the PRA (identification of risks in ALM based on the risks transferred to ALM) could be utilised in the development of a cash flow hedge accounting model? Please explain.

Other issues that are not addressed in the DP

Cross-cutting issues with other IFRS

IAS 21 The Effects of Changes in Foreign Exchange Rates

259 IAS 21 requires an entity to translate its foreign currency items into its functional currency. One could argue that when considering financial instruments as the underlying item on the statement of financial position this makes the application of the portfolio revaluation approach to foreign currency risk redundant as the exposures are expressed at current value. However IAS 21 only takes into account the exchange rate at period end and not expected future changes in this rate.

IFRS 9 Financial Instruments

260 A model bringing an overlay of current value on all managed portfolios would, de facto, contradict the conclusion reached in IFRS 9 *Financial Instruments* that the major part of banking books' financial instruments are best measured at amortised cost.

261 Relying on risk limits may interact with the business model. If the portfolio revaluation model were to require revaluation of exposures at a benchmark rate, entities may have an incentive to hold financial assets and collect their cash flows instead of holding them for sale as this would avoid remeasuring the basis spread. When risk limits apply without limitation, one could argue that significant risk exposures would remain within the entity as the portfolio revaluation approach requires no externalisation.

IFRS 13 Fair Value Measurement

262 EFRAG notes that the change in market practice of measuring external derivatives may have as an effect that the offset between the PRA and the external derivative(s) is less than perfect. Although due to a cause independent from the portfolio revaluation approach, it would affect its outcome. The difficulties related to the new market practice are discussed in paragraphs 21 to 24 of this Annex.

Negative interest rates

263 In January 2013 the IFRS Interpretations Committee discussed negative interest rates and decided to refrain from finalising the tentative agenda decision until the IASB had completed its re-deliberations on the Exposure Draft *Classification and Measurement*. EFRAG welcomed that decision as we were concerned that "the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification" is currently not an explicit requirement and was thus interpretative in nature (EFRAG letter of 17 January 2013 to the IFRS Interpretations Committee).

264 EFRAG is of the opinion that entities should be able to reflect the effect of dynamically hedging negative interests when such exposures are part of the overall interest exposure an entity has.

Hedging credit risk and insurance risk

265 As the portfolio revaluation approach in the DP does not focus on dynamic risk management of cash flows, extending its scope to other risks types may be

difficult especially for those risks where changes in current value are not the main drivers of risk. For example when considering credit risk and insurance risk.

266 When credit default swaps are used to hedge the ultimate credit risk of an exposure, the credit spreads on credit default swaps and underlying cash instruments do not move together, i.e. the correlation coefficient in market prices movements is less than one. Consequently, the offset under the portfolio revaluation approach would be less than perfect leading to volatility in profit or loss.

267 A similar issue arises when hedging insurance risk by relying on re-insurance. Also here the pricing of both items are not fully correlated which could lead to a less than perfect offset under the portfolio revaluation approach even though the reinsurance contract may be a perfect hedge of the insurance risk in the insurance contract.

Unit of account

268 The DP does not address the unit of account to be used as part of the approach. The choice of the unit of account has operational consequences as it will define the level of breakdown to account for the risks being mitigated.

269 EFRAG is of the opinion that the unit of account should be the one considered by ALM in transferring risk positions to the trading function. It is ALM which decides to transfer the risk exposure of an individual financial instrument, of a risk component or of a portfolio to the trading function. Therefore any final standard should allow the flexibility for the unit of account to depend on how ALM has decided to transfer the risk.