



EFRAG
35 Square de Meeûs
1000 Brussel
Belgium

Re: Comments on Discussion Paper “Accounting for dynamic risk management”

Dear Ms. Flores,

We are providing you with this comment letter from the perspective of KBC Group. KBC Group is an integrated bank-insurance group, focused on serving retail, private banking, SME and mid-cap clients. Geographically, we focus on our core markets of Belgium, the Czech Republic, Slovakia, Hungary and Bulgaria. We are also present in Ireland and, to a limited extent, in several other countries to support corporate clients from our core markets. KBC Group employs around 36 000 people and serves approximately 10 million customers.

We welcome the effort the IASB has put into developing a new framework for macro hedging and we do realize that for some elements the IASB is open to a progressive approach and might be going against the grain.

Overall, we would welcome a new approach, as we do realize that the current work-out around solutions which many banks apply, do not lead to useful/meaningful information, however the current work-out around solutions do achieve one primary objective; i.e. reduce to a large extent P&L volatility which is caused by an accounting mismatch due to the fact that hedging derivatives need to be at fair value through P&L. Hence **our fundamental concern with the portfolio revaluation approach (PRA) is that it would introduce volatility instead of reduce**. More specifically, we believe that the PRA approach focusing on dynamic risk management penalizes banks that perform dynamic hedging versus banks who would not. The **proposed alternative risk mitigating PRA approach** is in our opinion **operationally too complex** to implement and we believe that tracking requirements should be avoided to a maximum extent. In our view the lack of useful information under IAS 39 / IFRS 7 could alternatively be addressed through **additional disclosures**, e.g. the remaining interest rate sensitivity after hedging (based on behaviouralised cash flows), which in our view is the most useful information for someone who wants to understand the risk a bank is facing.

As an alternative approach, we urge the IASB to **reconsider accrual accounting** for macro hedging derivatives. We understand there is some skepticism in the market regarding derivatives at amortized cost (certainly as a result of the crisis), but please do not forget we are considering plain vanilla ALM derivatives, which were certainly not at the cause of the crisis. We concur with the IASB view that in that case any imperfections in the risk management activity will not show immediately in P&L, however it will be reflected in the income statement over time. This is consistent with the view that the P&L should reflect the performance of the current period taking into account the relevant business model (i.e. realizing an interest margin) and should not be influenced by a future outlook. Revaluation is a value at a point in time and does not provide information on actual future cash flows. As mentioned before, disclosures can fill the potential information gap for users. From an operational perspective, this would by far be the easiest solution to implement.

In case derivatives would need to remain at fair value, we would prefer the following **alternative approach** (following the cash flow hedge mechanics):

- ALM derivatives (based on internal controls) are measured at fair value (clean fair value change due to interest through OCI, other fair value changes through P&L)
- No revaluation of hedged items other than required from IFRS 9 Phase 1
- Recycling from OCI:
 - o If held to maturity: no recycling needed (as swap starts with zero fair value and ends with zero fair value)
 - o Unwind/sale of hedging instrument (3 options to consider): either amortization over residual life of derivative; or immediate recycling through P&L; or no recycling
- Additional disclosures to meet the demands of analysts (e.g. show the P&L before and after hedging)

This approach starts from internal controls, and we understand that the IASB has conceptual issues in terms of who would check these internal controls and whether there would be a level playing field. Our suggestion would be to incorporate the requirements for such internal controls in an IFRS standard, a bit similar to the current requirements which need to be met before one can apply hedge accounting under IAS 39. Auditors would then be responsible for checking these and for creating the level playing field. In banks these internal controls are in place as these are under scrutiny of the National Banks or similar authorities, however for corporates there is no such oversight, hence the plea for including into a standard. A clear benefit of this approach would be that tracking would not be required.

In case the IASB would decide to continue with the PRA, we would have a strong preference for the **approach through OCI**, again for the same reason i.e. avoid unnecessary P&L volatility. This is obviously under the assumption that the Basel exempt for cash flow hedges would be applicable here as well.

In our view the DP properly reflects the way banks often manage interest rate risk, i.e. dynamically and by open portfolios, however in our opinion there is insufficient **distinction between a hedging position and a transformation position**. We consider a hedging position as the net interest rate gap between assets and liabilities with a fixed maturity, whereby the interest rate gap is closed via IRS's. The transformation position – in our case – is determined by the current accounts and saving accounts with no fixed maturity, which are replicated into a bond portfolio, based on which a transformation result is realized. In our view, the transformation position should be kept out of the PRA approach. In fact if one would hedge an interest rate position with a non-derivative (e.g. bond) which is classified within the ALM portfolio either at amortized cost or at fair value through OCI, this would result in an accounting mismatch created by the application of the PRA.

Regarding **specific feedback** on the different PRA approaches, please find below our feedback:

- 1) If we start from the initial objective that the PRA wants to reflect the actual risk management activities, and if we take into account that these risk management activities are slightly different amongst financial institutions, it would seem only logical to provide different options/choices to be applied at the discretion of the preparers (i.e. most appropriate). Hence if a bank includes **pipeline transactions** (condition must be highly probable), **EMB and behaviouralisation** into its

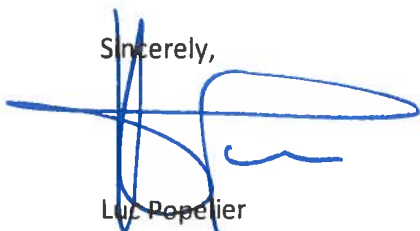
dynamic risk management process, it should be possible (not mandatory) to include in the PRA if this would be considered appropriate by the preparer.

- 2) We are a strong advocate of the **bottom layer approach** to avoid unnecessary P&L volatility. For prepayable portfolios that are dynamically managed on a behaviouralised basis, application of the PRA will lead to P&L volatility stemming from a.o. changes in behavioural assumptions, which are not a good representation of dynamic risk management, as this does not represent the performance of the current period, but only gives a look at the future. The prepayment issue can easily be addressed through under-hedging and when applying the bottom layer approach.
- 3) We concur that **risk limits** should not be reflected in the application of the PRA, as the wider the risk limits would be, the less volatility the P&L would show.
- 4) **Core demand deposits** are part of our transformation position, which is replicated into a bond portfolio, based on which a transformation result is realized. In our view, the transformation position should be kept out of the PRA approach. However, conceptually, we agree that including core demand deposits in the hedging position should be possible and obviously on a behaviouralised basis as this is the way that risk management typically would consider this. We do not believe guidance is required to determine the behaviouralised profiles of core demand deposits as this depends on many factors and is different from one bank to another. Restricting this would be in contradiction to reflecting actual risk management practices.
- 5) The goal of the PRA is to bring accounting closer to the risk management. Considering that risk management determines its net risk position against a benchmark interest rate, it seems only logical that **sub-libor hedging** should be possible, leaving the margin (positive or negative) within the business units, and hence outside the PRA. In addition any embedded floor would not be relevant if this is not included in the dynamic risk management process. Hence, we believe that approach 3 "Risk included in ALM (transfer pricing)" indeed is the most appropriate way to represent the actual dynamic risk management process (cfr. Question 10). Note that in our dynamic risk management process, the hedged/managed risk is the swap rate. The **transfer pricing rate** includes IRS rate, add-on, liquidity spread, ..., which besides the swap rate are not managed through the dynamic risk management process and hence should be out of scope of the PRA. We would therefore opt for approach 1 (cfr. Question 12). Regarding ongoing linkage (§4.3): if CU50 million is repaid, it means that the ALM interest rate position (= hedged item) has changed and that they will take appropriate action (e.g. new derivative) to close the ALM interest position again. From a dynamic risk management position, the risk has been adequately been dealt with and hence should not give rise to volatility. The effect of the prepayment will affect the net margin over time, but rightfully should not give rise to immediate P&L volatility, as from a dynamic risk point of view, the risk has been managed.
- 6) We believe the **scope** should focus on the **risk mitigation** activities of the dynamic risk management process, and more specifically the proportional approach. When one takes into account one of the primary objectives of a bank, i.e. making a transformation results, it is obvious that certain positions can be left unhedged. The transformation result would be achieved through instruments which are recorded at amortized cost and hence would not lead to P&L

volatility. If the scope of the PRA would focus on dynamic risk management instead of risk mitigation, this would lead to short term volatility, whereas the transformation result is a long term objective. The discrepancy would not result in meaningful information. As an alternative, and to accommodate most diverse entities and dynamic risk management processes, one could consider a toolkit approach, i.e. apply the scope which is deemed appropriate by the preparer.

- 7) We are of the opinion that in any case where PRA is applied, the exact **scope** should be defined in the hedge documentation (i.e. which portfolios are included in the hedge items?) and included in the disclosures. In addition, it seems also logical that once you **start**, you are not able to **stop** the PRA, unless you freeze/close a portfolio and let it mature.
- 8) In terms of **presentation alternatives**, our preference would be the “single net line item” presentation as this is the closest representation of the dynamic risk management process, where everything is looked at on a net basis. For the statement of comprehensive income, our preference would be the “actual net interest income presentation” approach as this reflects best the dynamic risk management process and in addition is the easiest to implement.
- 9) We are not in favour of including **internal derivatives**, as we believe it could lead to misleading information if results from trading activities are mixed with results from dynamic risk management. In addition, accounting for internal derivatives might have a tax impact, since some of the levies are based on the ‘trading volume’.

Sincerely,

A handwritten signature in blue ink, appearing to be 'Luc Popelier', written over a horizontal line.

Luc Popelier
CFO of KBC Groep NV