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**Discussion Paper - Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging**

Dear Mr Hoogervorst

The European Banking Authority (EBA) welcomes the opportunity to comment on the IASB's Discussion Paper DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging (DP hereafter). The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA welcomes the IASB initiative to develop a macro-hedge accounting model which aims to better reflect the dynamic risk management activities of entities in their financial statements. For banks, this is of particular relevance to the management of interest rate risk exposures in the banking book, which may be managed on an open portfolio basis. This initiative, if well implemented, would improve consistency and transparency in accounting for banks' dynamic risk management activities. While we have a number of concerns about the proposals as set out below, overall we encourage the IASB to further develop its proposals for reflecting banks' dynamic portfolio hedging in their financial statements.

The EBA understands that the objective of the proposed Portfolio Revaluation Approach 'PRA' (as defined in the DP) needs to be further clarified. In fact, the two proposed approaches included in the DP have different objectives: to reflect the entity's net open position with respect to a particular risk managed (the dynamic risk management approach) or to reflect the entity's hedging activity for such a net position (the risk mitigation approach).

Between the two proposed approaches, we see greater merits in the risk mitigation approach as it seems to be more consistent with an entity's risk management strategy. The EBA is concerned that the dynamic risk management approach does not reflect the actual hedging activities of an entity. This approach could lead to significant volatility in profit or loss resulting from the revaluation of dynamically managed portfolios (including the revaluation of credit intermediation activities) regardless of the extent to which these portfolios are hedged. This would also be inconsistent with the principles underlying IFRS 9.

However, we believe that under the risk mitigation approach, there are certain challenges that need to be addressed. More specifically, the macro hedging model should include a) sufficient guidance and safeguards (including sound eligibility criteria and appropriate documentation of the bank's risk management policies) to ensure robust and consistent application of the PRA, while ensuring the comparability and verifiability of the financial information and b) adequate disclosure requirements, to enable users of financial statements to understand a bank's risk management activities and their impact on the financial statements.

In addition, the EBA believes that not all aspects of an entity's risk management activities should be reflected in the financial statements. In particular, there should be a thorough consideration of the consistency of the macro hedge model with the overall IFRS conceptual framework, as well as consideration of the possible consequences on the comparability and verifiability of financial information. Also, a balance needs to be struck between improving the representation of the economics of hedging activities and avoiding undue complexity.

In this regard, considering the challenges in the development of a new accounting model we would also welcome the IASB to consider alternative solutions, such as amendments to existing standards (i.e. IAS 39/ IFRS 9).

Our comments on the DP are set out in the Annex to this letter.

If you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely

*(signed)*

Andrea Enria

## Annex

### **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?*

#### **Response**

As explained in the DP, the dynamic risk management of net open positions includes a continuous reassessment of the net open risk positions arising from the managed portfolios. As expressed in the EBA comment letter on the IASB Exposure Draft on Hedge Accounting<sup>1</sup>, the EBA supports the intention to increase the alignment of hedge accounting with risk management practices of banks, and to reflect appropriately these risk management activities in the financial statements.

The EBA agrees that dynamic risk management is different from other types of risk management addressed by the general hedge accounting requirements, due to the fact that it refers to the management of net open positions (rather than closed portfolios) which are constantly changing, as explained in the DP. We concur with the IASB that the application of the current IAS 39 provisions to exposures in open portfolios is challenging and complex and therefore institutions may find difficulties in representing faithfully their risk management activities in their financial statements. In particular, there are limitations in applying the requirements for fair value hedge accounting of a portfolio hedge of interest rate risk to macro hedging activities, such as the eligibility constraints in the designation of hedged items as well as the operational complexity (for example, prescriptive requirements for the measurement of hedge effectiveness and the requirements for continuous de-designation and re-designation of hedged items). These difficulties have led entities to adopt a 'patchwork' approach of presentation of their dynamic risk management activities in the financial statements, affecting the understandability, comparability and consistency of financial statements.

Therefore, there is a need for the development of an accounting solution which addresses the challenges in the current accounting for macro hedging (especially for banks managing their net interest margin), in order to provide users of financial statements with a fair representation of the economics of dynamic risk management in the financial statements.

However, from the analysis in the DP, it does not seem that all possible ways to address the issues of macro hedge accounting have been sufficiently explored. We question whether these issues could have been addressed through other alternatives such as amendments to current standards (i.e IAS 39/ IFRS 9).

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<sup>1</sup><https://www.eba.europa.eu/documents/10180/16535/2011-03-09-EBA-comments-ED-2010-13-Hedge-accounting.pdf>

In particular, considering the challenges in developing a new accounting model and the operational complexity of current provisions of IAS 39/ IFRS 9 (that led to the EU carve-out), it may be possible that current standards could be amended to enable entities to reflect dynamic risk management in their financial statements, for example by improving or removing of some of the existing restrictions in IAS 39/ IFRS 9 to allow for these requirements to be applied to open portfolios.

**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?*

**Response**

(a) The EBA is of the view that the DP has identified the main issues that entities currently face in applying the current hedge accounting requirements to positions under dynamic risk management, such as the challenges in applying the current accounting requirements to open portfolios, as well as the treatment of forecast transactions and demand deposits for risk management purposes.

However, the DP does not seem to have considered other accounting techniques that may be currently applied by banks to reflect dynamic risk management activities in their financial statements, for example proxy hedging techniques. In this regard, we believe that there is a need to consider the interaction of the macro hedging proposals with other accounting techniques that banks are currently applying.

(b) The PRA could be seen as a valuation model which focuses on the *valuation* of hedged positions. However, this does not seem to be aligned with the Asset Liability Management (ALM) of banks which focuses on the risk of *variability of future cash flows* arising from exposures sensitive to interest rate risk with the objective to stabilise/lock the net interest margin.

Therefore, while we acknowledge that the PRA could be a possible way to address current accounting issues in macro hedge accounting, it is then necessary that the objective of the model is further clarified. At this stage it is difficult to fully support any of the PRA approaches (see question 15) due to some concerns we have on certain aspects of the proposed model – as discussed in more detail in our responses to the questions below.

### **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? If not what changes do you suggest, and why?*

#### **Response**

The EBA is of the view that dynamic risk management is described rather broadly in the DP. The EBA supports the development of a macro hedge accounting model which appropriately reflects the risk management practices of banks. In this respect, a balance needs to be struck between improving the representation of the economics of hedging activities and avoiding undue complexity. However, we believe that not all the aspects of dynamic risk management need to be reflected in the financial statements (for instance the Equity Model Book).

We also support the introduction of some eligibility criteria in the macro hedge accounting model (for instance documentation requirements for items included in a hedging relationship to which macro hedge accounting is applied).

### **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 consideration 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 on a contractual basis (for example, after considering prepayment expectations), when the risk is managed on a behaviouralised basis? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework.*

## Response

(a) The EBA would be concerned with the inclusion of pipeline transactions, as described in the DP, in the model as recognition of such transactions may not meet the definition of assets and liabilities and may not be consistent with the principles of the conceptual framework. For example, they may not give rise to recognised assets or liabilities.

We would welcome the development of a clearer definition of pipeline transactions in the DP along with some specific eligibility criteria. Narrower eligibility criteria would restrict the recognition of “revaluation adjustments” to only those arising from eligible pipeline transactions. This would also reduce the concerns about comparability and auditability that might arise due to the significant degree of management judgment required.

(b) EBA believes that the application of the PRA to the EMB entails a significant departure from the conceptual framework where equity is defined as the residual interest in the assets of the entity after deducting all its liabilities. In addition, assuming a fixed base return for holders of instruments which do not involve any contractual obligation to deliver cash seems to be counterintuitive and would not provide useful information for users.

(c) EBA agrees that dynamic risk management is usually based on the expected cash flow profile rather than on the contractual life of the exposures and the inclusion of such exposures in the PRA on a behaviouralised basis would allow the financial statements to better reflect some commonly used risk management practices (such as interest risk management on banks’ core deposits). However, because it involves a significant use of judgment, we would be concerned if it could lead to earnings management practices and impair comparability and auditability of the financial statements.

Therefore, appropriate guidance and safeguards (for example through appropriate documentation) are needed when such assumptions are considered in the PRA in order to ensure faithful representation and consistency of application. In addition, disclosure of the assumptions and the inputs used in the models should be required in order to provide a comprehensive view of the bank’s risk management activities and allow users to better understand and compare financial information.

## 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.*

## Response

It should be noted that prepayment expectations are already considered in IAS 39. Prepayment risk may be considered by an entity in the risk management of an open portfolio and behavioural expectations might be developed by entities in order to manage these risks. Therefore, when applying the PRA, banks could consider the effect of prepayments when estimating cash flows. EBA also acknowledges that in some cases a bank might decide to protect only the net open position from changes in the downside risk with the use of options.

#### **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?*

#### **Response**

The EBA believes that if banks are required to consider cash flows on a behaviouralised basis rather than on the contractual life of the exposures, the changes in customer behaviour would need to be considered in the application of the PRA and the impact of such changes would have to be recognised in profit or loss. However, we are concerned that the recognition of changes in behavioural assumptions in profit and loss could lead to earnings management. Therefore we would welcome the introduction of appropriate guidance and safeguards (as mentioned in our responses to questions 4 and 9) in considering the genuineness of the changes in behaviour in order to ensure faithful representation and comparability.

#### **Question 7—Bottom layers and proportions of managed exposures**

*If a bottom layer or a proportion approach is taken for dynamic risk management purposes, do you think that it should be permitted or required within the PRA? Why or why not? If yes, how would you suggest overcoming the conceptual and operational difficulties identified? Please explain your reasons.*

#### **Response**

Both a bottom layer approach and a proportion approach may be consistent with the risk management practices applied by entities to some extent. However, the EBA believes that under both approaches, the model should ensure that the actual existing risk exposures are considered in the hedge accounting relationship and that the model can be applied in a robust and consistent manner by entities. The proposed approaches may be complex to implement and also impose operational burden which may be similar to some extent to the current hedge accounting requirements, because as explained in paragraph 3.7.3 of the DP, they would include tracking and amortisation requirements in order to identify the items within the macro hedge relationship

when changes to the level of the bottom layer or proportion occur (for example due to the addition or removal of exposures).

Additionally, in the absence of more details on the conditions on how to apply these approaches, for example, how to assess hedge effectiveness, it is not possible to assess the appropriateness of these methods to be considered in the model. The approach should ensure the recognition of any resulting gains and losses immediately.

#### **Question 8—Risk limits**

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

#### **Response**

The EBA shares the IASB's view that reflecting risk limits in the application of the PRA could lead to counterintuitive results. In addition, several concerns would arise regarding comparability and auditability of financial statements if entity specific thresholds are introduced in the PRA.

#### **Question 9—Core demand deposits**

*(a) Do you think that core demand deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA if that is how an entity would consider them for dynamic risk management purposes? Why or why not?*

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

#### **Response**

Core demand deposits, which are an essential element in interest rate risk management by many banks, are generally considered on a behavioural rather than on a contractual basis for risk management purposes and, theoretically, they could be reflected in the same way within an accounting model which seeks to depict dynamic risk management. However, considering the specific nature of these liabilities (no maturity and redeemable at demand), the EBA believes that core deposits should be shown on the face of the balance sheet at the amount due, with any hedge accounting revaluation presented separately (see also question 18).

We also note that banks with a similar portfolio may make different estimates (for example, the maturity of their portfolios). Therefore, it would be necessary to ensure comparability and consistent application to the extent possible and limit the room for possible earnings management. In this regard, the model should provide sufficient guidance on the development of estimates in this area and how these estimates and their effect should be disclosed in the financial statements. Such disclosures could possibly include benchmarking, peers' analysis, back-

testing, as well as robust documentation of the bank's current practices and any changes thereof being justified.

#### **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 (ie Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (ie Approaches 1 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? Why or why not?*

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

#### **Response**

In our opinion, sub-benchmark instruments may be included in the managed portfolio taking into account the extent to which they are considered in the risk management activities applied by an entity. It will of course be necessary to consider the appropriate accounting treatment for the option created by the floor in such instruments.

#### **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?*

#### **Question 12—Transfer pricing transactions**

(a) *Do you think that transfer pricing transactions would provide a good representation of the managed risk in the managed portfolio for the purposes of applying the PRA? To what extent do you think that the risk transferred to ALM via transfer pricing is representative of the risk that exists in the managed portfolio (see 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 think provides the most faithful representation of dynamic risk management? If you consider none of the approaches to be appropriate, what alternatives do you suggest? In your answer please consider both representational faithfulness and operational feasibility.*

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

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

**Question 13—Selection of funding index**

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

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

**Question 14—Pricing index**

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

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

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

**Response to Questions 11-14**

The EBA supports the revaluation approach to the extent that it is consistent with the purpose of the macro hedge model and the scope of the PRA.

We also note that the revaluation adjustments by type of risk are not identical to a full fair value approach which includes the revaluation of all risks. We agree with the DP that the PRA should not include customer-specific lending margins because this is not the risk that is being dynamically managed. Similarly, we support the use of a transfer pricing rate that reflects only general market funding conditions and excludes other transfer pricing spreads as these are typically not included in dynamic risk management. In line with the IFRS principles, we favour the use of external market prices/rates over the use of internal transfer prices or funding rates which are subject to a higher level of management judgment and potential manipulation. Moreover, we are concerned that the

use of entity-specific parameters could impair comparability among banks and raise auditability issues.

We do not think that it is possible to identify a single funding index for all dynamically managed portfolios within an entity as this may not reflect how the entity finance its transactions. We believe that as long as the funding indices are reasonable, verifiable and comprehensive, it should be possible to use more than one funding index for a bank's dynamically managed portfolios.

In addition, the financial reporting of banks should not reflect internal risks transfers within a bank but should reflect its risk vis-à-vis external to the bank.

### **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?*

### **Response**

These questions relate to the heart of the issues in the DP: the scoping of the PRA. The EBA appreciates the exploration of both approaches, i.e. the dynamic risk management and the risk mitigation approach. However, as noted in our response to question 1, we believe that the IASB could have explored other alternative solutions in addressing the current issues in accounting for macro hedging, such as amendments to current standards (i.e. IAS 39/IFRS 9).

Between the dynamic risk management approach and the risk mitigation approach discussed in the DP, the EBA sees greater merits in the risk mitigation approach which has a narrower scope. It seems to reflect more appropriately the risk management activities of banks and it could lead to a

reduction of accounting mismatches. However, we should also consider the possible operational complexity in the risk mitigation approach. In addition, it will be necessary that sound eligibility criteria are developed in order to ensure discipline and thus avoid earnings management and that transparency is increased through sufficient disclosures which provide a comprehensive view of the entity's risk management activities.

We do not favour the dynamic risk management approach, under which all exposures would be revalued irrespective of whether they are effectively hedged, and therefore does not reflect appropriately the actual risk management practices of an entity, for example, to stabilise net interest income. In addition, the EBA would be concerned if the application of the dynamic risk management approach would expand the use of fair value and lead to significant volatility in profit or loss resulting from the revaluation of the entity's dynamically managed portfolios (including the revaluation of credit intermediation activities) regardless of the extent to which these portfolios are hedged. This would also be inconsistent with the principles underlying IFRS 9.

#### **Question 16—Mandatory or optional application of the PRA**

*(a) Do you think that the application of the PRA should be mandatory if the scope of application of the PRA were focused on dynamic risk management? Why or why not?*

*(b) Do you think that the application of the PRA should be mandatory if the scope of the application of the PRA were focused on risk mitigation? Why or why not?*

#### **Response**

Pending the final outcome of the proposed accounting model, the EBA cannot express a view as to whether the application of the PRA should be mandatory in either of these approaches.

Nevertheless, we note below a few matters for consideration in determining whether the application of the PRA should be mandatory or optional:

- i. The application of the PRA should be mandatory if the final outcome of the macro-hedge accounting model provides a faithful representation of the economics and activities of all bank's models for effectively managing interest rate risk of open portfolios as described in the DP.
- ii. While requiring a mandatory application of the PRA would promote apparent comparability of financial reporting across banks (compared to an optional application requirement), the benefits could be limited due to the differences in banks reflecting the different risk profile and risk management strategies.
- iii. That said, a mandatory application could limit the current issue of 'patchwork' application of the existing accounting standards including proxy hedges.

In determining whether the application of the PRA should be mandatory or optional, the IASB should also consider the interaction between the application of the PRA and IFRS 9 general hedge accounting model – which is optional – under IFRS 9.

#### **Question 17—Other eligibility criteria**

*(a) Do you think that if the scope of the application of the PRA were focused on dynamic risk management, then no additional criterion would be required to qualify for applying the PRA? Why or why not?*

*(i) Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.*

*(ii) If the application of the PRA were optional, but with a focus on dynamic risk management, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.*

*(b) Do you think that if the scope of the application of the PRA were to be focused on risk mitigation, additional eligibility criteria would be needed regarding what is considered as risk mitigation through hedging under dynamic risk management? Why or why not? If your answer is yes, please explain what eligibility criteria you would suggest and, why.*

*(i) Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.*

*(ii) If the application of the PRA were optional, but with a focus on risk mitigation, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.*

#### **Response**

Regardless of the scope and of whether any of these approaches are to be made mandatory or optional, there needs to be some discipline in place around the use of PRA to ensure the appropriate and consistent application of the final standard.

These include clarifying the scope of the exposures that the PRA should be applied to under the adopted approach, and establishing specific requirements to promote appropriate governance, control, monitoring and assessment of the exposures under the adopted approach. Amongst other issues, the IASB should consider the following in the final standard:

- i. To clarify that the use of PRA is subject to designation and documentation rules broadly similar to the general hedge accounting model. For example, it should require a bank to demonstrate that the use of PRA appropriately reflects its actual and documented risk

management strategy and activities, and that the adopted hedging approach achieves its hedging objectives.

- ii. To include effectiveness criteria in the final standard in order to reduce, if not eliminate, the opportunities for banks to manage the recognition of gains/losses on the hedging instrument. Hedging relationships should be eligible for the PRA only if banks can show that there is a clear economic basis as well as a statistical one.
- iii. To require that the risks hedged be capable of being separately identified and reliably measured.
- iv. To require banks to demonstrate that the assumptions and inputs used in the adopted approach are appropriate. This may include requirements for independent verification of the model inputs and back-testing of the accuracy and appropriateness of the inputs.

For a dynamic risk management approach, the final standard should provide guidance to define the boundary of the exposures that can be included in the PRA scope of application. For a risk mitigation approach, the final standard should include more detailed criteria on which transactions would qualify to be included in the risk mitigation portfolio, and which would not.

### **Question 18—Presentation alternatives**

*(a) Which presentation alternative would you prefer in the statement of financial position, and why?*

*(b) Which presentation alternative would you prefer in the statement of comprehensive income, and why?*

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

### **Response**

At this stage, the EBA finds it premature to express a preference for any of the suggested presentation alternatives.

If we were to express a preference amongst the alternatives of the DP, with regard to the proposed presentation alternatives for the statement of financial position, the EBA sees more merits in the single net line item as proposed in paragraph 6.1.4 (c). As explained in paragraph 6.1.7 of the DP, this alternative seems more in line with the principles for dynamic risk

management and at the same time avoids the complexities of the line by line alternative. We also support this alternative as in our view the value of hedged instruments should remain unchanged (in particular demand deposits which should be presented on the Balance Sheet at their nominal value). This would also be in line with paragraph 6.1.10 of the DP, as under this approach the presentation of assets and liabilities in the statement of financial position will not be at a different amount than what is envisaged under IFRS 9 – Phase I.

With regard to the presentation alternatives for the statement of comprehensive income, the EBA sees more merits in the actual net interest approach outlined in paragraph 6.1.13 (a) due to the reasons explained in paragraph 6.1.14 and paragraph 6.1.15 of the DP.

#### **Question 19—Presentation of internal derivatives**

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

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

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

#### **Response**

The proposed “grossing up” presentation of internal derivatives is not consistent with the generally accepted approach to consolidated accounts under IFRS to eliminate intragroup transactions and, therefore, the EBA believes that internal derivatives should not be presented in the financial statements as they should net out at a reporting entity level. Only exposures created with external parties should be reflected in the financial statements.

#### **Question 20 Disclosures**

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

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

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

### **Response**

EBA is generally supportive of the four disclosure themes proposed in the discussion paper which aim to provide qualitative and quantitative information to users on the portfolio revaluation approach applied and to enhance the users' understanding of an entity's open risk positions, the risk management activities used and the impact on the current and future results of an entity. EBA finds it important that users get a comprehensive view of the activities undertaken and of the entity's risk profile. As also mentioned in our previous answers, disclosures will play a key role in informing users about the different assumptions and estimates used in applying the macro hedge model in the financial statements allowing them to make comparisons across banks.

However, the EBA believes that at this stage it is too early in the process to discuss specific disclosure requirements given that the scope of the model, including the most appropriate PRA model to use, has not yet been finalised. Nevertheless, in developing the disclosure requirements, the IASB should consider possible areas of overlap between the required disclosures and the existing disclosures as required by other relevant standards (for example IAS 39, IFRS 9 and IFRS 7).

### **Question 21 Scope of disclosures**

(a) *Do you think that the scope of the disclosures should be the same as the scope of the application of the PRA?*

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

### **Response**

EBA agrees that the scope of the disclosures should be consistent with the scope of the application of the PRA to ensure that the impact of applying the PRA is clearly identifiable in the financial statements and also to minimise the risk of overlap with disclosures required by other IFRS Standards.

### **Question 22—Date of inclusion of exposures in a managed portfolio**

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

- (a) If yes, under which circumstances do you think it would be appropriate, and why?
- (b) How would you propose to account for any non-zero Day 1 revaluations? Please explain your reasons and comment on any operational implications.
- Question 23—Removal of exposures from a managed portfolio**
- (a) Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?
- (b) Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from a managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?
- (c) If exposures are removed from a managed portfolio prior to maturity, how would you propose to account for the recognised revaluation adjustment, and why? Please explain your reasons, including commenting on the usefulness of information provided to users of financial statements.

**Response**

Given that the whole purpose of this model is to reflect more accurately the results of dynamic risk management employed by an entity, it is thus important that the model reflects this by allowing the addition and removal of exposures to and from managed portfolios on a continuous basis. In this regard, there should be sufficient disclosures in order to ensure a full and proper understanding of the impact of the removal or inclusion of managed exposures on the profit or loss account and therefore equally limiting the possibilities for earnings management.

**Question 24 – Dynamic risk management of foreign currency instruments**

- (a) Do you think that it is possible to apply the PRA to the dynamic risk management of FX risk in conjunction with interest rate risk that is being dynamically managed?
- (b) Please provide an overview of such dynamic risk management approach and how the PRA could be applied or the reasons why it could not.

**Question 25 – Application of PRA to other risks**

- (a) Should the PRA be available for dynamic risk management other than banks' dynamic interest risk management? Why or why not? If yes, for which additional fact patterns do you think it would be appropriate? Please explain your fact patterns.
- (b) For each fact pattern in (a), please explain whether and how the PRA could be applied and whether it would provide useful information about dynamic risk information about dynamic risk management in entities' financial statements.

## Response

The EBA believes that it is important that the macro hedge model for net interest rate risk positions is sufficiently developed in order to ensure faithful representation of the economic transactions, the understandability and comparability of financial statements as well as consistency of application before it is to be expanded to other types of risks. In addition, at this stage, we are also concerned with the following two issues: (i) that an overly large scope for application would make the model more complex and difficult to apply and (ii) a broader scope would move it closer to a full fair value model and we are not convinced that this is the outcome desired by shareholders. However, considering that usually IFRS are not industry specific and hence, once sufficiently developed, we could support the expansion of the PRA to other risks in banking.

### 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 PRA, how could the conceptual and practical difficulties identified with this alternative approach be overcome?*

## Response

Before the EBA can express a view on the use of PRA incorporating the use of OCI instead of profit or loss, this approach would need to be further articulated. In particular, the interaction with the existing IFRS 9 general hedge accounting requirements needs to be further explained as well as the purpose of the OCI (compared to the use of the profit or loss account), which is currently being reviewed under the Conceptual Framework project. In addition, this option might increase complexity as explained in the DP (i.e. internal derivatives) and also raises the issue of recycling of OCI items to the profit or loss.