Federation of European Accountants
Fédération des Experts comptables Européens

TEG Chair
EFRAG
Square de Meeûs 35
B-1000 BRUXELLES

E-mail: Commentletters@efrag.org

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Ref.: BAN/AKI/HBL/PPA/SRO

Dear Ms Flores,

Re: FEE comments on EFRAG draft letter re IASB's Discussion Paper: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to macro hedging

FEE is pleased to provide you below with its comments on the EFRAG's draft comment letter re IASB's Discussion Paper: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to macro hedging. Please note that in line with our established practice we will also provide a direct response to the IASB consultation.

We are generally pleased with the approach taken by IASB and principles developed in this DP, which should be welcomed by EFRAG. However, in our opinion, it is essential that the IASB reaches agreement on the key principles underpinning, and the approaches to, dynamic hedging prior to solving some of the detailed questions raised in the DP. Therefore we have focused our response on the principle issues and left some of the detailed queries open as we believe there is an order to be followed in the development of solutions for a suitable financial reporting model for reflection of the modern risk mitigation approaches. We will consider our position on the details in the next DP or ED phases of this project.

We are convinced the Board is focusing on the key issues. FEE believes that the model proposed, once limited to risk mitigation, is the right one. However, we are conscious of the conceptual and practical challenges, which relate mainly to pipeline transactions, equity model book and behaviouralisation (as addressed in the FEE response to question 4 of the IASB DP) that could be difficult to overcome. Should the Board conclude these challenges are unsurmountable, we recommend the IASB revisits the existing IAS 39 approach to portfolio interest rate management with a view to simplifying its application and to extend its use to capture the foreign exchange and commodity risks.

In our view, the proposed model, once the conceptual and practical challenges are overcome, would likely provide a clear solution to the issues which caused the existing "EU carve out" to the IAS 39 requirements.

We would also like to stress that in order to find a comprehensive and practical solution to the accounting reflection of the existing risk mitigation practices, the IASB would need to amend or modify some of the current principles of asset and liability recognition and measurement. We point out that such reflection would be useful for these specific circumstances but should remain limited to portfolios exposed to the managed financial risks rather than extended to other items or conceptual framework approaches.

For further information on this letter, please contact Pantelis Pavlou, Manager, from the FEE Team on +32 2 285 40 74 or via e-mail at pantelis.pavlou@fee.be.

Yours sincerely,

André Kilesse	Olivier Boutellis-Taft
President	Chief Executive

Section 1 - Background and introduction to the portfolio revaluation approach

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.

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

(1) FEE believes that the proposed approach in the Discussion Paper ("DP") is a step forward in financial reporting and in producing more relevant and useful financial information compared to the current hedge accounting treatment and the general hedging provisions of the new IFRS 9. The current approaches to risk management are either not eligible to be captured by financial reporting or not easy to be reflected by entities which use dynamic risk management ("DRM") or the open portfolio concepts.

(2) We concur that the Portfolio Revaluation Approach ("PRA") raises conceptual challenges regarding the scope of application and the elements of the managed portfolios. Furthermore the PRA raises operational challenges when it comes to its practical application. Key challenges include the identification of the managed portfolio, the changes in behaviouralisation and the identification of the portfolio that is within the scope of the PRA when the scope focuses on risk mitigation.

(3) Nevertheless, FEE believes that overall the suggested PRA approach is a step forward aiming to present more relevant financial information and to enhance understandability for the users of financial statements.

Scope alternatives

(4) FEE strongly supports the focus on risk mitigation. This scope provides users with useful information about the risk management objective, activities and performance. The combination of the quantitative information for risk mitigation transactions and the qualitative disclosures for the risk management objectives and activities provides users with a comprehensive view of the entities' risk management.

(5) The alternative approach ("full DRM") would lead to unnecessary volatility in the reported profit or loss, so impairing the usefulness of the financial information. Furthermore, this alternative scope conflicts with the IFRS 9 principles which state that measuring the banking book using the amortised cost measurement produces more relevant information than other alternative measurement methods. Therefore a comprehensive change of the measurement basis for the whole DRM positions using the PRA will not enhance the usefulness of the information to the users.

Section 3 - The managed portfolio:

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 model 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.*

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

(6) The borderline between a forecast and a pipeline transaction is not clear in the DP and should be defined more specifically.

(7) We are concerned that full inclusion of forecast transactions would significantly affect the objectivity and auditability of the risk mitigation model. FEE agrees with the DP that the PRA should accommodate the pipeline transactions – provided these are clearly defined based on commitments made by the reporting entity and their expected consequences.

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.

(8) One of the main conceptual challenges of the PRA is the recognition in the financial statements of the changes in the fair value of elements that do not meet the definition of individual assets and/or liabilities. This raises challenges as to whether recognition of these items enhances the quality and relevance of financial information.

(9) The DP discusses three different alternative presentations for the Statement of Financial Position. FEE supports the net presentation (presentation alternative 3) which removes the need to assign the changes in the fair value of the managed portfolio to the individual items or presentation lines of the managed portfolio. This can further help preparers to overcome some of the conceptual challenges for recognising items on the financial position that do not meet the definition of assets or liabilities. It would also assist the users in having clear insight into the effects of the risk mitigation model on the performance and position of the reporting entity, particularly once comprehended by well-defined qualitative and quantitative disclosure requirements.

(10) Isolated presentation of the specific effects of the measurement of the hedged portfolio in the risk mitigation model would also ring-fence the measurement effects of this approach without compromising the recognition and measurement principles of the individual recognised assets and liabilities.

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?

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

(11) FEE suggests a simplified presentation of this issue. Only financial instruments that are measured at fair value through profit or loss (ie. derivatives, trading instruments and other instruments where at least the hedged risk is generally measured at fair value as currently applied for the foreign exchange risk hedging) should be allowed as hedging instruments, while all others included in the hedging model should be considered as part of the managed portfolio (including financial assets measured through profit and loss based on entity designation, at amortised cost or at fair value through OCI).

(12) Please see our identification of further challenges as outlined below.

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

(13) Under the simplified identification that is explained above, changes in the hedging instrument and hedged item should be accounted as they occur and the effects of the changes in the portfolio will be reflected at least at each reporting date.

(14) The changes in the hedging instrument will be reflected, provided the entity uses contractual solutions to the risk mitigation, directly in the profit or loss.

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

(15) Under both approaches the main operational and conceptual challenge is to identify which proportion of the portfolio is included in the managed portfolio. The concept of DRM includes open portfolios in its entirety and the fair value net exposure changes over time.

(16) In addition the risk management policies of the entity will probably change over time since the portfolios change. Identifying the bottom layer or proportion of the portfolio is not an easy or a static task. It should reflect the dynamic nature of macro hedging.

(17) Another challenge that FEE has identified is the probability that the individual exposures within the portfolio will have different terms and behavioural characteristics; therefore identifying a homogeneous portfolio would be quite challenging. Designating a bottom layer or a proportion would require such a homogeneous portfolio, which would need to clearly identify defined policies and internal controls. Having said that, FEE believes that this issue is limited to the cases when the changes in the hedged risks are considered for recognition.

(18) Furthermore in the event that an individual prepayment exceeds the average prepayment of the portfolio, the entity cannot assess whether this is a prepayment that should be recognised in profit or loss or whether, as long as the overall prepayment of the portfolio is within the limit, no immediate recognition in the profit or loss is required.

(19) Were the bottom layer approach adopted, notwithstanding the challenges identified, FEE agrees that any changes should be immediately recognised in the profit or loss.

(20) Furthermore we agree with EFRAG that in order for the PRA to be effectively applied, the entity should ensure that adequate internal controls are in place to avoid any instances of misapplication of the PRA to achieve desired results.

(21) In cases of overhedging, the effect of the ineffectiveness would be reflected in the profit or loss through the application of the PRA. To identify overhedging, FEE suggests that the entity should compare the open net positions arising from the hedging instruments (those that are measured at fair value through profit or loss) to the open net position of the hedged items (those that are measured at amortised cost or at FVOCI).

Section 4 - Revaluing the managed portfolio

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?*
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.

(22) Based on our understanding of the practical risk management activities, the objectives of risk management are well documented. The use of transfer pricing transactions is a common activity for risk management in larger banks and with rare exceptions they are properly documented and well established, therefore the systems are in place that can be used for accounting/linkage purposes.

(23) Since such banks have the systems and documentation in place, the IASB could introduce some requirements for proper documentation of transfer pricing transactions in order for the transfer pricing transactions to be used as proxies for the hedged external exposures (for example similar requirements to the designation of the hedging relationship as described in the general hedge model).

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?*
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.**

(24) At this preliminary stage, FEE considers the IASB'S efforts should be concentrated on defining the scope and key elements of the model. When that has been achieved, aspects of funding and pricing indices can be addressed.

Section 5 - Scope

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.*

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.

(25) FEE agrees with EFRAG that this example raises additional complexity and implementation difficulties to the accounting model for macro hedging. However, the immediate objective is to reach agreement on the accounting model. In FEE's opinion, fully addressing implementation challenges is not something to be solved by the current DP. In addition, in FEE's opinion this implementation issue forms and intrinsic part of the consolidation adjustments and implementation.

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.

(26) We agree that general hedge accounting model and macro hedge accounting model should not be applied to the same risk exposure and relevant financial risk simultaneously. Due to the definition of the DRM and PRA, a risk that is eligible to be accounted for under the macro hedging model would not be eligible to be accounted for under the general hedge accounting model.

(27) In addition, FEE believes that the application of PRA should be optional (FEE's response to question 16 of its letter to IASB), provided this is in line with the entity's risk management objectives and policies.

Section 6 - Presentation and disclosures

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?*

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.

(28) FEE does not agree that different valuation techniques should be used when valuing external or internal derivatives. In a simple example the sum of the two positions in the same internal derivative should in all material respects add to zero as the trading unit would be the counterparty in a derivative exposure with the ALM unit.

(29) We acknowledge that in certain circumstances there would be a difference in the valuation (e.g. due to the use of difference yield curves), however these differences should be limited to the minimum acceptable level and we do not believe that these differences would be material in most cases. No additional material differences should be accepted due to different valuation techniques.

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

(30) No. FEE believes that the treatment of internal derivatives as proposed in the DP does not enhance the operational feasibility for preparers. However it enhances the usefulness of the information presented in most cases. The internal derivatives are part of the risk management strategy since the entity manages its risks on an aggregated basis through a central department and then it normally transfers the risk to the trading units.

(31) Grossing up the internal derivatives in the financial statements generally enhances the usefulness and relevance of the financial information. The users will be in a position to better assess the entity's risk management policies and results, provided sufficient disclosure requirements are defined for items relevant on an individual basis.

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.

(32) As explained in Paragraphs 22 and 23, the risk management policies, activities and transfer pricing activities are most probably well explained and documented in most entities' risk management systems. Aligning the accounting requirements to the risk management activities would enable the entities to use the same systems for both purposes and thus reduce its implementation and operational costs.

(33) FEE believes that the IASB should consider introducing similar requirements like in general hedge accounting to require the entities to properly document the risk management activities and document the hedging relationships. In the case of internal derivatives, the entity should disclose how the internal derivatives mitigate the managed external risk and how the risk management objectives are achieved by the use of internal derivatives.

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

(34) No. FEE believes that the general requirements for external derivatives are sufficient also for internal derivatives. In addition, internal derivatives should be measured by the ALM and the trading units using the same or materially similar valuation techniques based on IFRS 13.

Section 7 - Other considerations

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.*

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

(35) Tracking would be required in order to identify which exposures are removed from the managed portfolio and which are not. Management may use their existing tools which can analyse the distinct cash flows to identify and assess the open positions for tracking of the exposures in the managed portfolio.

(36) Since the information of exposures excluded from the managed portfolios is already available to risk managers, it can be easily used for accounting purposes as well.

(37) As with other changes in the managed portfolio, like the changes in behaviouralisation, the effects of changes in the managed portfolio of hedged items should be recognised in the profit or loss at the earlier of their identification or removal from the portfolio.

(38) Entities that are not able to track these issues through their information systems should always be permitted to apply a model where items are included into or excluded from the macro-hedging portfolio solely on their recognition and derecognition, respectively.

(39) FEE identifies additional challenges where exposures are included in the risk mitigated portfolio after their initial recognition or exposures are removed from the portfolio before their maturity. In FEE's opinion these implementation challenges can be addressed once the general model issues are resolved.

Question 24 - Dynamic risk management of foreign currency instruments *(a) Do you think that it is possible to apply the PRA to the dynamic risk management of FX risk in conjunction with interest rate risk that is being dynamically managed?* (b) *Please provide an overview of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not*.
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.

(40) FEE agrees with the DP that an entity might manage differently the interest rate risk and foreign exchange risk of its portfolios denominated in foreign currencies. Depending on the risk management policies, an entity should have the possibility to apply the accounting treatment that best reflects its economic reality.

Section 8 - Application of the PRA to other risks

Question 25 - Application of the PRA to other risks *(a) Should the PRA be available for dynamic risk management other than banks' dynamic interest rate risk management? Why or why not? If yes, for which additional fact patterns do you think it would be appropriate? Please explain your fact patterns.* (b) *For each fact pattern in (a), please explain whether and how the PRA could be applied and whether it would provide useful information about dynamic risk management in entities' financial statements*
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.

(41) In FEE's understanding an accounting model for macro hedging can be applied not only to the interest rate, but also for commodity and foreign exchange risks. FEE notes that model may be relevant to the energy and public utility industry sectors. However, in FEE's opinion, before assessing whether other industries would be interested, the model needs to be further developed and refined.

Section 9 - Alternative approach - PRA through other comprehensive income

Question 26 - PRA through OCI *Do you think that an approach incorporating the use of OCI in the manner described in 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?*
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.

(42) The main characteristics of a cash flow hedge accounting model are:

a. The hedged item is not accounted for at full fair value,
b. Hedging instruments are recognised at fair value and any changes in fair value of the hedging instrument are deferred in the OCI,
c. The ineffectiveness part of the hedge relationship is accounted for in the profit or loss,
d. Once the hedged item gets realised/expires, the cumulative change of the fair value of the hedging instrument is capitalised in the cost of the hedged item or recognised in retained earnings.

(43) It makes sense to have a cash flow hedge accounting model for the hedge of variable rate exposures, as these exposures do not give rise to fair value risk and as stated in IAS 39 BC 148(c), exposures that do not give rise to fair value risk should be accounted for as cash flow hedges.

(44) However, operational challenges exist when the open portfolio changes profile and the risk management policy changes from managing the variable interest rates exposures to managing fixed rate exposures. This means that the "cash flow hedge" relationship is discontinued and recycling adjustment is required.

(45) A requirement to account for the cumulative change in the fair value of the open portfolio, at the time of a change of the model from a "cash flow" to a "fair value" hedge accounting model, in the profit or loss may compensate for the volatility arising from a recycling adjustment, however this requires individual transaction tracking and it might not produce relevant financial information to the users.

(46) Therefore if a cash flow hedge accounting model is to be considered it should be for all types of exposures and not only for the hedge of variable interest rate exposures.

(47) Having a cash flow hedge accounting model means that there would be no need to apply the PRA on the open portfolios, since they can still be measured at amortised cost. Any changes in the hedging instrument would be deferred in the OCI and not affect the profit or loss and these instruments would be reflected at fair value in the statement of financial positon.

(48) Although this approach seems to give solutions to some of the main issues that the DP identifies, it raises additional conceptual and practical challenges. Firstly the ineffectiveness cannot be easily measured as there is no one-to-one designation and hedging instruments in an opened portfolio keep changing on a regular basis. Secondly it is not clear how and when a recycling adjustment should take place and how it should be measured. Finally, once the hedging instruments expire or the hedge relationship ceases to exist, it is not clear how the cumulative adjustments that have been accumulated in a cash flow hedge reserve gets transferred to other elements of the statement of financial position (e.g. retained earnings) or whether there should a recycling adjustment through OCI at all.

(49) On top of the issues that exist with the concept of the cash flow hedge accounting, the DP correctly identifies an issue with reporting of internal derivatives. Under the assumption that internal derivatives are grossed up in the profit or loss, recognising the part that is attributable to the hedge relationship in the OCI will have an impact on the profit or loss.

(50) As explained in the DP, grossing up of internal derivatives does not have any impact on the profit or loss as long as both positions are reported in the same statement (i.e. profit or loss) and measured using same valuation methods. FEE believes that the internal derivatives should not have any material impact on the profit or loss.

(51) In concluding, FEE believes that the alternative to use the OCI (a "cash-flow hedge" accounting model) for the PRA raises more conceptual and practical challenges that it solves, and therefore, we do not support this alternative approach to the model."

Avenue d'Auderghem 22-28 • B-1040 Brussels • Tel: +32 (0)2 285 40 85 • Fax: +32 (0)2 231 11 12 • secretariat@fee.be • www.fee.be
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