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Comment letter to the Discussion Paper DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

Dear Mr. Hoogervorst,

Thank you for the opportunity to comment on the discussion paper.

We appreciate that IASB addresses the issues which banks face when striving for reflecting their risk management activities in accounting. The discussion paper provides a thorough analysis of actual risk management practices at banks and is a good basis for developing a proper solution.

We support the approach based on revaluation of interest risk bearing exposures and instruments managing the risk. However, we believe that the model should not be based on the full revaluation of the banking book positions (i.e. we do not support the dynamic risk management alternative). Instead it <u>should focus on economic hedges where the identified risks are being mitigated by risk management instruments</u>. Interest rate risk in the banking book resulting from unhedged positions should not be subject to P&L volatility. We believe that such P&L volatility would be difficult to understand by users of financial statements. P&L effects in the banking book are predominantly based on amortised cost measurement, i.e. they result from accrual rather than revaluation accounting. Interest rate risks inherent in the banking book are best to be addressed by banking supervision and the related disclosures are already provided under Pillar 3 of Basel regulations.

The model in discussion should serve as a means of reducing accounting mismatches in the area where risks are dynamically managed but standard accounting requirements lead to measuring of instruments with set off positions on a different basis. It should coexist with standard hedge accounting models (fair value, cash flow hedges of interest rate risks) and the entity should be able to choose the model which best suits its risk management practice.

We express our opinion in connection with interest rate risk management practices by banks. We have not analysed other types of dynamically managed risks for which the model may be applied as well. We do not manage such risks as part of our business. However, the comment letter contains discussion of foreign currency risk as a part of dynamic risk management of interest rate risk of exposures in foreign currency.

Question 1—Need for an accounting approach for dynamic risk management

Do you think that there is a need for a specific accounting approach to represent dynamic risk management in entities' financial statements? Why or why not?

Yes, definitely there is a need to have an accounting model relevant for showing the effects of risk mitigation practices for 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?

Yes, the DP provides detailed analysis which reflects the difficulties which our bank faces when applying hedge accounting.

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

The basic principles of the proposed approach based on revaluation of open portfolios would bring a proper accounting mechanism to reflect economic hedges in the environment of dynamically changing exposures. However, in order not to end up in the position of a theoretically correct but restrictive model, it also has to address properly all aspects of dynamic risk management like demand deposits, equity book, internal transactions.

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?

Yes, we consider the description as succinct.

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).

Even when our bank does not consider pipeline transaction as defined in the DP in its interest rate risk management we believe that pipeline transactions should be included in the

PRA. We believe that the PRA should reflect all aspects of interest rate risk management as actually applied by a bank. As regards operational feasibility, usefulness and consistency with the Conceptual Framework please see below.

Our bank enters into deals which have similar substance to the pipeline transactions. The bank occasionally agrees upon conditions of future issues of debt securities including the interest rate. However, at this point in time there is no obligatory contract. Due to reputational risks the bank has little chances to withdraw from the transaction. Knowing the conditions such positions are included in the management of interest rate risk and they are hedged by forward starting interest rate swaps. We firmly believe that such transactions should be part of the model.

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.

Equity model book should be included in the PRA if it is part of internal risk management practices in the banking book. As regards operational feasibility, usefulness and consistency with the Conceptual Framework please see below.

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.

It is crucial that behaviouralisation in the area of modelling of demand deposits and prepayment expectations is included in the model as long as it is part of risk management practices.

Operational feasibility

For banks which include pipeline transactions, equity model book in their risk management practices operational feasibility is not an issue. The respective cash flows are modelled and revaluations can be performed. To ensure operational feasibility banks should not be forced to go for modelling and revaluations in the areas which are not part of their risk management (e.g. they should not be forced to model the prepayment risk if they internally focus on contractual cash flows not reflecting the prepayment features).

Compliance with the Conceptual Framework and usefulness of the information

The PRA model should portray the effects of actual risk management practices. This should involve all kinds of cash flows considered in the risk management. If any kinds of cash flows were excluded it would result in less useful information for the users focused on actual risk management practices. The reason is that some derivatives mitigating the risks would continue to be revalued through profit or loss as the cash flows which they hedge could not be considered in the model.

The model should focus on cash flows rather than underlying items. Interest margin which is hedged by the banks results from cash flows which are not brought only by recognised assets and liabilities with their contractual life. Sticking to revaluation of only recognised assets and liabilities would ensure compliance with the Conceptual Framework. But on the other hand it would impose significant restrictions on the capability of the model to portray the effects of actual risk management practices.

The fact that this is a *revaluation* model should not lead to a conclusion that necessarily the revaluations have to result only from recognised assets and liabilities. The revaluation, i.e. reflecting changes in present value of cash flows, should be understood as an accounting mechanism to show the offsetting effects of the risk management instruments and the hedged risk bearing exposures in profit or loss. The linking of cash flows to assets and liabilities is not a necessary condition for the model to work. Any cash flows with known amount disregarding the substance of underlying item can be subject to revaluations. This is true for cash flows modelled by considering prepayments and/or extending the contractual maturities, modelling of cash flows from equity book, considering pipeline transactions and even forecast transactions (which we discuss further).

Therefore the model should have an objective which is to show the effects of using risk management instruments for mitigating the risks in the area of net interest income. The net interest income should have a broad meaning and incorporate also non-interest cash flows if they are considered part of the managed net income from risk management point of view. Such interest-like cash flow can arise e.g. on equity.

From this point of view the model would not be perceived as leading to revaluation of equity and unrecognised items as the focus is on modelled cash flows. This would ensure compliance with the Conceptual Framework.

We admit that modelling of cash flow brings subjective view of the entity in the accounting. Transparency in this area should be introduced by proper disclosures.

Regarding the criticism that revaluations should not be performed for equity because it is a residual item having its loss absorption function we would like to note that equity gives rise to cash flows which bear the risk if the aim is to stabilise the return to the shareholders. From this point of view the revaluation would be substantiated.

Forecast transactions

We would also like to discuss eligibility of the forecast transactions for the PRA. We believe that they should be part of the model. However, the cases when revaluation of forecast transactions would lead to a proper solution are rather restricted. Future *unknown fixed rates* of anticipated business cannot be swapped into variable rates as long as the level of fixed rates is not known. In this area cash flow hedge mechanism provides proper protection of net interest income if the hedge designation focuses on the variability of the interest rates up to the moment of the future transaction occurrence. On the other hand, future business with *known level of fixed rates* can be understood as some kind of pipeline transaction in a broad sense and the PRA provides proper solution here as discussed above.

As regards forecast transactions the PRA can properly show the effects of risk mitigation in the area of swapping variable rates from future forecast business with known benchmark level (e.g. 12M Euribor) into shorter term rates with tenor of the funding curve used in the risk management (e.g. 3M Euribor or overnight). Basis interest rate swaps would be used as hedging instruments.

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.

If options are used as risk management instruments the entity should have the possibility to replicate the risk of the prepayable items by options. Otherwise undue volatility would arise caused by revaluation of the time vale of the option on the risk management instrument side.

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?

Changes in the assumption of customer behaviour should be recognised in full in profit or loss at the moment when it comes to the change.

Question 7—Bottom layers and proportions of managed exposures
If a bottom layer or a proportion approach is taken for dynamic risk management purposes, do you think that it should be permitted or required within the PRA? Why or why not? If yes, how would you suggest overcoming the conceptual and operational difficulties identified? Please explain your reasons.

We believe that application of the bottom layer or proportion approaches are valid risk management strategies which should be reflected in the PRA. The top layer should not be part of the revaluations as long as it is not considered as part of the fixed rate exposure by the bank.

Question 8—Risk limits
Do you think that risk limits should be reflected in the application of the PRA? Why or why not?
We do not believe that it is substantiated to mix internal or regulatory risk limits with accounting. There is no relation between them.

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?

It is crucial that core demand deposits are included in the PRA. They give rise to large interest rate risk exposures which are mitigated by risk management instruments. Without demand deposits, there would be a big gap in the model.

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

We believe that no further guidance is necessary to specify how the demand deposits should be treated in the PRA. Bahaviouralisation should be purely based on the risk management practices of the banks.

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?

Sub-benchmark instruments should be included based on the benchmark risks managed by ALM (Approach 3).

(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?

We believe that it is appropriate not to reflect the floor as part of the revaluation once it is not integral part of the interest rate risk management. If the floor was included in the revaluations the model would contain artificial element which is not line with the goal to align accounting with the interest rate risk management practice. The effects of floor should be accounted for on accrual basis at the time when they are borne by the business unit.

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?

The revaluation calculations in the DP which are based on the funding index provide a faithful representation of dynamic risk management. They are in line with calculations performed by our bank.

We would also like to mention another aspect of revaluation of the managed exposures which we believe should be considered. It is the basis risk which is inherent in derivatives managing the risk. This element is present in basis interest swaps (e.g. hedging of 12M Euribor variable exposures into the short term rate used in risk management, e.g. 3M Euribor) and in cross currency swaps if used for hedges of interest rate risk in foreign currency. Interest and currency basis spreads are not inherent in the revaluation of the managed exposures. However they have known final impacts and the derivatives can effectively stabilise the interest rate margin. Therefore a suitable accounting solution should be found in this area which would remove artificial volatility arising from basis spreads.

For basis currency swaps similar issue was addressed within the general hedge accounting model and a solution has been brought by IFRS 9 (volatility removed on the side of the hedging derivative by recognising it in OCI). In the PRA it is more suitable to focus on the side of the managed exposures. Therefore we propose that a proper mechanism should be developed which would incorporate the basis risk as a part of the revaluation of the managed exposures.

(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?

It is inevitable that the managed risk is based on the funding curve of the bank once it is used for internal management of the interest rate risk as well.

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)?

Yes, the risk transferred to ALM via transfer pricing is fully representative of the risk in the managed portfolio. It represents the market level of interest risk which is managed and can be effectively mitigated by ALM.

(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.

The best approach is to exclude all the spreads inherent in the transfer pricing above the market funding index. The spreads are not managed as regards market interest rate risk. In our bank the separation of the spreads would not cause significant operational difficulties.

(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?

There should not be any restrictions on the basic market interest rate index. As regards spreads we believe that the best approach is to exclude them as described above in (b).

(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?

At our bank we have developed a well functioning system which captures what actually happens to the risk bearing exposures (e.g. prepayments) and provides timely reflection of the events in the ALM risk management practice. Therefore our bank should not face the issues concerning ongoing linkage identified in the DP.

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.

At our bank we use multiple funding indexes based on one type of funding market interest rate curve (e.g. 3M Euribor curve). When constructing the funding index often combination of a short term (e.g. 1M Euribor) and long term rate is used (e.g. 5Y rate). Moreover long term rates are often calculated as moving averages over the period of the tenor of the rate (e.g. 5-year moving average of 5Y rates calculated on monthly basis). All such kinds of indexes are constructed in order to replicate behaviour of contractual cash flows of the underlying items with respect to the benchmark interest rate risk. Therefore using of multiple indexes is inevitable.

(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?

The banks can best choose the indexes representing the cash flow profile of the underlying items. Therefore the selection should not be anyhow restricted.

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?

Our bank does not use pricing index in the interest rate risk management activities. Therefore we cannot provide answer to this question.

Question 15—Scope

(a) Do you think that the PRA should be applied to all managed portfolios included in an entity's dynamic risk management (ie a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (ie a scope focused on risk mitigation)? Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

The PRA should be restricted to circumstances when risks are mitigated through hedging. We believe that revaluation of all positions which are dynamically managed would lead to undue volatility in profit or loss which is not in line with general accounting mechanism applied for the banking book. The profit or loss effects from banking book exposures are predominantly based on amortised cost measurement and the interests are accrued rather than revalued. This is true also for open interest positions. Bringing any additional profit or loss volatility resulting from unhedged (open) interest rate positions volatility would be misleading for the users. Showing such economic volatility would bring element of fair value accounting in the area where recent discussions in connection with IFRS 9 project have led to a conclusion that fair value is not appropriate.

The economic volatility is best to be addressed by regulators.

(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?

The dynamic risk management approach involves fewer operational complexities. However the benefits are outweighed by bringing undue profit or loss volatility in the financial statements.

The solution which we strongly prefer is to focus on risk mitigating activities and apply the PRA to in the area of dynamic risk management activities. As regards the alternatives in the risk mitigation approach we would apply it on sub-portfolio rather than proportional basis.

The PRA should coexist with the standard hedge accounting requirements. Entities should decide whether the standard hedge accounting or the PRA are the best means to remove accounting mismatches for the financial statements.

(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?

As discussed above operational feasibility of the dynamic risk management approach is not a sufficient argument to support the resulting volatility in profit or loss. The operational difficulties of the risk mitigation approach are an acceptable trade-off for having a model which faithfully represents the effects of hedging activities.

We assume that changes in our portfolios would be done on a monthly basis in order to capture the dynamic aspect of the banking book activities on a timely basis.

(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?

As mentioned above we are not in a position to express our opinion with respect to risks other that interest rate risk as we do not dynamically manage them.

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?

For reasons discussed above we believe that the scope of the PRA should not be focused on dynamic risk management. However, if the final model was based on this scope alternative its application should not be mandatory. This approach results in the volatility in the profit or loss statement. If the entity considered the volatility as unsubstantiated for a faithful presentation of its performance it should not be forced into applying the PRA. Accounting should not be based just on that fact that the management have decided to steer the interest rate risk in the banking book.

(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?

The model should serve as a means for removing accounting mismatches in the area of interest rate risk management when other accounting mechanics fail to bring proper solution. Therefore it should be understood as an extension of the standard hedge accounting model. Therefore it should not be mandatory.

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 our 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.

As discussed above we do not believe that the PRA focused on dynamic risk management is the right approach. However, if this alternative was chosen we would agree that no additional criteria should be required for its application. If the application was optional entities should be able to start and stop the PRA based on their decision with no additional criteria imposed. As above, the reason for optionality would be that the dynamic risk management approach leads to volatility in profit or loss which entities may consider as unsubstantiated.

Equally entities should be able to withdraw their decision to apply the dynamic risk management PRA for example once they feel to face undue volatility during its application. The situation is different to the prohibition of voluntary discontinuation of hedge accounting in IFRS 9. Under IFRS 9 the hedge accounting should continue as long as the objective of mitigating the risk persists. In the PRA discontinuation should be allowed in situations when it is necessary to avoid undue volatility from the positions for which risk are not mitigated.

(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.

In our opinion, the PRA focused on risk mitigation applied on non-mandatory basis is the right approach to address accounting mismatches when risks are dynamically managed. Risk mitigation in the area of dynamically managed risks should be the only criterion for applying the PRA. Effectiveness assessment would not be necessary as the ineffectiveness is immediately recognised in profit or loss.

Voluntary discontinuation basically should not be possible as long as the risk mitigation objective still exists. However, it should be possible to discontinue the PRA if the entity decided that other accounting mechanism would provide a more suitable solution to portray the risk mitigation, e.g. that it would be more appropriate to switch from PRA to a standard fair value hedge accounting for specific risk exposures.

Question 18—Presentation alternatives

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

In the statement of financial position we prefer the alternative (c) of single net line item. Revaluation is a proper technical mechanism to show offsetting effects from economically hedged risk positions in profit or loss. There is not much merit in allocating the revaluations to the specific exposures or to the asset and liability side of the balance sheet.

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

From our point of view the only relevant alternative is the actual net interest income presentation. It properly shows the extent to which the net interest income is actually stabilised. The residual net effects from revaluations are suitably presented in a separate line item outside the net interest income.

The stable net interest income presentation alternative contains distorting effects when presenting artificially smooth net interest income even if in reality is not that stable.

(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.

In our opinion the presentation alternatives which we prefer faithfully present the accounting effects of the dynamic interest rate risk management activities so there is no need to consider any other approach.

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?

We highly appreciate that internal derivatives are included as they are inevitable for the model to be operationally feasible. Gross presentation of internal derivatives in profit or loss, i.e.

- dirty price revaluation of the internal derivatives from trading book point of view in the net trading result merged with the effect from external derivatives,
- clean price revaluation of the internal derivatives together with clean price revaluation of the risk bearing exposures as part of the ALM result and interest accruals from the derivatives presented separately in the net interest income

exactly represents the approach taken in the managerial accounting.

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

As above, the proposed treatment of internal derivatives is fully in line with the risk management practice and internal performance measurement. Therefore it is a major contribution to the operational feasibility.

(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?

We do not think that any additional conditions are necessary. Determining the level of externalisation of the internal derivatives is not desirable as it would deviate the model from actual risk management practice. Moreover the overall profit or loss effect of internal derivatives is zero which is another reason why there should not be any restrictions on using them in the PRA.

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.

As we prefer the risk mitigation approach the disclosures should be primarily focused on the risk management instruments and exposures whose risk are mitigated. Therefore we do not agree with any quantitative disclosures concerning open positions for which no risk mitigation is applied.

We believe that the disclosures should provide a good basis for the users of the financial statements to be able to understand and assess the effects of risk mitigation techniques within the context of dynamic interest rate risk management.

In our opinion, the disclosures which primarily focuse on risk mitigation do not fit well to the four identified themes. We provide our proposal of the points which should be covered by the disclosures:

- description of the dynamic risk management process including:
  - internal organisation of the dynamic risk management process
  - description of the risk exposures
  - description of risk management instruments and their position as internal and external transactions
  - curves used for valuation
  - techniques used for calculations of the extent of the risks
  - explanation of the transfer pricing system in replicating the interest cash flows
  - extent of using the standard hedge accounting model and the PRA risk mitigation approach in accounting for the risk mitigation techniques

- exposures whose risks are mitigated (based on the types of exposures if relevant)
  - basis on which the risks are analysed and measured (contractual basis, behaviouralisation...)
  - description of estimation techniques used for behaviouralisation
  - extent to which the managed exposures are based on behaviouralised rather than contractual terms

- risk management instruments
  - fair values of the risk management instruments
  - quantitative information on the extent of internal and external risk management instruments used.

We believe that the effects of the model are faithfully portrayed by the actual net interest income approach in the statement of profit or loss. So no additional disclosures of accounting effects would be necessary. As regards disclosures related to the statement of financial position we believe that no disclosures with respect to revaluations of classes of financial instruments are necessary.

Question 21—Scope of disclosures
(a) Do you think that the scope of the disclosures should be the same as the scope of the application of the PRA? Why or why not?

In our opinion disclosures should be based on the same scope as the application of 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?

We strongly support the risk mitigation PRA alternative. Therefore also the disclosures should be focused on the risk management instruments and exposures whose risks are mitigated. Focus on the entire banking book interest rate risk position is not substantiated and furthermore disclosures in this area are already provided under IFRS 7 (sensitivity analysis disclosures).

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?

In the answer to the question we consider that the risk mitigation rather than dynamic risk management approach applies.

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

Generally speaking, interest risk management is a dynamic process where the bank can decide to start to mitigate the risks during the life of the exposures. Another example may be two non-derivative exposures which offset each other but due to unexpected prepayment of one of them the position opens and it might be necessary to mitigate the risk of the other exposure from that point in time.

Therefore inclusion of new exposures during their lives is a necessary condition for the PRA to function well if the focus is on risk mitigation.

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

The non-zero Day 1 revaluation should be amortised and presented as "Net interest income from dynamic risk management". We do not expect significant operational difficulties with respect to this as similar amortisations are performed in our current system for hedge accounting.

We would like to note that the non-zero Day 1 revaluation can also arise in cases other than including exposures during their lives. For example when the transfer pricing index is based on moving averages of market rates over their tenor period then cash flows of a new exposure are largely based on historical rates and discounting them with the current market rate leads to the Day 1 effect.

Question 23—Removal of exposures from a managed portfolio

In the answer to the question we consider that the risk mitigation rather than dynamic risk management approach applies.

(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?

As written in the answer to the question 17(b) exposures should not be removed from the PRA as long as the risk mitigation objective still exists.

However, the risk mitigating management objective with respect to exposures may no longer exist. In such circumstances stopping of the revaluation is necessary.

(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?

Generally speaking, interest risk management is a dynamic process where a decision of a bank to cease risk mitigation with respect to particular exposures is a valid risk management objective.

(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.

Upon removing the exposure amortisation of the revaluation adjustment over the remaining life of the exposures should start. Using a straight-line method of amortisation should be considered as sufficient. The profit or loss effect of the amortisation should be presented as "Net interest income from dynamic risk management". We do not expect significant operational difficulties with respect to this as similar amortisations are performed in our current system for hedge accounting.

Amortisation is a preferable treatment to the immediate impact to profit or loss. It can prevent from wrong incentives to argue that the risk mitigation objective has been changed and the exposures can be removed in situations when this would lead to desirable profit or loss effect.

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.

PRA should also provide proper solution for dynamic risk management of FX risk in conjunction with interest rate risk.

At our bank most of the risk management instruments which are used for mitigation of both interest and FX risk of foreign currency instruments copy the conditions of the managed exposures on one-to-one basis. Internal cross currency swaps are used as risk mitigating instruments. ALM manages the resulting aggregate interest rate position in the functional currency. The swap and the foreign currency instrument are subject to spot FX revaluation with offsetting effect in profit or loss. However, the currency basis spread valuation input on the swap side (as part of its fair value measurement) brings unsubstantiated volatility in profit or loss as also described in the answer to the question 11a. A proper solution to remove such volatility should be found within the PRA approach.

In some cases both lending and funding is carried out in foreign currency and the resulting interest risk is managed in that currency. At our bank such business is usually run on variable rate basis so no significant interest risk mitigation is necessary. Open FX position between assets and liabilities in the foreign currency may be swapped into functional currency on portfolio basis. (Cross currency basis swaps with both legs variable are used, i.e. no transformation of interest rate position performed at this level). In this area the bank again faces the issue of basis currency spread volatility as described above (and in the answer to the question 11a) and we call for a solution to this issue.

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.

We have not analysed other types of dynamically managed risks for which the model may be applied as well. We do not manage such risks as part of our business. Therefore we are not in a position to provide relevant answers.

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?

Presentation of revaluation through OCI should only be considered if the dynamic risk management alternative was chosen. Presentation through OCI might be a suitable way to avoid the undue volatility in P&L. As discussed above we do not agree with this alternative. With the risk mitigation alternative in place there would be no need to use OCI.

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

Yours sincerely,

Manfred Schmid
Head of Group Accounting