POSITION PAPER

**WSBI-ESBG Position Regarding the Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging**

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Dear Mr Hoogervorst,

Thank you for the opportunity to comment on the discussion paper "Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging".

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

We are of the opinion that the objective of a future macro hedge accounting standard should be limited to eliminating accounting mismatches and its scope limited to risk mitigation. We do not believe that the model should be based on the full revaluation of the banking book interest rate positions (i.e. we do not support the dynamic risk management alternative). In our opinion the model should instead focus on economic hedges where the identified risks are mitigated by risk management instruments.

Interest rate risk in the banking book resulting from un-hedged position should not be subject to P&L volatility. We believe that this type of P&L volatility is 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 addressed by banking supervision and the related disclosures are already provided under the Basel Pillar 3 requirements.

The model in discussion should serve as a means of reducing accounting mismatches in the area where risks are dynamically managed and standard accounting requirements lead to the measuring of instruments with offsetting positions on a different basis.

We firmly believe that a risk mitigation approach should not lead to volatility in the P&L if the risk is indeed mitigated. The revaluation 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 and loss only. It should not penalise entities which mitigate their risks compared to entities which do not use economic hedging at all. On the other hand, if macro hedging derivatives do not contribute to mitigating risk they should be treated as trading[1] derivatives. The risk-mitigating qualification of macro hedging derivatives should be demonstrated on the basis of indicators used for management purposes.

The model 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 reflects its risk management practice.

**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?*

[1] The process of identifying the portion of "non-mitigating/non-hedging" derivatives should be determined and established in a group policy (for example: first-in-first out, last-in first-out, proportion of all derivatives etc). It should also be disclosed in the notes to the financial statements.

Yes, there is definitely 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 a detailed analysis which reflects the difficulties our members face when applying hedge accounting.

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

We think that the DP has identified many of the key issues. However, the DP does not provide a solution consistent with the risk management practices identified in the DP as mainly used by banks (based on the analysis of the sensitivity of the net interest margin and "gap analysis"):

- The DP recognises that many banks monitor their dynamic management of interest rate risk in the banking book on an accrual basis and not on a revaluation basis. As a consequence, those banks choose to manage their interest rate risk profiles on a cash flow basis rather than on a valuation basis. However, the DP only proposes a revaluation approach. We are of the opinion that there are alternative approaches that represent the economics of dynamic risk management with a focus on risk mitigation in the financial statements and these may deserve additional consideration.
- The DP recognises that demand deposits, the equity model book and pipeline trades are part of the hedged position. In order not to end up in the position of a theoretically correct but restrictive model, the model has to address all these aspects of dynamic risk. If it does not, banks will have no choice but to continue their proxy-hedging and no improvement would come from the macro hedging project.

Our members are also specifically worried regarding the following items:
- The PRA leads to paradoxical situations in which a bank, which macro hedges its interest rate position in the banking book, will suffer more volatility compared to a bank which leaves the position fully un-hedged.
- The PRA discourages banks from hedging their banking book, as hedging creates volatility.
- The PRA conflicts with IFRS 9 phase I, under which retails loans and deposits are accounted for at amortised cost. Under the PRA, retail instruments will be revalued for the interest rate component as soon as a macro hedging derivative is traded.

**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?*

We thank the IASB for all the work performed in order to understand and correctly describe interest rate risk management as it is performed in a commercial bank.

Yes, we think that the DP has in general correctly identified the main issues banks currently face.

**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).*

We believe that the macro hedging model should reflect all aspects of interest rate risk management as actually applied by a bank and thus we believe that pipeline transactions should be included.

Some of our members enter into deals which are similar in substance to pipeline transactions. They occasionally agree to conditions for future issues of debt securities including the interest rate. However, at this point in time there is no obligatory contract. Due to reputational risks they have little chance of withdrawing from the transaction. Knowing these 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.*

The equity model book should be included in the macro hedging model if it is part of internal risk management practices in the banking book.

*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.

For banks which include pipeline transactions and an equity model book in their risk management practices operational feasibility is not an issue. The respective cash flows are already modelled. Generally, in order 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.

*Compliance with the Conceptual Framework*

We believe that the macro hedging model should portray the effects of actual risk management practices. This should involve all the items considered by risk management. If any managed exposures were excluded it would result in less useful information for the users focused on risk management because some derivatives mitigating the risks would continue to be revalued through profit and loss while the cash flows which they hedge would not be considered in the model.

The model should focus on managed exposures rather than the recognised underlying items. Interest margin which is hedged by banks results from cash flows not limited to recognised assets and liabilities within their contractual life. Sticking to revaluation of only recognised assets and liabilities would ensure compliance with the Conceptual Framework, but 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 the conclusion that revaluations necessarily have to result only from recognised assets and liabilities. The revaluation 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 and 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 amounts, disregarding the substance of the 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 the equity book, considering pipeline transaction and forecast transactions.

The model should have as an objective to show the effects of using risk management instruments when mitigating the risks in regards to net interest income. Net interest income should have a broad definition and also incorporate non-interest cash flows if they are considered part of the managed net income from a 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 the modelling of cash flow introduces a subjective view of the entity into the accounting. Transparency should be introduced by proper disclosures in this regard.

Regarding the criticism that revaluations should not be performed for equity because it is a residual item with a 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 believe forecast transactions should be part of the macro hedging model. Cases when the revaluation of forecast transactions would lead to an appropriate solution are, however, quite restricted. Future unknown fixed rates of anticipated business cannot be swapped into variable rates if the level of the fixed rate is not known. In this area the cash flow hedge mechanism provides appropriate 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. On the other hand, future business with known levels of fixed rates can be understood as a type of pipeline transaction in a broad sense and the macro hedging model provides an appropriate solution here as discussed above.

As regards forecast transactions the macro hedging model can correctly 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 tenors based on the funding curve used in risk management (e.g. 3M Euribor or overnight). Basis interest rate swaps would then 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.*

We believe that prepayment risk could be:

- behaviouralised and included in the expected cash flows, and/or;
- hedged with options.

Both strategies are commonly accepted as best practices for IRR management. Therefore, they must also be accepted as such for accounting purposes, without penalising one of them by artificial restrictions of effectiveness measurement. If options are used in risk management, they should be included in the macro hedging model.

### 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 and loss through the application of the PRA when and to the extent they occur? Why or why not?*

Changes in customer behaviour that only lead to a change of the un-hedged position should not lead to P&L volatility. As long as the risks are still mitigated, there should be no impact on profit or loss from a change in assumptions. However, we would expect an impact in the P&L if the revised expectation leads to an increase instead of a mitigation of risks.

### 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 proportional approaches are valid risk management strategies which should be reflected in the macro hedging model. 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 relevant to mix internal or regulatory risk limits with accounting.

### 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 macro hedging model. They give rise to large interest rate risk exposures which are mitigated by risk management instruments.

*(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 demand deposits should be treated. Behaviouralisation should be based on the risk management practices of the bank.

**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 if it is not an integral part of interest rate risk management. If the floor was included in the revaluation the model would include an artificial element which is not in line with the goal of the model to align accounting with interest rate risk management practice. The effects of the floor should be accounted for on accrual basis at the time when these 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?*

We agree that the revaluation calculations as presented are a reasonable approach to calculate any potential fair value impact of changes to hedged items due to interest rate risk. However, we must reiterate our point that a fair value approach can never faithfully represent dynamic risk management activities if these activities are not performed on a revaluation basis.

We would also like to mention another aspect in regards to the revaluation of managed exposures which we believe should be considered, namely the basis risk which is inherent in the process of using derivatives to manage the risk. This element is present in basis interest swaps (such as hedging of 12M Euribor variable exposures into the short-term exposures used for the purposes of risk management, e.g. 3M Euribor) and in cross-currency swaps if used for the hedging 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 a known impact and derivatives can effectively stabilise the interest rate margin. We therefore believe that a suitable accounting solution is needed in order to remove the resultant artificial volatility.

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

We believe that it is inevitable that the managed risk is based on the funding curve of the bank if it is used for the internal management of the interest rate risk.

**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)?*

It is our understanding that the risk transferred to ALM via transfer pricing is often representative of the risk in the managed portfolio. It usually represents the market-level interest rate 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 to the transfer pricing above the market funding index. This should 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?*

Our members have different experiences in regards to the possible use of transfer pricing as a practical expedient.

Some members have in place systems that ensure a timely linkage and they should therefore not face the issues outlined in the DP.

Other members believe that the issues identified in paragraphs 4.3.1–4.3.4 concerning ongoing linkage could only be addressed with a backstop measure, as ALM's hedging strategy is focused on the sensitivity of the interest rate margin rather than the level of the interest margin. An example of a backstop measure could be to demonstrate that the global future interest rate margins (including all components, e.g. credit margin, liquidity, etc.) are positive. Such demonstrations could be interesting for investors, not only when entities use macro hedging derivatives, but also for cash exposures. (Banks may fund new business at historic rates with cash instruments as well as derivatives. From an ALM perspective the issue is the same whatever the instruments used, cash or derivative). In case of negative future margins, the losses should be recorded in P&L.

**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.*

We believe that entities must be able to choose those indexes that best represent the managed portfolio due to the diverse nature of funding. Our members use diverging strategies, for example multiple funding indexes based on one type of funding market interest rate curve (e.g. 3M Euribor curve). When constructing the funding index, often a combination of a short-term rate (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. five-year moving average of 5Y rates calculated on a monthly basis). All these indexes are constructed in order to replicate the behaviour of contractual cash flows of the underlying items with respect to the benchmark interest rate risk. The use of multiple indexes is therefore 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?*

Banks are best equipped to choose the indexes representing the cash flow profile of the underlying items. Consequently, the selection should not be 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 members do not use pricing index in the interest rate risk management activities.

**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 macro hedging model should be restricted to circumstances when risks are mitigated through hedging. We believe that the revaluation of all dynamically managed positions would lead to undue volatility in the P&L, which is not in line with the general accounting mechanism applied to the banking book.

The profit and 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. To involve any additional profit and loss effects resulting from the un-hedged (open) interest rate positions' volatility would be misleading for users. Showing such economic volatility would introduce fair value accounting (limited to interest rate risk) into an area where recent discussions in connection with the IFRS 9 project have led to a conclusion that fair value is not appropriate.

Economic volatility is best addressed by regulators.

We favour a "risk mitigation" approach, though one that is different from that exposed by the IASB.[2] We believe that the demonstration of risk mitigation should be based on indicators used for management purpose.

- We understand from the ALM departments of our members that revaluation (limited to the interest rate component) is not the indicator used. Relying on this indicator would thus be inappropriate.

- Instead, we would favour a test showing that macro hedging derivatives mitigate the sensitivity of the net interest rate margin.

    - This test could be supplemented by a backstop measure which aims to demonstrate that global future interest margins (including all components for example credit margin, liquidity, etc.) are positive. Such a demonstration could be interesting for investors, not only when entities use macro hedging derivatives, but also for cash exposures. In case of negative future margins, the losses should be recorded in P&L.

- Relying on management indicators will help the accounting department accurately translate risk management into financial reporting figures. It will facilitate the disclosures in the financial statements and make them more understandable. It will also limit the implementation burden as those indicators are already available for management purposes.

We also believe that a risk mitigation approach should not lead to volatility in P&L as long as the risk is mitigated. It should not penalise entities which mitigate their risks compared to entities which do not (by using no economic hedging at all). On the other hand, if macro hedging derivatives do not contribute to the mitigation of risks, they should be treated as trading derivatives.

- The process to identify the portion of "non-mitigating" derivatives should be defined and included in a Group policy (for example: first-in-first-out, last-in-first-out, proportion of all derivatives.) It should also be disclosed in the notes to the financial statements.

[2] That is why we prefer the term "macro hedging model" rather than "PRA"

*(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?*

We believe that the usefulness of information would depend on the degree and extent that the IASB is willing to permit risk management elements (demand deposits, equity model book, etc.) to be included in the application of the macro hedging model. Information is at its most useful when all risk management elements are permitted since this depicts actual risk management.

The solution which we strongly prefer is to focus on risk mitigating activities. We believe that a risk mitigation approach should not lead to volatility in P&L as long as the risk is mitigated. It should not penalise entities which mitigate their risks compared to entities which do not (no economic hedging at all). The revaluation 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 and loss only. Undue volatility could confuse users regarding the classification and measurement principles.

Furthermore, a change in accounting principles would most probably alter the behaviour of banks. Banks would be led to manage current period fair value volatility instead of a continued focus on long-term interest income. This will erode the collect cash flows business model of banks and this is not to the benefit of the user.

The macro hedging model must also coexist with the standard hedge accounting requirements. Entities should have the freedom to decide whether the standard hedge accounting or the macro hedging model provides the best means to remove accounting mismatches from 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?*

The dynamic risk management approach replaces issues concerning artificial designation and tracking with issues regarding revaluation. The banking book is made of illiquid and behaviouralised instruments managed in a collective cash flow business model. To calibrate models to revalue these instruments is a challenge. We believe that the benefits from attempting to simplify the management in a macro hedge accounting model are outweighed by bringing undue profit and loss volatility into the financial statements. We are concerned that the proposal leads to a paradoxical situation in which a bank, which macro-hedges its interest rate position in the banking book, will suffer more volatility compared to a bank which leaves the position fully open.

We believe that 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.

As already mentioned, a relevant alternative would be to rely on management indicators to assess the "risk-mitigating" effect of macro hedging derivatives. This would limit the implementation burden, as those indicators are already available for management purposes.

*(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?*

We believe that the above considerations would also be applicable to FX and commodity risk.

**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 should not be focused on dynamic risk management. Thus if the final model is based on this scope alternative, its application should not be mandatory. This approach results in volatility in the profit and loss statement. If the entity considered that the volatility deters from a faithful presentation of its performance, it should not be forced to apply the PRA. Accounting should not be based only on the fact that management has decided to manage 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 to removing accounting mismatches in the area of interest rate risk management when other accounting mechanics fail to provide a faithful presentation. Thus it should be understood as an extension of the standard hedge accounting model and 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 due to the increase in complexity that additional criteria would bring. If the application is optional, entities should be able to introduce and stop using the PRA with no additional criteria imposed. As above, the reason for optionality would be that the dynamic risk management approach leads to unsubstantiated volatility in profit and loss.

Entities should be able to withdraw their decision to apply the dynamic risk management PRA, for example, if they risk facing undue volatility during its application. The situation is different from the prohibition of voluntary discontinuation of hedge accounting in IFRS 9. Under IFRS 9 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 is 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 macro hedging model focused on risk mitigation and applied on a 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.

Voluntary discontinuation should not be possible as long as the risk mitigation objective still exists. However, it should be possible to discontinue the macro hedging model if the entity decided that another accounting mechanism would provide a more suitable solution to portray the risk mitigation, e.g. that it would be more appropriate to switch from a macro hedging model to a standard fair value hedge accounting model for specific risk exposures (for example, in the case of unexpected sales of assets previously held in a hold-to-collect business model).

**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 alternative (c), single net line item. Revaluation is an appropriate technical mechanism to show offsetting effects from economically hedged risk positions in profit and 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. We do not believe that the other alternatives provide additional relevant information for users of the financial statements which would improve their understanding of an entity's dynamic risk management.

*(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 accurately portrays the extent to which the net interest income is 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 which 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 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 greatly appreciate the inclusion of internal derivatives, as they are indispensable to the model's operationally feasibility. Gross presentation of internal derivatives in profit and loss, i.e.;

- dirty price revaluation of the internal derivatives from a trading book point of view in the net trading result merged with the effect from external derivatives; and
- clean price revaluation of the internal derivatives together with clean price revaluation of the risk bearing exposures 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 accounts.

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

As mentioned above, the proposed treatment of internal derivatives is fully in line with risk management practice and internal performance measurement. Therefore, the treatment is a major contribution to 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 result in a deviation of the model from actual risk management practice. Moreover, the overall profit and 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 we believe that the disclosures should be primarily focused on the risk management instruments and exposures whose risk is 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, disclosures which primarily focus on risk mitigation do not fit well with the four identified themes. We provide below our proposal of which points should be covered by the disclosures:

- A description of the dynamic risk management process including (but not limited to):
  - the internal organisation of the dynamic risk management process;
  - a description of the risk exposures;
  - a description of the risk management instruments and their position as internal and external transactions;
  - the curves used for valuation;
  - the techniques used for calculations of the extent of the risks;
  - an explanation of the transfer pricing system when replicating the interest cash flows; and
  - the extent of the use of the standard hedge accounting model and the macro hedging model risk mitigation approach in accounting for risk mitigation techniques.

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

- For the risk management instruments:
  - the fair values of the risk management instruments;
  - the quantitative information regarding the extent of internal and external risk management instruments in use; and
  - an explanation to users of what kind of test is performed when qualifying macro-hedging derivatives as "mitigating" derivatives (sensitivity analysis, gap analysis, etc.).

We believe that the effects of the model are faithfully portrayed by the actual net interest income approach in the statement of profit and loss and thus no additional disclosures for accounting effects would be necessary. As regards disclosures related to the statement of the 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 the disclosures should be based on the same scope as the application of the macro hedging model.

*(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 alternative. We therefore believe that the disclosures should also be focused on the risk management instruments and exposures whose risks are mitigated. A focus on the entire banking book interest rate risk position is not substantiated and 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 answer to this question we consider that the risk mitigation approach 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 at any point during the life of the exposures. Another example may be two non-derivative exposures which offset each other but due to the 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 throughout their lives is a necessary condition for the macro hedging model 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 would like to note that the non-zero Day 1 revaluation can arise in different cases for example when the transfer pricing index is based on moving averages of market rates over their tenor period. The 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**

*(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 question 17(b) exposures should not be removed from the macro hedging model as long as the risk mitigation objective still exists.

However, should the risk mitigating management objective with respect to exposures cease to exist, then stopping of the revaluation would be 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.*

Revaluations of removed portfolios should be recognised in P&L depending on the reason of the removal. If the removal results from a decision to no longer hedge the existing portfolio, the revaluation of the previously hedged portfolio should be amortised. If, on the contrary, the removal of the portfolio results from a sale of the portfolio (to a securitisation for instance), the gain or loss resulting from the sale should be taken flat in P&L.

**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.*

The macro hedging model should provide a solution for dynamic risk management of FX risk in conjunction with interest rate risk.

As an example one of our members takes this approach:

- 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 a 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 instruments are subject to spot FX revaluation with offsetting effect in profit and loss.
- However, the currency basis spread valuation input on the swap side (as part of its fair value measurement) brings unsubstantiated volatility in profit and loss as also described in the answer to the question 11a. An appropriate solution to remove such volatility should be incorporated within the PRA approach.

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

**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 are not in a position to provide a relevant answer to these questions.

**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?*

A presentation of the 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.

## About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks from 78 countries, representing the interests of approximately 6,200 banks in all continents. As a global organisation, WSBI focuses on issues of global importance affecting the banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalisation that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that responsibly meet customers' transaction, saving and borrowing needs. To these ends, WSBI recognises that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.

WSBI represents more than 6,200 financial institutions from 78 countries. At the end of 2013, these institutions operate through more than 160,000 branches and outlets, employ more than 1.8 million people and serve more than 1000 million customers. Assets of member institutions amounted to more than US $13.5 trillion at the end of 2013, while non-bank loans amounted to US $8 trillion and non-bank deposits 5.5 trillion.

## About ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG’s 25 members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €6,800 billion, non-bank deposits of €3,420 billion and non-bank loans of €3,710 billion (31 December 2013).

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