Federation of European Accountants
Fédération des Experts comptables Européens

Mr Hans Hoogervorst
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Ref.: BAN/AKI/HBL/PPA/SRO

Dear Mr Hoogervorst,

Re: FEE comments on IASB Discussion Paper: Accounting for Dynamic Risk Management: A portfolio Revaluation Approach to Macro Hedging

(1) FEE is pleased to provide you below with its comments on the IASB's Discussion Paper (DP): Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to macro hedging.

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

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

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

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

(6) Finally FEE shares the concerns of the insurance industry that the macro hedging project should be aligned with the work that is done in the entire "financial sector" standards (and not only focusing on IFRS 9 and the banking sector). The development of an approach that aims to account for macro-hedging should be aligned with the work and the discussions re the Phase II of the Insurance Contract standard to ensure that the final standards fit well together.

For further information on this letter, please contact Pantelis Pavlou, Manager, from the FEE Team on +32 (0) 2 285 40 74 or via e-mail at pantelis.pavlou@fee.be.

Yours sincerely,

André Kilesse
President

Olivier Boutellis-Taft
Chief Executive

Encl. Appendix: FEE response to specific questions.

Section 1—Background and introduction to the portfolio revaluation approach (PRA)

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) FEE welcomes IASB's initiative to develop an approach for hedge accounting of open portfolios and dynamic risk management (DRM). FEE agrees with the DP that the current hedge accounting framework cannot accommodate dynamically hedged portfolios and therefore there is a need for a different approach. However, as explained in Question 15, FEE believes that any hedge accounting requirements should only be applied in instances that a hedge relationship, using suitable hedging instruments, exists (i.e. FEE supports an approach that is applicable to so called "macro-hedging" instead of developing an approach that deals with the dynamic risk management in its entirety).

(2) FEE does not agree that hedge accounting should aim to fully align the financial reporting with the risk management policies; instead we believe that financial reporting should portray the effects of risk management actions by eliminating accounting mismatches that exist from the mix measurement model in the financial statements.

(3) Furthermore, FEE agrees with the IASB in its Basis for Conclusions on IFRS 9 (BC6.79-BC6.80) where the board explains that a hedge accounting model based on risk management strategies is too broad and therefore it limits its application to the instances that an actual hedge activity (using suitable hedging instruments) takes place.

(4) Having said that, FEE also identifies that there is a need to enhance the disclosures re financial instruments and hedge relationships (including economic hedges) to provide useful and relevant information to the users. FEE believes that reporting risk management policies can be achieved through the combination of the quantitative and qualitative disclosure requirements for macro-hedging and the qualitative disclosure requirements of IFRS 7 (please refer to the FEE response to Question 20).

(5) Finally, FEE identifies that some of the shortcomings of the general hedged accounting requirements of IFRS 9 (IAS 39) do not necessarily relate exclusively to macro-hedging and by addressing them through enhancements to hedge accounting requirements and disclosures in IFRS 7 the general hedge accounting model might accommodate some of the macro-hedging accounting needs.

Question 2—Current difficulties in representing dynamic risk management in entities' financial statements

(a) Do you think that this DP has correctly identified the main issues that entities currently face when applying the current hedge accounting requirements to dynamic risk management? Why or why not? If not, what additional issues would the IASB need to consider when developing an accounting approach for dynamic risk management?

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

Question 2 (a)

(6) FEE agrees with the IASB that the current accounting requirements fail to faithfully represent the economic substance of macro hedge activities which results in a patchwork presentation of different accounting requirements, including the general hedge accounting.

(7) FEE also agrees with the IASB that one of the main drawbacks of financial reporting when it comes to hedging is the accounting mismatch of measurement of the hedged position (the majority of the exposures are measures at amortised cost, for financial instruments, or cost for non-financial assets) and the measurement of the hedging instruments (measured at Fair Value Through Profit or Loss – FVTPL).

(8) We also agree that IFRS 9 and IAS 39 general hedge accounting requirements aim to eliminate the accounting mismatch arising from risk management activities either by changing the measurement basis of the hedged item (fair value hedge) or by deferring the changes in fair value of derivatives in the Other Comprehensive Income (OCI) (cash flow hedges). However there are significant shortcomings in the practical application of the general hedge accounting to dynamically managed exposures. FEE does not identify any additional issues apart from those explained in the DP, namely the open portfolios, demand deposits and deemed exposures.

Open portfolios

(9) FEE agrees that banks manage their exposures on an open portfolio basis, which means that exposures are added and removed on a continuous basis. Since the current hedge accounting requirements do not accommodate open portfolios as hedged items, the preparers usually treat the open portfolios as a series of closed portfolios with short lives in order to be able to apply hedge accounting.

(10) Furthermore, FEE agrees with the analysis of the DP regarding the hedge of net positions in that the entities hedge their exposures on a net basis rather than as a portion of assets or liabilities (which is currently required by IAS 39).

(11) FEE also identifies that other industries (e.g. energy and utility industry) also manage their risks on a net open position. Therefore, despite the fact that the DP focuses primarily on managing the interest rate risk from banks, some of the issues identified in the DP are applicable to other industries and other financial risks as well.

Demand deposits

(12) FEE agrees with the DP that risk managers account for behavioural changes to exposures and not solely for their legal form. The current hedge accounting requirements and *IFRS 13 – Fair Value Measurement* do not allow demand deposit exposures to be designated as hedge items, irrespective of the view of the risk managers who include such exposures into the managed portfolio, since the demand deposits do not carry fair value risk under this measurement approach.

Deemed exposures

(13) FEE agrees with the DP that risk managers include in their analysis exposures that are currently not eligible for designation as part of a hedge relationship. FEE identifies the need for an accounting system that accommodates such exposures in order for the financial reporting to be aligned with the risk mitigation activities of the entity.

Question 2(b)

(14) FEE believes that the PRA as proposed in the DP can address the issues identified above. However, on the other hand, we concur that the PRA raises conceptual challenges regarding the scope of application and the elements of the managed portfolios. Furthermore the PRA raises operational challenges when it comes to its practical application. Key challenges include the identification of the managed portfolio, the changes in behaviouralisation, the expected maturities of demand deposits and pipeline transactions and the identification of the portfolio that is within the scope of the PRA when the scope alternative focuses on risk mitigation.

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

(16) FEE would like to reiterate that some of the points mentioned above relate to shortcomings of the general hedge accounting requirements. The general hedge accounting shortcomings may be addressed in the context of developing an accounting framework for macro-hedging.

Section 2—Overview

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?

(17) FEE agrees with the characteristics of DRM as expressed in the DP as described in paragraphs 2.1.1 and 2.1.2 of the DP.

(18) As an additional point, FEE encourages the IASB to consider introducing an additional example in paragraph 2.1.2 which does not directly relate to the interest rate risk management by banks in order to demonstrate that the concepts discussed in the DP can be applied in other industries (e.g. utility industry).

Section 3—The managed portfolio

Question 4—Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

(a) Do you think that pipeline transactions should be included in the PRA if they are considered by an entity as part of its dynamic risk management? Why or why not? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework for Financial Reporting (the Conceptual Framework).

EMB

(b) Do you think that EMB should be included in the PRA if it is considered by an entity as part of its dynamic risk management? Why or why not? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework.

Behaviouralisation

(c) For the purposes of applying the PRA, should the cash flows be based on a behaviouralised 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.

(19) FEE agrees with the DP that pipeline transactions, equity model book (EMB) and behaviouralisation should be included in the managed portfolio in the context of developing an accounting framework for dynamic risk management and macro hedging. Below, FEE summarises its comments regarding the operational feasibility and usefulness of the information presented to users for all three elements (pipeline transactions, EMB and behaviouralisation).

Operational feasibility

(20) From an operational point of view, the systems that are used for risk management purposes reflect the effects of pipeline transactions of EMB and behaviouralisation in the managed portfolios. Therefore the same systems can be used for financial reporting purposes. Currently the information that is provided by risk management cannot be used for financial reporting purposes; hence, we believe, that establishing a reporting framework which can use the same information would enhance the operational efficiency of financial reporting for preparers.

(21) In addition, banks need to prepare regulatory reports which include a large amount of information regarding their risk management activities. Therefore (part of) regulatory reports can also be used for financial reporting purposes.

Usefulness of information

(22) FEE does not have any specific input from users, however from a conceptual point of view, the users of financial statements would be provided with a complete picture of the bank's risk management policies, objectives, activities and results. Currently, in order to present useful information preparers usually use other reports that accompany financial statements in the annual report (for example management commentary reports). This underlines the failure of the current financial reporting requirements to faithfully and comprehensively portray the risk management and hedging activities of an entity.

(23) By including pipeline transactions, EMB and behaviouralisation in the managed portfolios, users would be provided with financial information that better reflects the hedging relationships without any artificial designations between hedged items and hedging instruments, provided entries into the models are evidence-based and hence reliable.

Consistency with the Conceptual Framework

(24) Despite the conceptual challenges that pipeline transactions, EMB and behaviouralisation raise if they are included in the PRA, FEE believes that departing from basic concepts of the framework (e.g. definitions of assets and liabilities) may assist in presenting more relevant information to the users. Having said that, FEE strongly believes that such a departure from the basic conceptual principles should remain limited to portfolios exposed to managed risks under a macro-hedge accounting model.

Question 4(a) - Pipeline transactions:

(25) Despite the fact that the pipeline transactions do not meet the high probability criterion of the Conceptual Framework (please refer to below), FEE agrees that pipeline transactions can be included in the managed portfolio.

(26) Since risk managers account for pipeline transactions as deemed exposures, it makes sense that the hedge activities will be influenced by these transactions. Therefore including them in the managed portfolio and the PRA, as long as there is a hedging relationship in place, would, in our opinion, produce relevant information to users.

(27) The pipeline transactions do not meet the probability criterion as required in paragraph 4.38 (a) of the Conceptual Framework to be recognised in the financial statements. However the IASB's Discussion Paper: A Review of the Conceptual Framework for Financial Reporting issued in 2013 states that the IASB's preliminary view is that the "expected" criterion should not be retained (paragraph 2.35). A change in the Conceptual Framework may allow such transactions to meet the criteria for being recognised in the financial statements.

(28) FEE is also concerned that the borderline between a forecast and a pipeline transaction is not clear in the DP and should be defined more specifically.

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

Question 4(b) - EMB

(30) Despite some conceptual challenges that EMB raises, FEE believes that the benefits to the users would outweigh those challenges and therefore we agree that it should be part of the managed portfolio.

(31) The main conceptual challenge that FEE identifies if the EMB is included in the managed portfolio is the treatment of the "guaranteed" return to shareholders. This can be seen as treating part of equity similarly to an exposure (for risk management purposes) however, in our understanding the main reason why risk managers include the EMB in the risk management model is the link between the equity and the equity funded assets. Even though the link is not direct (i.e. not on an asset by asset basis), risk managers consider this as a fixed interest rate exposure.

(32) Despite the conceptual challenges that we explained above, and due to the fact the EMB is part of risk management activities, FEE believes that including it in the managed portfolio enhances the usefulness of the information presented to the users re macro hedging activities; therefore FEE supports its inclusion in the model.

Question 4 (c) - Behaviouralisation

(33) FEE believes that the concept of behaviouralisation is crucial in the financial services industry. Therefore we agree that behaviouralisation should be part of the managed portfolio. However, the IASB should consider the following key aspects in its work on this issue.

(34) FEE identifies that estimating the effect that behaviouralisation would have on the volume of deposits, or the level of prepayment involves a significant amount of judgment and estimations. Those estimations might change at each reporting date; therefore we agree that the PRA should include guidance on how the changes in estimates should be accounted for (please refer to Question 6).

(35) FEE identifies that behaviouralisation is an application of the concept of "substance over form" and risk managers' analyses include the risks that arise from the actions of depositors or customers based on behaviour rather than solely on the contractual terms of the agreements. The current accounting requirements (fair value hedge accounting for a portfolio hedge of interest rate risk in IAS 39) introduce the concept of behaviouralisation and allow the managed portfolio to include estimates based not solely on contractual terms.

(36) Furthermore evidence shows that depositors' behaviour is sensitive to the service that they enjoy from a bank and not so sensitive to interest rates. This "inconsistency" with efficient markets drives the decision of risk managers to include behavioural aspects in their analysis.

(37) Due to the high degree of estimation and judgment involved in this process, FEE identifies a need to have proper controls and evidence-based documentation in place in order to ensure that reporting entities are not able to adjust their estimations to achieve certain reporting results. Although internal controls are outside of the remit of the IASB, we suggest that the IASB considers introducing a reference to them.

(38) With the reservation for the need to create a solid framework to avoid the abuse of this concept (as explained above) FEE supports the view that behaviouralisation should be included in the managed portfolio.

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.

(39) FEE agrees with the DP that prepayment risk affects the open position of the interest rate risk and that it is a common practice for banks to use instruments with optionality, for example swaptions, to manage part of the prepayment risk. These instruments with optionality are used to manage one-side of the risk, since the bank is not concerned with positive changes in interest rates.

(40) The changes in value of these instruments should be included within the concept of the PRA as long as they are used within genuine hedging activities.

(41) As in its response to Question 4, FEE raises the issue of the need for strong internal controls and evidence-based documentation for estimating the amount of prepayment in the managed portfolio.

(42) Finally, including prepayment risk in the PRA may create an overlap with the general hedged accounting requirements. As explained in its response to Question 16, FEE supports that a bank should have flexibility on selecting which accounting model it should apply for accounting for the risk management activities.

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?

(43) In developing an accounting approach for macro hedging, the IASB should provide guidance on any changes to the managed portfolios, since by definition, DRM accommodates for open portfolios.

(44) In defining the managed portfolios, banks should make estimations for behavioural aspects of the portfolio, for example the level of prepayment that risk managers expect for a given portfolio. FEE believes that in order to apply the same principles in the IFRSs the effect of changes in estimations on prepayment risk should be reflected in the profit or loss in the period they occur. Therefore FEE agrees with the proposal of this DP.

(45) However, FEE points out that it might be premature to discuss the details of the treatment of the proposed approach, without first agreeing on the approach itself.

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.

(46) As explained in Question 15, FEE supports the focus on a risk mitigation scope alternative. Under both approaches (sub-portfolio or proportional approach) the main operational and conceptual challenge is to identify which proportion of the portfolio is included in the managed portfolio.

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

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

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

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

Question 9—Core demand deposits

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

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

(51) FEE believes that demand deposits are a key concept for this model. In line with its comment re behaviouralisation, FEE believes that contractual cash flows are disregarded by risk managers since they focus on the expected cash flows, based on the customers'/depositors' behaviour.

(52) FEE agrees with the views as explained in the DP re core demand exposures. We share the IASB's views that for behavioural reasons a part of the demand deposit shares similar characteristics with longer term deposits. It is our understanding that banks' clients are generally more sensitive to the quality of the service that they enjoy from the bank rather than the cost of the service.

(53) Currently, IFRSs do not permit designating such demand deposits as hedged items, since *IFRS 13 – Fair Value Measurement* states that liabilities that are payable on demand cannot have a fair value less than their nominal value, therefore they do not carry any fair value risk. On the other hand, from a risk management perspective, the core deposits are considered as fixed interest rate exposures and risk managers include them in their assessment for the open portfolios, although their estimated maturities applied in the models vary significantly in practise.

(54) Therefore FEE believes that the model for accounting for macro hedging should accommodate the concept of core deposits. In addition, FEE strongly believes that entities need guidance on how to identify and assess the behaviouralised profile of core deposits together with a strong internal control system. These would be necessary in order to establish a framework that entities should follow and to avoid instances of abuse of the concept of core demand deposits in order to present favourable results (e.g. avoid volatility in the profit or loss).

(55) However, the guidance for determining the profile should allow entities to consider any other relevant factors that they use in the risk management decisions as long as they aim to determine the core demand deposits within the limits of faithful representation and relevant qualitative characteristics.

Question 10—Sub-benchmark rate managed risk instruments

(a) Do you think that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if it is consistent with an entity's dynamic risk management approach (ie Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (ie Approaches 1 and 2 in Section 3.10) for calculating the revaluation adjustment for sub-benchmark instruments provide an appropriate reflection of the risk attached to sub-benchmark instruments? Why or why not?

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

(56) FEE agrees with Approach 3 as this is consistent with the approach in which exposures are managed by a central Asset Liability Management (ALM) unit. Usually the ALM manages the exposures using the benchmark rate and does not account for any sub-benchmark rates. Approach 3 best reflects the economics of the hedging relationship, as the hedged risk relates to changes in the benchmark rate.

(57) In addition the interest income is recognised at the contractual rate (i.e. sub-benchmark and any embedded floor is applicable) which is consistent with the actual interest income alternative presentation in the income statement (please refer to question 18).

(58) Regarding the embedded floor, FEE believes that it should only be part of the managed portfolio to the extent that it is included in the risk management objective and to the extent that the ALM hedges against this risk.

Section 4—Revaluing the managed portfolio.

Question 11—Revaluation of the managed exposures

(a) Do you think that the revaluation calculations outlined in this Section provide a faithful representation of dynamic risk management? Why or why not?

(b) When the dynamic risk management objective is to manage net interest income with respect to the funding curve of a bank, do you think that it is appropriate for the managed risk to be the funding rate? Why or why not? If not, what changes do you suggest, and why?

(59) FEE agrees with the proposals of the DP on the valuation of the managed portfolios. We also agree with the need to have different valuation methods for fixed rate exposures and for variable rate exposures.

(60) FEE agrees with the concept of recognising only the changes in the fair value that are attributed to the managed risk (i.e. the interest rate risk) and not a full fair value model. Also the reflection of the changes in the fair value of the managed risk and the fair value of the hedged instrument would present relevant and useful information to the users of the financial statements.

(61) The effect of changes in the fair value of the managed risk and the change in the fair value of the hedging instrument would properly reflect the risk management strategy and objectives and any ineffectiveness of the hedging relationship. Therefore FEE supports the recognition of the changes in fair values in the profit or loss.

(62) On the other hand, the valuation of the managed portfolio should account for the already recognised interest income in the profit or loss under the amortised cost measurement of the banking book (in accordance with IFRS 9 or IAS 39). FEE suggests that instead of comparing the changes in the fair value from the prior period, the valuation should also account for the interest income that has already been recognised. Therefore from the change in the fair value an amount equal to the interest income that has been recognised in the profit or loss as part of the amortised costs should be deducted to reflect the "clean" change in the fair value of the managed risk.

(63) FEE has also considered as an alternative the introduction of a "cash flow hedge accounting model", however due to operational and conceptual challenges, FEE concluded that this approach should not be introduced (please refer to Question 26).

Section 5 – Scope

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?

(b) Please provide comments on the usefulness of the information that would result from the application of the PRA under each scope alternative. Do you think that a combination of the PRA limited to risk mitigation and the hedge accounting requirements in IFRS 9 would provide a faithful representation of dynamic risk management? Why or why not?

(c) Please provide comments on the operational feasibility of applying the PRA for each of the scope alternatives. In the case of a scope focused on risk mitigation, how could the need for frequent changes to the identified hedged sub-portfolio and/or proportion be accommodated?

(d) Would the answers provided in questions (a)–(c) change when considering risks other than interest rate risk (for example, commodity price risk, FX risk)? If yes, how would those answers change, and why? If not, why not?

Question 15 (a)

(64) FEE supports the focus on the risk mitigation approach as this is consistent with other IFRSs. The objective of hedge accounting as defined in paragraph 6.1.1 of IFRS 9 is to represent the effect of risk management activities for which the entity uses hedging instruments to manage the exposures arising from a particular risk. Furthermore FEE agrees with the analysis in the paragraph BC6.79 and BC6.80 of IFRS 9 where the board has concluded that a hedge accounting model that is linked to the entity's risk management is too broad and might not present relevant information to the users of financial statements.

(65) Also a focus on dynamic risk management would require that for exposures which are not hedged (or for which the risk is not mitigated), the (part of) banking book is measured at fair value while IFRS 9 has concluded that the amortised cost measurement basis best reflects the economic substance of a bank's loan portfolio.

Question 15 (b)

(66) As we explain in part (a) above, for some elements of the statement of financial position, the amortised cost measurement basis is more appropriate; therefore FEE believes that the information from the scope alternative which focuses on dynamic risk management would not assist in presenting useful information regarding the entity's performance and positon.

(67) On the other hand the focus on risk mitigation would result in useful information for users regarding the actual risk mitigation that the entity undertakes. With a combination with the hedge accounting requirements under IFRS 9 the entity has the necessary tools to produce a useful set of financial information for the users of financial statements.

(68) Finally FEE identifies the need to revisit the disclosures re the risk management practices (as required in the IFRS 7) in order to develop a robust comprehensive accounting model.

Question 15 (c)

(69) While FEE supports the scope alternative that focuses on risk mitigation, we acknowledge that the application of this scope alternative would introduce a certain degree of complexity in financial reporting.

(70) On the other hand, a focus on risk mitigation would require an increased effort for tracking since exposures are added to or excluded from the managed portfolio on a continued basis, therefore a bank would need to keep track of those exposures (please refer to our answer to Questions 22 and 23).

(71) Under this scope alternative there are two approaches, the sub-portfolio and the proportional approaches. Under both approaches the bank should keep track of either the portfolios that are included within the scope of the PRA or the percentage of the each portfolio that is included in the scope.

Question 15 (d)

(72) FEE does not believe that the answer to these questions would have been different if the managed risk would have been commodity or foreign exchange 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?
(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?

(73) As explained in Question 15 above, FEE supports the scope alternative that focuses on risk mitigation; therefore our answer to this question reflects this view.

(74) FEE believes that the application of the PRA should be optional in order to be in line with the general hedge accounting requirements.

(75) FEE believes that there should not be any hierarchy on which accounting model should be used (if any) in each case between the general hedge accounting model and PRA. FEE believes that PRA is not an accounting model that should replace general hedge accounting; instead it introduces a new accounting model to be applied in circumstances that the current accounting requirements fail to provide a solution.

(76) As explained in our response to Question 17, FEE suggests that the dynamic management of open portfolios should be the eligibility criterion for the application of the PRA, which means that by not making a one-to-one designation of the hedged item and hedging instrument in the financial statements an entity presents more relevant and useful information to the users. This assumes that an entity should use its judgment to decide which model it should apply. In this case an entity should consistently apply the model that is chosen at the inception of the hedge relationship.

Question 17—Other eligibility criteria

(a) Do you think that if the scope of the application of the PRA were focused on dynamic risk management, then no additional criterion would be required to qualify for applying the PRA? Why or why not?
   i. Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.
   ii. If the application of the PRA were optional, but with a focus on dynamic risk management, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

(b) Do you think that if the scope of the application of the PRA were to be focused on risk mitigation, additional eligibility criteria would be needed regarding what is considered as risk mitigation through hedging under dynamic risk management? Why or why not? If your answer is yes, please explain what eligibility criteria you would suggest and, why.
   i. Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.
   ii. If the application of the PRA were optional, but with a focus on risk mitigation, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

(77) As explained in Question 15, FEE supports the scope alternative on risk mitigation, therefore our response to the questions below are drafted with this in mind. In addition, as stated in Question 16, we are in favour of an optional application of the PRA without prescribing any hierarchy between the PRA and the general hedge accounting models.

(78) As the key eligibility criterion FEE suggests that the entity should demonstrate that it dynamically manages open portfolios and that a risk mitigation activity using hedging instruments takes place. Therefore the IASB should develop a definition for dynamic risk management and for open portfolios. FEE suggests that additional eligibility criteria should be in line with IFRS 9 on general hedge accounting (in section 6.4). Therefore FEE suggests:
   a. The relationship should consist of the open portfolio (or part of the portfolio) and the hedging instrument (e.g. the interest rate swap);
   b. At the inception of the hedge relationship there is an official designation of the open portfolio and the type of instruments that will be used in the dynamic risk management (the documentation should not refer to specific values of portfolios or specific instruments since the portfolio and instruments change over time in the context of macro hedging). This designation and documentation should reflect the risk management objectives

c. At the inception of the hedge relationship there is a clear economic relationship between the open portfolios and the hedging instruments.

Section 6 – Presentation and disclosures

Question 18—Presentation alternatives

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

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

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

Question 18 (a)

(79) FEE supports the third option for the statement of financial position (SoFP). We believe that a single line item which represents the net revaluation for all exposures subject to the PRA would represent the most relevant information to the users.

(80) In addition this approach would help to overcome the conceptual challenges that might arise from presenting some items on the SoFP, for example the revaluation for the EMB or the pipeline transactions. Therefore, using this presentation alternative, an entity should not assign the changes in fair value to specific items on the SoFP.

Question 18(b)

(81) FEE supports the presentation of the actual net interest income on the profit or loss of the entity. This information would enable the users to assess the impact of the net interest income (NII) pre and post the risk management of the exposures.

(82) Furthermore FEE believes that the actual NII presentation presents information regarding the current interest rate exposures and the way the bank is managing them, while the alternative (stable NII) represents information regarding future NII in the current profit or loss.

(83) FEE also believes that it might be useful if the presentation of risk management policies and hedge accounting is presented together in the profit or loss to facilitate users' analysis and assessment.

Question 18 (c)

(84) FEE does not propose any alternative presentation for profit or loss or for the statement of financial position.

Question 19—Presentation of internal derivatives

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

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

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

(85) The discussion paper assumes that all banks have a central unit that dynamically manages the interest rate risk. FEE agrees that this is the case for major banks; however some smaller banks may not have such a unit, therefore this might not be relevant for all.

(86) When a bank uses a central ALM unit to manage the risk and a different trading unit that undertakes all the trading activities, then the internal derivatives that the different units are using to transfer the risk should be reflected in the financial statements as they reflect the risk management and the macro hedge activities of the bank.

(87) The way that internal derivatives should be presented is adequately explained in the DP and we agree with the views in the DP. We however share similar concerns as EFRAG on the valuation of the internal derivatives. In some circumstances it might be appropriate to use different yield curves to value the different positions on the same internal derivative which may cause the grossing up of internal derivatives not being completely offset in the profit or loss. On the other hand we do not believe that these differences would be material.

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.

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?

(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?

(88) FEE in general agrees with the disclosure themes as discussed in the DP. However FEE raises some concerns that if the disclosure themes regarding the interest rate risk management of open portfolios are developed outside of IFRS 7 then there is a risk that preparers would need to duplicate disclosures to comply with both requirements. Therefore FEE suggests that the IASB should consider these disclosure requirements in the context of IFRS 7.

(89) FEE supports the focus on a risk mitigation approach (Question 15) however we believe that disclosures to financial statements may include additional information re the risk management policies, objectives and activities as long as the information is available without undue cost and effort and provide that the information is not commercially sensitive. However this discussion can be postponed until a decision re the scope of the new model has been reached.

Section 7 – Other considerations

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

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

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

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

Question 23—Removal of exposures from a managed portfolio

(a) Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?

(b) Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from a managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?

(c) If exposures are removed from a managed portfolio prior to maturity, how would you propose to account for the recognised revaluation adjustment, and why? Please explain your reasons, including commenting on the usefulness of information provided to users of financial statements.

(90) Since FEE supports the focus on a risk mitigation alternative and the optional application of the model (refer to the questions above); we consider the Questions 22 and 23 to be significant for the development of the model for macro hedging.

(91) Some exposures might enter the managed portfolio after the date of their initial recognition. In addition some exposures might exit the managed portfolio before their expiry date and they might re-enter in a subsequent period, depending on the risk mitigation activities of the entity.

(92) Therefore FEE agrees with the DP that this raises additional operational challenges like the Day 1 revaluations. One way to eliminate those differences is by recognising the Day 1 revaluations in the profit or loss when they occur, or, alternatively the Day 1 revaluations can be amortised over the term of the exposures.

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

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

(95) As with other changes in the managed portfolio, like the changes in behaviouralisation, the effects of changes in the managed portfolio of hedged items should be recognised in the profit or loss at either identification or removal from the portfolio, depending on which takes place earliest.

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

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

Question 24—Dynamic risk management of foreign currency instruments

(a) Do you think that it is possible to apply the PRA to the dynamic risk management of FX risk in conjunction with interest rate risk that is being dynamically managed?

(b) Please provide an overview of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not.

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

Section 8—Application of the PRA to other risks

Question 25—Application of the PRA to other risks

(a) Should the PRA be available for dynamic risk management other than banks' dynamic interest rate risk management? Why or why not? If yes, for which additional fact patterns do you think it would be appropriate? Please explain your fact patterns.

(b) For each fact pattern in (a), please explain whether and how the PRA could be applied and whether it would provide useful information about dynamic risk management in entities' financial statements

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

Section 9—Alternative approach—PRA through other comprehensive income

Question 26—PRA through OCI

Do you think that an approach incorporating the use of OCI in the manner described in paragraphs 9.1–9.8 should be considered? Why or why not? If you think the use of OCI should be incorporated in the PRA, how could the conceptual and practical difficulties identified with this alternative approach be overcome?

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

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

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

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

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

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

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

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

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

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

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