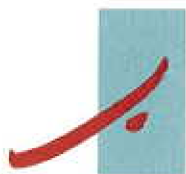

FEDERATION
BANCAIRE
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Banking supervision
And Accounting issues Unit

The Director

Paris, October 17th 2014

FBF Response to the Discussion Paper on Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

Dear Mr Hoogervorst,

The French Banking Federation (FBF) welcomes the opportunity to comment on the Discussion Paper on Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging.

We welcome the IASB for the research work undertaken and the good understanding of banks' risk management related to interest rate risk. We welcome the intention to enhance the usefulness of the financial information to users and to reduce operational complexity of hedge accounting.

We support an approach that reflects actual risk management activities. Management of risks related to interest rate fluctuation is a continuous process that evolves over time along with the risk positions that are being hedged. Risks often are managed on a portfolio basis. The objective of risk management is to stabilize the interest net margin in hold and collect business model.

As highlighted by the IASB, there is a need for a specific macro hedging approach as the current hedge accounting is difficult to apply to actual hedge accounting as, notably, it requires a one-to-one designation between the hedged item and the hedging instrument and it limits the scopes of eligible hedged items. The new model for macro hedge accounting should ensure consistency with IFRS 9 hedging disposals.

Mr Hans HOOGERVORST
Chairman
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We would like to emphasize that the DP highlights most important issues when considering the following items as hedgeable items: prepayable mortgages, core demand deposits, sub-benchmark rate exposures, equity book model, pipeline trades/loan commitments.

The DP proposes a new model, the Portfolio Revaluation Approach (PRA) which requires to revalue at full fair value the interest rate risk of the entire banking book regardless of whether the exposures have been hedged or not. Revaluation of all unhedged portions goes far beyond the objective of the project which is to resolve the accounting mismatch between the fair value measurement of the hedging instruments and the amortised cost measurement of the hedged item. Moreover it would increase volatility in profit or loss as part of the banking book not subject to risk mitigation will be revalued.

For these reasons, we do not support the full PRA approach. It challenges the "hold and collect cash flow" business model of the banking book and the underlying principles of classification and measurement based on amortised cost.

We support an approach of risk mitigation that stabilizes the net interest margin in a "hold and collect cash flow" business model which is in line with the risk management practices. Although the managed risks are the starting point for the risk mitigation, we believe that the accounting impact of a risk mitigation approach should be determined from the risk mitigating instruments point of view rather than from the risk mitigated exposures point of view. This is in alignment with the IFRS 9 business model approach. When a risk of a single exposure or a portfolio including behaviouralisation of this risk is mitigated, this should not result in an increase of volatility in the income statement from hedging instruments compared to no reduction in risk.

In our view, behaviouralisation of exposures is a major step forward. When the risk is managed on a behaviouralised basis then for accounting purposes cash flows should also be considered on a behaviouralised basis rather than a contractual basis. When using behaviouralisation in the context of a risk mitigation approach, the unhedged positions should not lead to increased profit or loss volatility. Changes in expected customer behaviour that only concern the unhedged position should not be recognised in profit or loss. Changes in behavioural assumptions should not affect profit or loss as long as the interest rate risk is mitigated.

We fully support the IASB view that disclosures are important to enhance transparency of an entity's risk mitigating activities. They should be descriptive and specific to the entity. Information to users should be improved regarding risk mitigating activities, significant modelling assumption and overall risk mitigation strategy. However, should be kept in mind that such information might be considered sensitive information depending on the level of detail disclosed.

As mentioned above, we do not support the full PRA as it will result in fair valuing the entire banking book based on a "hold and collect cash flow" business model. A macro hedge accounting should be consistent with the risk mitigation activity and the business model of the bank.

Therefore, in the context of its future research project, we propose the following alternative solutions that we believe the Board should consider in order to address the issues relating to hedge accounting for open portfolios under the current hedge accounting requirements:

- Risk mitigation from a derivative perspective.
- Add eligible hedged items to the current hedge accounting requirements under IAS 39, such as prepayable assets (bottom layer), core demand deposits, sub-benchmark items, pipeline trades /loans commitments and the equity model book.
- Risk mitigation approach through OCI.
- Hedging derivatives at amortised cost.

Our detailed responses to the questions in the DP are included in the Appendix to this letter. We will be pleased to give you any further information that you may require.

Yours sincerely,

Jean-Paul Caudal

APPENDIX

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?

We welcome the initiative of the IASB to review the existing hedge accounting rules and to develop an approach to account for open portfolios and dynamic risk management.

Current accounting requirements as developed under IAS 39 or general hedge accounting of IFRS 9 are often difficult to apply to macro-hedging. They usually imply a one-to-one designation between the hedged item and the hedging instrument. They limit the scope of exposures that are part of the risk management in banks to be eligible for hedge accounting. They do not accurately portray the entities' current risk management activities. As a consequence, entities are in situation where they use a patchwork of accounting requirements which may not always provide a complete picture of the effect of risk management activities and which lead to operational complexity to follow hedge relationship and amortizing hedge adjustments.

Therefore we agree that there is a need for a specific accounting approach to represent dynamic risk management in entities' financial statements.

As stated in the DP, the macro hedge accounting should address the accounting mismatch between derivatives which are accounted for at fair value through profit or loss and positions to be hedged (the banking book) which are accounted for on an amortised cost basis. But macro hedge accounting should not change the classification and measurement principles based on business model, i.e. the accounting treatment of banking book exposure that is not hedged should not change.

Yet, the PRA proposes to measure at fair value the entire banking book for its interest rate risk which contradicts the classification and measurement principles under IFRS 9 applied to the underlying business model of the banking book.
So an institution with no hedging activity will have interest margins in future reporting periods impacted by changes in future rates. Under the PRA, an institution will have all the changes in future interest margins due to changes in future rates reported in the current reporting period. This would create undue volatility into P&L that could be hardly understandable and difficult to explain to users. This would be inconsistent with a faithful representation of the result in the banking book based on a hold and collect business model.

For these reasons, we do not support the full PRA.

The aim of a risk management approach is to stabilise the net interest margin in a hold an collect cash flow business model. Banks manage their interest rate risks on an open portfolio basis in order to accommodate the constant changes in risk exposures.
So we support the concept of risk mitigation in line with these risk management practices.

We believe that the accounting impact of a risk mitigation approach should be determined from the risk managing instruments' point of view rather than from the managed risks' point of view. This is in alignment with the IFRS 9 business model approach, when risk of a single exposure or a portfolio including behaviouralisation of this risk in the banking book is mitigated, this should not result in an increase of volatility from hedging instruments compared to no reduction in risk (no economic hedging).

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?

We welcome the research work undertaken by the IASB. We appreciate the analysis provided and the good understanding of risk management activities within the banking industry.

The DP has correctly acknowledged the specific characteristics of risk management and listed the main issued banks currently faced. We agree that the current hedge accounting (IAS 39 / IFRS 9) prevents from applying an appropriate hedge accounting to fully represent the dynamically managed exposures.
We have not identified issues other than those mentioned in the DP. Namely, prepayable mortgages; core demand deposits, sub-benchmark issue, pipeline trades / loan commitments, equity model book and the bottom layer designation.

We agree with the IASB that the main drawback of macro hedging is the mismatch between measurement of the banking book exposures at amortized cost and measurement of the hedging instruments at FVTPL.

Although issues relating to risk management of foreign currency instruments (such as FX basis, also known as cross currency basis, and multiple curves) are acknowledged in the discussion paper, we believe that additional clarification would be necessary to reduce accounting volatility that doesn't represent economic results.

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

We believe the PRA as proposed in the DP would address a large part of the issues identified above. All exposures that are part of interest rate management can be included in the PRA.

However, the proposed PRA approach would require a revaluation of the whole portfolio rather than the exposures that are risk mitigated. All exposures even if not hedged whether or not measured at fair value will be adjusted to reflect the effect of changes in value. For example, a bank's portfolio of assets and liabilities on which interest rate risk (IRR) is being managed dynamically would be revalued under the PRA for the effects of interest rate changes. This change in value would be recognized in the P&L. Any derivatives used to mitigate the IRR would be measured at FVPL. At the same time, an institution with the same balance sheet, but which – under the categorization defined in the paper - does not manage the interest rate risk dynamically, would display a stable interest margin on an accrual basis.

It would introduce volatility in the profit or loss. Changes in the fair value of assets and liabilities that would otherwise be recorded at amortized cost, would not reflect the actual risk management objectives and would not be helpful to users of financial statements.

We are opposed to the application of the PRA to the whole portfolio.

A macro-hedge model should deal with the fundamental accounting mismatch, i.e. hedging instruments measured at fair value and exposures measured at amortized cost.
The proposed approach should not result in a measurement method that contradicts the principle of measurement applied to a "hold and collect cash flow" business model and that would result in profit or loss volatility not representative of the "hold and collect cash flow" business model.

We favor an alternative approach that would focus on risk mitigation. It would better reflect the economics of actual risk management.

Although hedging for FX risk is addressed in the DP, more clarification on cross currency basis should be added. Currently the financial statements of European banks face volatility from cross currency basis risk, while economically the risk is hedged. Cross currency basis risk should be included in the future approach.

The same applies for the application of multiple curves in the future approach.

Question 15 is answered next, as we oppose the full PRA and as the answers on many questions depend on the scope. The questions will be answered based on a risk mitigation 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 (i.e. a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (i.e. a scope focused on risk mitigation)? Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

We support the focus on risk mitigation as a scope including all portfolios will challenge the amortised cost measurement applied to hold and collect contractual cash flows business model.
A macro hedging model should not override the measurement model applied for banking book. A focus on dynamic risk management as proposed in the DP would lead to revalue all the banking book including portfolios, or parts thereof, not subject to risk mitigation at fair value increasing volatility in P&L. A similar model was proposed by the FASB in 2010: it was rejected by all but a very few of the thousands of ED respondents and therefore dropped by the US standard setter.

(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?**

Information is at its most useful when all risk managements elements are permitted to be included in the application of the PRA since it depicts the actual risk management perspective. Excluding those elements would not permit to address the accounting mismatch and to have a fair representation of the effects of risk mitigation.

We believe that the information presented under the scope focus on dynamic risk management would be less useful than that presented under the scope focus on risk mitigation, because:

- Requiring under the dynamic risk management approach to re-measure the un-hedged positions at fair value for interest rate risk would bring confusion to users regarding classification and measurement principles under IFRS 9

- Limited information will be provided regarding future net interest income and future risk exposure arising from changes in the hedged risk as the revaluation is a value in time and does not provide information regarding future cash flows. Therefore we believe that the disclosures are better suited to provide information regarding full PRA.

- Behaviour of banks could be altered due to the accounting changes as they might be tempted to start managing current period fair value volatility instead of a continued focus on long term interest income.

- Comparability between companies could be compromised in particular between companies that do not undertake dynamic risk management and those that do but do not hedge the entire risk exposure.

The volatility arises from the fact that the instruments used for risk mitigation are at fair value and the hedged items at amortised cost. As long as risk is mitigated, this should not result in an increase of volatility from hedging instruments relative to a no reduction in risk scenario. When the scope is on risk management there is a possibility that the volatility from applying the full PRA will be larger than the volatility arising from the hedging instruments. This is not in line with the measurement criteria in IFRS9.

(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?

We are of the opinion that both scope alternatives result in operational challenges, as they both require a certain amount of tracking of individual items. In those situations where a limited amount of tracking is required, we believe most banks would tolerate this as a consequence of risk mitigation approach.

Both scopes of alternatives would raise operational challenges as they would require tracking of individual exposures. Tracking requirements should be limited to a minimum to avoid incremental costs. They should be limited to what is already required for actual risk mitigation activity in order to allow re-using the risk management processes.

(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 do not believe that answers provided in questions (a-c) would change considering risks other than interest rate risk as those risks are managed similarly.

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 agree that the description of risk management is accurate and complete except when mentioned that "only risk arising from external exposures is included within the managed portfolio".
In the banking book, the managed portfolio could include both internal and external exposures. The external exposures are often hedged with internal derivatives to a trading desk of the bank. The interest rate risks in the managed portfolio's (banking books) are transferred to trading books by the use of internal derivatives. The trading books will externalise the net risk position on a macro basis. On each portfolio level no distinction is made between internal and external positions - for risk management purposes they are contractually the same.

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 pipeline transactions should be included in the PRA if they are part of the entity's risk management, given that the risk is mitigated and that they are included in the exposure measurement. Otherwise, it would lead to volatility and it would not faithfully represent dynamic risk management.

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 need to consider equity has increased recently. Indeed with the recent changes in solvency legislation, the required equity has dramatically increased and it cannot be possible to argue that for most institutions equity is broadly the funding of non-earning assets. Therefore, the inclusion of EMB is a condition of adequately reflecting the actual risk managment.

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.

We agree that the cash flows could be based on behaviouralised basis if the risk is also managed dynamically on a behaviouralised basis.

It is common for risk management to model exposures based on expected cash flows rather than on contractual cash flows. For example, the interest rate risk in a portfolio with prepayment risk is managed based on the expected cash flows. Therefore compared to the contractual cash flows there is an under hedge. should the revaluation of the hedged portfolio be based on contractual cash flows, there would be accounting P&L volatility which is not correct.

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.

Prepayment risk results from the sale by banks of fixed-rate loans (resp. deposits) which offer to the borrower the right to prepay (resp. call) the loan (resp. deposits) before maturity, with or without penalty.

Most risk management approaches regarding prepayment risk can be sorted into two classes:

- Some banks deal with prepayment risk on a loan-by-loan basis, using options both for modeling the customers' prepayment rights and for hedging prepayment risk. Instruments commonly used for this purpose are options on swaps, or swaptions.

- Other banks deal with prepayment risk on an aggregate level, by splitting their loan portfolio into tranches that differ from one another with regard to the probability with which the tranche might be prepaid. A simple variant of this approach would differentiate between a portion that is likely to be prepaid and a portion that will almost certainly not be prepaid. Only the latter tranche would be considered a source of interest rate risk and consequently be hedged.

Some institutions use a combination of these two strategies, with several layers of potentially prepaid loans corresponding to various prepayment probabilities. Such an institution would typically also use swaptions while still working with an aggregate portfolio model, to hedge the prepayment risk in the middle tranche that consists of loans that could be, but are not certain to be, prepaid.

All of these strategies are commonly admitted as best practices for IRR management. Therefore, they must also be accepted as such for accounting purposes, without penalizing one of them by artificial restrictions in effectiveness measurement.

A simple way of achieving conformity between risk management and accounting would be for banks using a tranched portfolio approach to be able to designate a bottom layer in their hedge accounting.

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?

When the risk is managed on a behaviouralised basis then for accounting purposes cash flows should also be considered on a behaviouralised rather than a contractual basis. When using behaviouralisation in the context of a risk mitigation approach, the unhedged positions should not lead to increased accounting P&L volatility.
Changes in expected customer behaviour that only concern the unhedged position should not be recognised in P&L. Changes in behavioural assumptions should not affect P&L as long as the interest rate risk is mitigated.

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 agree that under a scope of risk mitigation a bottom layer should be permitted.
Under a bottom layer approach, a portfolio of prepayments of loans is splitted in two layers: a bottom layer and a top layer. It is assumed that all prepayment loans of a portfolio take place in the top layer and accordingly that risk management only hedges portion of the bottom layer of the portfolio (partial hedging or under-hedging).
No ineffectiveness and no tracking or amortisation should be required as long as it can be demonstrated that the bottom layer has not been breached (eg: by showing that the use of mitigating derivatives lower the sensitivity of future interest margin to interest rate changes and that there are sufficient outstanding mortgages).
In case the bottom layer is breached due to significant prepayments, the entity is overhedged and the ineffectiveness is recognised in profit or loss.

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 agree to incorporate risk limits in the application of the PRA. Risk limits are part of the risk management of a bank subject to internal control processes. We see no reason why they should have any impact on the way the hedging transactions are accounted for.

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?

We believe that core demand deposits should be included in the managed portfolio on a behaviouralised basis.

For banks non-interest bearing deposits are a significant part of their risk management. They are treated by bank as fixed rate funding and are used to mitigate a portion of the fixed rate assets for a stable interest margin. The eligibility of demand deposit on a behaviouralised basis would better reflect risk management.

We believe that the inclusion of demand deposits in the managed portfolio (on a behaviouralised basis) would be one of the most important achievements of the DP.

(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 the behaviouralisation should rely on an entity's risk management. Therefore we do not believe that guidance would be necessary for entities to determine the behaviouralised profile of demand deposits.

We believe that adequate disclosures should allow users to understand the methodology used for estimation and policies.

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 (i.e. Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (i.e. 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 within the management portfolio as benchmarks instruments if it is consistent with entities risk management approach. Excluding such instruments would result in inappropriate day 1 revaluation gains and losses.
The accounting treatment of sub-benchmark instruments should reflect the actual rates used in managing the IRR.

(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 embedded floor included within sub-benchmark instruments should not be part of the dynamic risk management when they are not part of the managed exposures.

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 fair value for the interest rate component. However, we would reiterate our point that a fair value approach does not faithfully represent actual risk management activities.

(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 agree that customer margins either in borrowing or lending should not be included in the hedged portfolio. Therefore it is appropriate to include the funding rate to the PRA to the extent it represents estimated cash flows.
The accounting treatment for actual risk management should reflect the interest rate risk management. There should be no restrictions as to the rate that is used to manage risks.
There is not just one funding curve used in practice. Different risk management approaches are used to determine the benchmark interest rate.

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)?

The transfer pricing mechanism is a key part of the risk management activities. As stated above, we strongly believe that risk management activities cannot be correctly represented under the full Portfolio Revaluation Approach.

(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.

To the extent that managed risk is based on a market funding index, we support the use of market funding index.
Credit spreads should not be included as they are not part of the managed risk and as, with the increasing collateralization of the deals, credit risk is globally appreciated by counterpart.

(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?

Should restrictions be required they should reflect the managed risk in the managed portfolio.

(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?

Most banks do not allow ongoing linkage. Internal transactions are discontinued if external transactions are derecognised. Similar discussion as in Question 6 on how to account for changes in customer behaviour. No proposal for how to resolve ongoing linkage if it exists.

Issues can only be resolved if there will be a link between transfer pricing transactions and change in external exposures and hedging instruments. This will increase operational complexity.

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 a bank should be able to have a choice to identify funding indexes that best reflect their risk management and their hedging activities.

Funding indexes can be chosen on the basis of different parameters (nature of the funding, currency ...) and should reflect the way entities finance transactions. Entities should be allowed to use funding indexes that better reflect the way they manage their risk mitigation activities. Several funding indexes should be allowed.

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

The identification of funding indexes should follow the strategy of the entity and should be based on the indexes used to manage the risk.
Therefore we believe that criteria or restrictions on this process should not be imposed for the purpose of accounting for macro hedging.

The way an institution decides to fund its exposure is a part of its strategy for risk management. Such strategy should not be driven by accounting. Therefore no additional criteria should be defined for the identification of funding index or indexes. Those should be based on the indexes used to manage the risk.

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?

No comment.

QUESTION 15 ***(SEE PAGE 6)***

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?

We believe that the application of a macro hedging approach should also be optional in order to be in line with the general hedging requirements.
Moreover, entities should have the opportunity to decide which hedge accounting standard is appropriate as the macro-hedging model is justified by the hold and collect business model.

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?

We believe that no additional criteria should be required

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

Our answer would not differ whether the application of the PRA was mandatory or not.

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.**

An optional application of the PRA would allow each entity to decide when to apply the PRA. However appropriate disclosures should explain reasons for starting and stopping.

(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.

Regarding risk mitigation through hedging under dynamic risk management, the criterion to be considered is that risk is mitigated by entering into risk mitigating derivatives.

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

Our answer would not differ whether the application of the PRA was mandatory or not.

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.

An optional application of the PRA would allow each entity to decide when to apply the PRA. However appropriate disclosures should explain reasons for starting and stopping.

QUESTION 18—PRESENTATION ALTERNATIVES

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

We favour a single line with aggregated adjustments for all exposures as it would better reflect hedging activities.

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

We favour the presentation of the actual net interest income approach as it distinguishes the net interest income accrued from mismatches in anticipated future net interest income and as it provides useful information for users.

(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.

We do not favour any alternative presentation in the statement of financial position or in the statement of comprehensive income.

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?

A gross presentation of internal derivatives of a dynamic risk management in the statement of comprehensive income would provide useful information.
Indeed, internal derivatives are part of the risk management strategy. They are the actual hedging derivatives for the banking book. The accrual result of these derivatives is recorded in the banking book and represents the realised interest margin in the banking book. When risks to manage are transferred to the trading unit, the trading unit considers the overall exposures of the bank including the position from the banking book. In some circumstances, a position might not be externalised which results in a trading P&L based on fair value movements.

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

We agree that the described treatment of internal derivatives enhances the operational feasibility of the PRA as there are no externalization requirements that would add operational complexity and tracking.

(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 believe that additional conditions should be required as for most banks a robust governance process defines the use of internal derivatives.

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.

For transparency reasons we suggest to split hedge accounting disclosures into two parts: general accounting and macro hedge accounting. We believe the macro hedge accounting should be separately disclosed and within the risk management chapter of the annual report considering the accounting model aims to reflect the companies' risk management activities.

Theme 1: Qualitative information on the objectives and policies for dynamic risk management, including the identification of risks within exposures
We believe the first disclosure theme is useful given it concerns the basis of the embraced risk management approach being the objectives and policies. We agree these elements should be highlighted to enhance transparency and accommodate comparability. Especially, financial institutions should stress the application of concepts that may not be familiar to users of financial statements. We believe all such extensions should be covered, if applicable. In addition, some of the required disclosure information in theme one is partially available as consequence of current regulatory requirements.

We believe quantitative information on modelling (e.g. expected duration of the demand deposits) is commercial sensitive information. Instead of providing quantitative information around modelling, we want to suggest to disclose information that supports how robust a model is. This information should cover:

- The comprehensive governance framework and processes that are in place for ensuring modelling covering:
    - Clear responsibility allocations to Board, senior management, (interest rate) risk in the banking book management function.
    - Documentation of applied methodologies, data, assumptions and monitoring of actual implementation with review of the most important assumptions by the Executive Board.

- Interest Rate Risk in the Banking Book (IRRBB) measurement framework based on stress testing of interest rate scenarios, identification of all material sources of IRRBB, going concern approach with net interest income perspective and/or dynamic economic value perspective.
- When it comes to assumptions included in a model, e.g. behavioural assumptions, disclosures should help users understand the assumptions being used by the entity and the internal control procedures that overlay risk management.

We agree the effect of risk management on the net interest income and the risks involved in the business should be disclosed. This information provides the users information on the effect of the risk management undertaken. We believe the actual net interest income should be disclosed as this provides information of the net interest income before and after dynamic risk management. As included as a general remark, we believe PRA adjustments related to future interest rate income should not be recognised in the Profit & Loss or in the OCI as this would contradict with general accounting principles. We do, though, believe that quantitative information on the impact of risk management is viable, that is, disclosure of the net interest income and the sensitivity of an entity's net interest income.

Theme 2: Qualitative and quantitative information on the net open risk position(s).
The second disclosure theme identified in the DP involves information on the unhedged and its impact on application of an approach based on risk mitigation. We believe information on this topic should be merely qualitative. For instance information on the methodologies used to determine are valid and would be informative.

Theme 3: Risk management activity
Similar to the preceding disclosures themes, we support the third disclosure theme as we believe it will enhance the disclosure of risk management activities. We believe this theme is a follow-up on what is covered in the first disclosure theme. Consequently, we believe these themes should be clearly related which includes information on specific disclosures in light of actual risk management e.g. (changes in) behavioural assumptions, pipeline transactions, prepayment risk, risk limits, and demand deposits. Also, we believe more general information, say, on the application of the applied risk mitigation approach and underlying choice of indices should be disclosed. We do believe that the disclosures should be mainly qualitative given that quantitatively coverage would lead to sharing of (potential) commercial sensitive information. Altogether, these disclosures should enable the user to understand the linkage between accounting and risk management and the impact of risk management on the financial statements.

Theme 4: Quantitative and qualitative information on the impact of dynamic risk management on the current and future performance of an entity
Information on the impact of the risk management on the current and future performance would be useful but we caution about requiring certain quantitative information that may be commercially sensitive.

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

Please refer to 20.a)

(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.

We actually believe that more disclosures will be required if a dynamic risk management approach is adopted, particularly to enable a level of comparison between different entities.

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?

As we support an approach based on risk mitigation, we believe that the disclosures should be aligned with this approach. Additional disclosures regarding the unhedged position could be useful information for the users. Considerations should be put on sensitiveness of information. As we support a risk mitigation, we believe that disclosure should be aligned with this approach.

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?**

Consistent with the management based on open portfolios, the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract should be allowed. Depending on changing market conditions or hedging objectives, the entity might decide to hedge a part of the before unhedged position,
Accordingly, should also be allowed removal of exposures from the managed portfolio depending on the risk mitigation activities of the entity.

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

To clarify matters, we would like to differentiate three dates:

- The date at which a balance sheet item (eg a loan) is contracted (t0).
- The date at which the interest rate risk of this loan is transferred to ALM (t1).
- The date at which ALM decides to (fully or partially) hedge this loan (t2).

The accounting status of this loan as of t0 is given by the classification rules of IFRS 9.
Usually, the loan will be transferred to ALM as soon as the bank enters the contract in order to avoid unmanaged interest rate risk.

If, for any reason, such a loan is transferred after the normal period defined by a bank's internal policy for risk centralization, ALM can nevertheless hedge it only at the then-prevailing market conditions. Therefore, the internal contract between the customer segment and ALM will also be written at these conditions. Hence, there should be no Day-1 P&L in t1, not even under a PRA with a focus on dynamic risk management.
Whether or not this loan is also hedged in t1 or only at some later date should not be relevant for its treatment under hedge accounting rules. In other words, late hedging should be permissible without leading to volatility in profit or loss.

For this reason, we do not support the PRA with a focus on dynamic risk management – as this would lead to exactly such volatility in P&L – but advocate an approach based on risk mitigation.

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?

We do not agree. When focus is on risk mitigation and entity decides no longer to hedge exposures, this will result in volatility as there will be no hedging derivative anymore. The cumulative recognised revaluation should be amortised over the remaining time until maturity.

(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?

Changes in risk management strategy or exposures resulting from instruments to be sold in the near future are circumstances when exposures are removed from the managed portfolio. Accounting should reflect such changes.

(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.

We suggest amortization over the remaining time until maturity instead of recognizing the revaluation adjustment in P&L in order to reflect appropriately the risk management activities.

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?

Volatility of cross currency basis risk (FX basis risk) is a big issue for banks. A solution is essential.
It has to be, as these risks are interlinked.

(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.

No comment

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.

No comment

(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.

No comment

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?

No comment