European Financial Reporting Advisory Group

DP/2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*

Feedback to respondents – EFRAG Final Comment Letter

January 2015

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Introduction

Objective of this feedback statement

EFRAG published its final comment letter on the Discussion Paper *DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* ('the DP') on 30 October 2014. This feedback statement summarises the main comments received by EFRAG on its draft comment letter and explains how those comments were considered by the EFRAG Technical Expert Group (EFRAG TEG) during its technical discussions leading to the publication of EFRAG's final comment letter.

Background to the Discussion Paper

On 17 April 2014 the IASB published for public comment a DP on macro hedge accounting which contained a possible approach to accounting for an entity's dynamic risk management activities: the portfolio revaluation approach (PRA).

The PRA did not change the measurement basis of the risk management instruments (derivatives) - these would remain at fair value through profit or loss. However, the risk managed exposures would be revalued with respect to the managed risk (e.g. three month LIBOR) and the resulting revaluation adjustment would be recognised in the balance sheet and income statement. The revaluation adjustment would therefore counterbalance the fair value changes of the risk management instruments.

Changes would also be made to how net interest income is shown on the income statement, including showing the effect of risk management.

The DP focused on the way banks dynamically manage their interest rate risk as a starting point because it provided a common example of a risk for which dynamic risk management is undertaken. However, the IASB intended the approach to also be applicable to other risk types and industries.

The PRA would be applied to open portfolios of hedged items (i.e. portfolios are portfolios that change frequently because new exposures are added and existing exposures are removed). The DP discussed the sources of risk managed exposures, and introduced notions including behavioural estimates, core demand deposits, equity model book and pipeline transactions.

The PRA proposed two scope alternatives, one that included the revaluation of all managed exposures and one that included the revaluation of only the exposures being risk mitigated.

Finally the DP discussed an alternative approach where the net effect of the revaluation of the managed portfolios and the changes in the fair value of the risk management instruments would be recognised in OCI rather than in profit or loss.

Further details are available on the EFRAG's project webpage and on the IASB's project webpage.

EFRAG's draft comment letter

EFRAG published a draft comment letter on the proposals on 1 July 2014. In the draft comment letter, EFRAG commended the IASB's efforts in analysing banks' risk management practices and developing new thinking in how to best reflect the effects of such practices on an entity's financial position and performance.

EFRAG noted that the IASB had expanded the scope of the project by considering the revaluation of all portfolios that are dynamically managed, rather than focusing on finding a hedge accounting solution for open portfolios which was the original objective when the project was decoupled from phase III of IFRS 9 *Financial Instruments* on general hedge accounting. EFRAG did not support this wider scope on the basis that the information produced by a revaluation of all portfolios which were dynamically managed, regardless of whether they had been risk-mitigated through hedging, was not decision-useful as it ignored the amortised cost measurement attribute for financial instruments in the banking book. Consequently, EFRAG called for a return to the original aim of the project: the development of a hedge accounting solution for open portfolios.

In addition EFRAG was concerned that the suggested approach in the DP that was restricted to mitigated risk would be operationally difficult to implement.

EFRAG argued that it was necessary to keep the model closely aligned with risk management practices, thus considering pipeline transactions, equity model book and behaviouralisation of core deposits and prepayment options. EFRAG asked its constituents whether forecast transactions were to be included.

Further, EFRAG preferred a presentation of net interest income in the income statement based on the actual net interest approach.

Finally, EFRAG believed that an impact assessment would be necessary before an Exposure Draft could be published.

Comments received from respondents

EFRAG received comments from 21 constituents which were considered by EFRAG TEG before finalisation of the EFRAG comment letter. These comment letters are available on the EFRAG website.

Overall, the majority of respondents supported EFRAG's tentative position on most of the issues. However respondents from the insurance and the utility industry noted that the specific characteristics of their industries needed to be taken into account when further developing the model.

Also respondents had mixed views on whether accounting should reflect aspects considered in risk management such as the equity model book and forecast transactions.

EFRAG's final comment letter

EFRAG published its final comment letter on 30 October 2014. In its final comment letter, EFRAG confirmed its positive assessment of the IASB's efforts in analysing bank's risk management practices.

Based upon the comments received from constituents, the final comment letter emphasized that in addition to banks, other sectors (e.g. insurance industry and utilities sector) were also interested in the development of a macro hedge accounting solution covering different types of risks.

Although EFRAG encouraged the IASB to continue its work on a macro hedge accounting model, EFRAG believed that it was necessary to finalise the Insurance Contracts project before it was possible to assess how any macro hedge accounting solution could apply to the insurance industry.

EFRAG confirmed its disagreement with the Discussion Paper's proposed scope focussed on dynamic risk management and confirmed its preference for a scope based on risk-mitigation.

EFRAG also confirmed its concern that the risk mitigation approaches identified in the DP would be operationally difficult to implement.

EFRAG believed that a macro hedge accounting model should remain consistent with IFRS 9 and asked the IASB to investigate whether IFRS 9 could be the starting point for the future macro hedge accounting model.

Further, EFRAG believed that a cash flow hedge accounting model should be considered as the project developed, as many banks managed their interest rate risk on a cash flow basis rather than a valuation basis. Also many of the concepts proposed in the DP would fit more comfortably with a cash flow hedge model than with a fair value hedge model.

Finally, EFRAG confirmed its request for an impact assessment during further development of the approach.

EFRAG's discussion of the concerns reported by some respondents is explained in the detailed analysis of the responses received.

Detailed analysis of issues, comments received and changes made to EFRAG final comment letter

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Scope of the Portfolio Revaluation Approach (PRA)

Proposals in the DP

The DP discussed two potential scope alternatives, depending on whether the focus should be on dynamic risk management or on risk mitigation.

EFRAG's tentative position

EFRAG did not believe that the PRA should be applied to all managed portfolios as it would not meet the objective of eliminating the accounting mismatch and would result in overriding the amortised cost attribute for a number of financial instruments that were not being hedged. For this reason, EFRAG supported a scope focused on risk mitigation.

Respondents' comments

Most respondents agreed that the scope should be limited to circumstances where risks were mitigated through hedging.

Respondents from the insurance industry disagreed and supported a scope focused on dynamic risk management.

Regulatory respondents pointed out that neither approaches were fully satisfactory. In addition, they noted that the scope based upon dynamic risk management might have as a consequence that some banks needed to revalue loans that were currently accounted for at amortised cost. The resulting increase in profit or loss could increase procyclicality and thus might negatively impact financial stability.

EFRAG's response to respondents' comments

EFRAG's final position

Based on the input from most respondents, EFRAG confirmed its original position with a support for a scope based upon risk mitigation.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Application to other industries

Proposals in the DP

The DP focussed on dynamic interest rate risk management by banks as a starting point as it provided a common example of a risk for which dynamic risk management was undertaken. However the DP used that example to seek input from constituents as to whether there was a need for a model to address other applications of dynamic risk management in other industries.

EFRAG's tentative position

EFRAG believed that a macro hedge accounting model could be of particular interest to industries such as insurance, utility, pharmaceutical and manufacturing and to other risks, such as commodity price risk and foreign exchange risk, in addition to banks and interest rate risk.

Respondent's comments

Respondents from the insurance and the utility industry noted that the specific characteristics of their industries needed to be taken into account when further developing the model.

EFRAG's response to respondents' comments

EFRAG's final position

EFRAG agreed with the request from the insurance and utility industry that any future model should take into account the characteristics of their industries.

Hence EFRAG emphasized this message in its final comment letter by encouraging the IASB to undertake further analysis with different industries before concluding whether it is possible to develop a one-size-fits-all solution or whether a family of models was needed to address the needs of different industries. This request addresses, amongst others, the comment from the insurance industry to apply a scope based upon dynamic risk management instead of being based on risk mitigation.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Current difficulties in representing dynamic risk management in entities' financial statements

Proposals in the DP

The DP identified and discussed issues that banks are struggling with such as the sub-LIBOR issue, the reliance of banks on core deposits, the use of an equity model book and the use of bottom layers.

EFRAG's tentative position

EFRAG agreed that the DP had accurately depicted many of the characteristics of dynamic interest rate risk management within banks, but the DP remained unclear whether these characteristics also covered dynamic risk management within other sectors.

Respondents' comments

Respondents generally agreed that the DP had identified the issues banks face when applying hedge accounting. One bank responding noted that there was insufficient distinction between a hedging position and a transformation position. One respondent from the energy sector agreed with this comment and, based upon dynamic risk management practices in the energy sector, advocated that the new standard should distinguish between deemed (or structural) exposures and exposures for which active risk management was ongoing and hedging had started.

One regulatory respondent noted the PRA was too ambitious and should be limited to those issues that have led to the EU carve-out.

EFRAG's response to respondents' comments

EFRAG's final position

EFRAG agreed with respondents' comments that in identifying risk exposures a difference could be made between structural (or deemed) exposures and contractual exposures of interest rate risk.

EFRAG believed that explicitly distinguishing between contractual and structural sources could be helpful both in identifying the boundaries of a macro hedge accounting model for interest rate risk management in banks and for determining the application of the model to the insurance and utilities sectors in particular.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Pipeline transactions, EMB and behaviouralisation

Proposals in the DP

The DP described pipeline transactions as forecast volumes of drawdowns on fixed-rate products at advertised rates and asked whether these should be included in the PRA if they were considered as part of dynamic risk management.

The DP did not propose that forecast transactions other than pipeline transactions should be included in the PRA as they did not represent an existing revaluation risk.

The DP explained that some banks disaggregated the return on their own equity into a base return similar to interest. This practice was done making use of a replication portfolio and was known as the equity model book (EMB). The DP asked whether the equity model book should be included in the PRA if it was considered part of dynamic risk management.

Finally, the DP explained that for risk management purposes the interest rate risk of prepayable open portfolios was determined taking into account behavioural expectations of prepayments. The DP asked whether estimates based on behavioural estimates should be included in the PRA.

EFRAG's tentative position

EFRAG noted that any approach that was designed to represent faithfully the impact on performance of dynamic risk management actions should aim to limit accounting mismatches to the extent feasible.

Consequently, EFRAG believed that to reach the maximum offset between the revaluation adjustment and the changes in value of hedging instruments in the PRA applied to risk mitigation, a hedge accounting model would have to incorporate pipeline transactions, the equity model

EFRAG's response to respondents' comments

EFRAG's final position

EFRAG nuanced its position on the inclusion of the equity model book. EFRAG acknowledged that including the equity model book in the PRA would, in essence, mean a (partial) re-measurement of equity, which would conflict with the current literature, especially the Conceptual Framework and IFRS 9. However, EFRAG believed that it should be considered where an entity included it as part of its interest rate risk management. Should the hurdles for including the equity model book be too high to overcome, EFRAG encouraged the IASB to search for an alternative hedge accounting solution that addresses the conceptual concerns.

Based on the support from respondents, EFRAG confirmed its support for the inclusion of pipeline transactions in the model but thought it was necessary to define clear criteria distinguishing these from forecast transactions.

Based on the input received from respondents, EFRAG thought that forecast transactions should not be included in the scope of hedge accounting for dynamic risk management when applied to the banking sector as doing so could affect significantly the verifiability of the resulting information.

However, EFRAG added that it currently had insufficient insight into the reasons why sectors other than the banking sector would include future transactions in the scope of the PRA. Therefore EFRAG asked the IASB to research this issue further before concluding on the eligibility of forecast transactions. If the IASB were to consider a cash flow hedging solution, EFRAG thought forecast transactions could be included in the scope of the model.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**EFRAG's response to respondents' comments**
book and core deposits. EFRAG asked its respondents whether forecast transactions were also to be included. *Respondents' comments* Most respondents agreed with including pipeline transactions in the scope of the PRA. Of those respondents which provided input to the question whether forecast transactions were to be included in the scope of the PRA, banking respondents supported the inclusion when specific conditions were fulfilled. One national standard setter did not support their inclusion as it would affect the objectivity and auditability of the risk mitigation model. Banking respondents were in favour or argued that including the equity model book in the scope of the PRA should be optional. One national standard setter and one regulator disagreed with the inclusion of the equity model book in the scope of the PRA as it would result in the revaluation of an entity's own equity and a step too far in aligning hedge accounting with an entity's risk management practices. Most respondents agreed with including behavioural estimates in the scope of the PRA.	Finally, EFRAG agreed with the use of behavioural assumptions as a means of estimating the cash flows to be included in the portfolio revaluation approach, because: (a) Relying on dynamic risk management for defining behavioural cash flows would increase operational feasibility, as the entity already identified the cash flows; and (b) Doing so also increased the relevance and, hence, the usefulness of the information provided in the financial statements as using another basis (such as contractual cash flows) would misrepresent the efforts from dynamic risk management to hedge the risks related to the portfolios.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

PRA through OCI

Proposals in the DP

The DP proposed an alternative approach for presenting the portfolio revaluation approach through other comprehensive income (OCI). Under this approach both the net revaluation adjustment from managed exposures and the changes in the clean fair value of risk management instruments would be recognised in OCI rather than in profit or loss.

EFRAG's tentative position

EFRAG did not support the use of OCI as proposed by the DP as there was no disconnect expected between the revaluation adjustment and the fair value of the hedging instruments other than ineffectiveness and basis risk of the hedging instruments. Accordingly, EFRAG saw no reason why recognition in profit or loss should be deferred in OCI.

Respondents' comments

Most respondents agreed that using OCI would raise more conceptual and practical challenges than it would solve. However respondents from the insurance industry believed the use of OCI could be further explored pending the finalisation of IFRS 4, phase II.

EFRAG's response to respondents' comments

EFRAG's final position

In its final answer EFRAG made a distinction in its analysis between the situation of the banking sector and the insurance sector. The analysis that there was no presentation mismatch expected between the revaluation adjustment and the fair value of the hedging instruments remained valid for the banking sector.

EFRAG recognised that the situation could be different for the insurance industry. Here, the analysis could not be completed before the finalisation of IFRS 4, phase II. Consequently EFRAG noted that it was too early to decide whether macro hedge accounting through OCI could be appropriate.

EFRAG added that many banks do not manage their interest rate risk on a valuation basis but rather on a cash flow basis. Hence, if a cash flow hedge model were to be developed, the use of OCI would become appropriate. In that case EFRAG suggested that the IASB work closely with prudential regulators to avoid any distortion in the prudential equity of banks.

List of respondents

Constituents whose comment letters were considered by EFRAG TEG before finalisation of the comment letter	*Country*	*Nature*
European Central Bank	Germany	Central bank
Gesamtverband der Deutschen Versicherungswirtschaft (GDV)	Germany	Preparer Association
Fédération des Experts Comptables Européens (FEE)	Belgium	Accountancy Association
KBC	Belgium	Preparer
Financial Reporting Council (FRC)	United Kingdom	National Standard Setter
ESMA	France	Regulator
Erste Group	Austria	Preparer
Insurance Europe – CFO Forum	Belgium	Preparer Association
International Energy Accounting Forum (IEAF)	Belgium	Preparer Association
EACB	Belgium	Preparer Association
WSBI-ESBG	Belgium	Preparer Association
EBF	Belgium	Preparer Association
EBA	United Kingdom	Regulator
ACTEO-AFEP-MEDEF	France	Preparer Association
ASCG	Germany	National Standard Setter
Enel	Italy	Preparer
FFSA	France	Preparer Association
FBF	Belgium	Preparer Association
BusinessEurope	Belgium	Preparer Association
Denise Silva Ferreira Juvenal	Brasil	Private person
DASB	The Netherlands	National Standard Setter