CHIEF EXECUTIVE

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Subject*:** ***EBF Comment Letter on the IASB Discussion Paper Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

Dear Mr Hoogervorst,

The European Banking Federation (EBF) is grateful for the opportunity to comment on the proposals in the IASB Discussion Paper on accounting for dynamic risk management: a portfolio revaluation approach (PRA) to macro hedging.

The EBF compliments the Board on their research and understanding of banks' dynamic risk management practices regarding interest rate risks and other risks and welcomes the intention of the Board to reduce the complexity of hedge accounting and improve the information to the users of the financial statements.

The objective of risk management is to preserve future interest margins in an originate and hold to collect cash flow business model, as is correctly recognised under IFRS 9. However, under the current hedge accounting framework of IAS 39 and IFRS 9, achieving hedge accounting for open portfolios is difficult and some very important exposures are excluded from hedge accounting even though they are included in actual risk management. The EBF considers it a major step forward that the discussion paper considered the following items as hedgeable items:

- Prepayable mortgages (including bottom layer principles)
- Core demand deposits
- Sub-benchmark rate exposures
- Equity (through the Equity Model Book)
- Pipeline trades/loan commitments

Any future accounting model aiming to reflect risk management should take account of these items.

The basis for embarking on the hedge accounting challenge is the mismatch in accounting treatment between financial instruments which are classified based on the underlying business purpose and the derivatives which are classified at fair value through profit and loss by default.

The EBF noticed that the IASB proposed a completely new model, the Portfolio Revaluation Approach, introducing a fair value model (for interest rate risk) instead of addressing the issues banks face under the current hedge accounting requirements of IAS 39 in a new macro hedge accounting solution.

Full PRA with a focus on dynamic risk management

The EBF does not support the full PRA approach. This scope alternative will change the classification and measurement of the entire banking book, by measuring it at fair value for interest rate risk. It would directly conflict with the banking book business model to originate and hold to collect cash flows. We are of the opinion that the full PRA would *not* give a faithful representation of the banking book.

According to the classification and measurement criteria under IFRS 9, the banking book is measured at amortised cost. Without hedging activity, an exposure, if any, would result in interest margins in *future* reporting periods that would change with change in *future* rates. However, under the full PRA, the application of the fair value valuation to the whole banking book, all the changes in *future* interest margins due to changes in *future* rates would be reported in the *current* reporting period - which is inconsistent with the business model to originate and hold to collect cash flows over time. Managing interest rate risk must not trigger a drastic change in measurement of the banking book items.

In our opinion, as long as the interest rate risk is mitigated, this must not result in an increase of accounting P&L volatility, especially compared to the result of an institution which neglects that risk.

PRA with a focus on risk mitigation

The EBF supports the *concept of* risk mitigation as proposed in the discussion paper, as this is in line with the risk management practices to stabilise the future interest margin.

Although the managed risks are the starting point for the risk mitigation, the EBF believes 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 risk of a single exposure or a portfolio including behaviouralisation of this risk is mitigated, this should not result in an increase of accounting P&L volatility in the income statement from hedging instruments compared to no reduction in risk.

We are aware of the fact that a *risk mitigation approach* may require designations and the need to link risk mitigated exposures to balance sheet items, and we accept that fact. To the extent that these processes are consistent with the risk mitigating activity of the bank, there is no incremental cost in using them for accounting purposes.

Behaviouralisation: changes in parameters

The EBF considers that the '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 based on a behaviouralised rather than on a contractual basis.

When introducing behaviouralisation, including the bottom layer principle, to a *risk mitigation approach*, we are of the opinion that the unhedged portion should not result in an increased accounting P&L volatility either. When for example core demand deposits are modelled based on their behaviour with a maturity of 10 years and their contribution to risk exposure is risk mitigated with derivatives up to the 9 year maturity bucket, the portion in the 10 year maturity bucket should not result in accounting P&L volatility in the current period.

Not every behaviouralisation model update modelling risks should result in accounting P&L volatility. As long as the risks of a modelled portfolio are mitigated (including when the bottom layer is not breached) this should not result in accounting P&L volatility.

Disclosures on risk mitigating activity of the bank, including the behaviour modelling process, would be helpful for investors to understand the risk mitigation strategy.

Disclosures

The EBF fully supports the Board's intention to enhance the transparency of an entity's risk mitigating activities. We also support the Board's view that the added value of disclosures is enhanced if these are descriptive and specific to the entity.

In general, disclosure should be relevant and only essential information should be included to avoid excessive amount of disclosures.

FX basis and multiple curves

Issues relating to risk mitigation with foreign currency instruments (FX basis/cross currency basis) and multiple curves are only briefly mentioned in the discussion paper. However given the importance of these topics to European banks, risk mitigation accounting should cover these issues to ensure artificial accounting volatility is addressed. We considered essential to be able to include both FX and interest rate risk in the same hedge relationships, since many of the present difficulties in using the present hedge accounting principles in IAS 39 comes from the need to artificially bifurcate different risks from FX consistent yield curves.

Alternative approaches

As mentioned above we are of the opinion that the full PRA would not give a faithful representation of the results in the banking book based on a business model to originate and hold to collect cash flows. Full PRA would require a bank to manage interest rate risk in the banking book as if it was a trading book, with a focus on short term accounting P&L volatility rather than the long term originate-and-hold business model they operate in. Hence, full PRA would change rather than convey the business model of banks, which will not benefit the users.

In our opinion, an accounting standard should be consistent with the actual risk mitigation activity and business model of the bank.

The EBF proposes the following alternative approaches for the Board's consideration to address the issues relating to hedge accounting for open portfolios under the current hedge accounting requirements of IAS 39:

- Risk mitigation from a derivatives perspective
- Enrich current portfolio hedge accounting requirements under IAS 39 by including prepayable assets (bottom layer), core demand deposits, pipeline trades/loan commitments and the equity model book as eligible hedged items
- Risk mitigation approach through OCI
- Hedging derivatives at amortised cost

The detailed responses from the EBF to the questions in the discussion paper can be found in the appendix. As the discussion paper focuses on the less-favoured full PRA approach, not all questions have been answered.

The EBF experts are at the disposal of the IASB Board and Staff to engage with them into technical discussions on possible alternative approaches.

Yours sincerely,

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APPENDIX

EBF RESPONSES TO THE IASB DISCUSSION PAPER ON ACCOUNTING FOR DYNAMIC RISK MANAGEMENT: A PORTFOLIO REVALUATION APPROACH TO MACRO HEDGING

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?

- Banks manage their (interest) rate risk on a portfolio basis, with continuous changes in the risk position. Such open portfolios require an ongoing risk management approach. Under the current micro-hedge accounting requirements of IAS 39 or future hedge accounting requirements of IFRS 9, achieving hedge accounting for open portfolios is difficult as the requirements are based on a one-to-one designation between the hedged item and hedging instruments. Furthermore not all exposures (hedged items) that are part of the risk management ("Generally Accepted Risk Management Practice") in banks are eligible for hedge accounting. As a result it is difficult to faithfully represent the result of actual risk management in the financial statements.

- As a result, we are of the opinion that a solution is required to be able to faithfully represent actual risk management for open portfolios within banks.

- According to the classification and measurement criteria, the banking book is measured at amortised cost. As a result an unhedged exposure should result in a changed interest margin in *future* reporting periods. Accounting volatility arises from the fact that the instruments used for risk mitigation are measured at fair value and the hedged items in the banking book at amortised cost. In our opinion, as long the (interest rate) risk is mitigated, this should not result in an increase of volatility from risk mitigating instruments.

- For this reason, the EBF cannot support the full PRA with a focus on *dynamic risk management*. This scope alternative will change the classification and measurement of the banking book, by measuring the banking book at fair value for interest rate risk. We are of the opinion that the full PRA is not a faithful representation of the result in the banking book based on a business model to collect and hold cash flows. A change in fair value (for example 100 million) of the total *future* interest margin (for example 10 billion) should not be reported in the income statement of the *current* reporting period. The disclosures are better suited to provide information regarding risk management activities.

- In our view, the accounting needed is to have a macro-hedge accounting standard addressing the accounting mismatches of the mixed measurement model when risk mitigation activities are undertaken.

- In general, we do support the scope of risk mitigation as proposed in the discussion paper as this is in line with the risk management practices to stabilize the interest margin. Although the managed risks are the starting point for the risk mitigation, the EBF believes 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 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

- Alternative solutions should be considered, such as adding the identified eligible hedged items to IAS 39 to achieve a risk mitigation hedge accounting solution or even looking at recognising hedging derivatives at amortised cost.

- There is also a need to clarify the practicalities of the co-existence between IFRS 9 general hedging model and the specific (hedge) accounting treatment for open portfolio hedges which are dynamically managed, as banks micro hedge some stable positions.

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 would like to compliment the board on their research on and good understanding of *dynamic risk management* activities within the banking industry.

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

- Not all exposures and the modelling of exposures part of risk management systems of banks can be represented by the current hedge accounting requirements (IAS 39 / IFRS 9).

- Many of the issues at stake have been identified:
    - Prepayable mortgages (including bottom layer principles)
    - Core demand deposits
    - Sub-benchmark rate exposures
    - Equity (through the Equity Model Book)
    - Pipeline trades/loan commitments

- Although issues relating to risk management of foreign currency instruments (FX basis/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 think the PRA in general would address a large part of the issues identified when all exposures that are part of interest rate management can be included in the PRA (cf issues listed in response to previous question). This would help avoiding designating items that are not directly related to the actual risk mitigating transactions (proxy-hedging).

- 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.

- However the PRA with a focus on *dynamic risk management* is a holistic approach, i.e. it suggests to revalue the whole portfolio rather than the portions thereof that are being risk mitigated. Indeed, although the managed exposures are not measured at fair value, an entity applying the PRA would be required to adjust all the exposures; even if not risk mitigated 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 IR changes. This change in value would be recognized in the P&L. Any derivatives used to mitigate the IRR would be measured at FVPL. An institution with the same balance sheet, but which – under the categorization defined in the paper - would not manage the interest rate risk dynamically would display a stable interest margin on an accrual basis.

- The PRA must deal with the fundamental accounting mismatch between hedging derivatives at fair value and hedged cash position at amortised cost. The solution to this problem should not be a change in revaluation principle of the exposures and/or in the collect cash flow business model.

- The main stumbling block with the PRA arises from the holistic revaluation approach itself which would result in accounting P&L volatility not representative of the collect cash flows business model.

- A focus on risk mitigation is preferred by the EBF.

- We are of the opinion that there are alternative approaches to represent the actual risk management with a focus on risk mitigation in the financial statements which may deserve further consideration.

- Question 15 is answered next, as for the EBF a full PRA is not an acceptable option and the answers on many questions depend on the scope. As a result the questions will be answered based on a risk mitigation scope or not answered if not seen as relevant.

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?

- Scope should be based on risk mitigation. As a result of choices in classification and measurement the banking book is measured at amortised cost. A scope including all portfolios would change measurement to fair value for interest rate risk.

- The basis of the macro hedging project should not lead to a reopening of the debate about the best measurement model for the banking book. With the reasoning developed in 5.2.1 and further, as banks manage also their credit risk and liquidity risk dynamically in most circumstances, the banking book would be accounted with a full fair value model. A similar model was proposed by the FASB in 2010: it was rejected by all, except for 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?

We believe that the usefulness of information would depend on the degree and extent the IASB is willing to permit risk management elements to be included in the application of PRA. Information is at its most useful when all risk management elements are permitted since it depicts the actual risk management perspective; and its value deteriorates in tandem to the degree and nature of restrictions imposed on the eligibility of risk management elements. Excluding valid elements considered in *dynamic risk management* would make it harder to close the gap between actual risk management and accounting and will increase the need for proxy hedging approaches.

Even if the net unhedged risk position is correctly depicted, we believe that the information generated under the scope focus on dynamic risk management would not be useful than that generated under the scope focus on risk mitigation, because:

- There is a potential to confuse users on the classification and measurement principles due to the requirement under the dynamic risk management focus to re-measure the un-hedged positions at fair value for interest rate risk.

- The results shown in the financial statements would not provide insight into the future risk exposure arising from changes in the hedged risk since the resulting figure shown in the financial statements is nothing more than point-in-time information. Limited information is provided regarding future net interest income as the revaluation is a value in time and does not provide information regarding future cash flows. A change in fair value (for example 100 million) of the total *future* interest margin (for example 10 billion) should not be reported in the income statement of the *current* reporting period Therefore we believe that the disclosures are better suited to provide information regarding actual risk management.

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

- 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 risk mitigating instruments.

(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 and amortizations 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.

(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?

- No difference as the risk managed is similar and the same arguments apply for these risks as well and risk mitigation should not result in an increased volatility, by changing measurement criteria.

QUESTION 3—DYNAMIC RISK MANAGEMENT

Do you think that the description of dynamic risk management in paragraphs 2.1.1–2.1.2 is accurate and complete? Why or why not? If not, what changes do you suggest, and why?

- Yes, we think it is quite accurate, except for:

The only risk arising from external exposures is included within the managed portfolio. On a portfolio level, the managed portfolio in the banking book could include both internal and external exposures. In a banking book the external exposure is often hedged with an internal derivative 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.

Additionally, more clarification is necessary regarding what is meant with targeted sensitivity. In banks the targeted sensitivity are set by defining risk limits per portfolio. The risk limits can be defined set per time bucket, interest curve, currency etc or holistically at portfolio level using VaR for example.

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).

- Yes. Pipeline transactions are generally accepted as risk exposures.

- It should be possible to include pipeline transactions in the PRA if they are part of the entity's actual risk management (hedging based on expected cash flows) and included in the exposure measurement.

- Not including pipeline transactions would lead to accounting P&L volatility, while the risk is actually mitigated compared to no volatility when there is no risk mitigation. This does not result in useful information in the financial statements.

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 objective of Asset-Liability Management (ALM) is the stabilisation of net interest income (NII). In order to achieve this objective, it is necessary to capture all balance sheet exposures that contribute to NII. Hence, all assets (e.g. mortgage loans), liabilities (e.g. deposits, issued bonds) in the banking book and equity are considered in managing interest rate risk in the banking book.

- Equity is a source of funding that is invested, no matter what. As such, the reinvestment of equity contributes to the NII. If the investment is short term (e.g. overnight investment), NII would be volatile with any changes in short term rate. As equity is a significant portion of bank balance sheet, even more so with changes in prudential regulation that requires more and more equity, banks have to determine the horizon on which equity is invested (rate-wise). Once this horizon is determined, equity is considered in the risk metrics like a fixed rate liability with the term determined by the bank.

- When the excess of fixed rate assets over fixed rate liabilities is not large enough (balance-wise and/or term-wise) for equity to be invested at the determined term, equity is invested too short, which leads to NII sensitivity that is too high. In such circumstances, ALM has to mitigate this risk by entering fixed rate received transaction (fixed rate receiver swap or investment securities).

- The need to consider equity has increased recently. A few years ago, it was possible to argue that for most institutions equity was broadly the funding of non-interest-bearing assets such as real estate or shareholdings, and that the residual "net equity" position was not material. With the recent changes in solvency legislation, however, the required equity has dramatically increased while banks' shareholdings, e.g. in corporates, have gone out of fashion, due to their prudential cost in own funds. Therefore, net equity is no longer negligible, and the inclusion of equity is a necessary condition for adequately reflecting a bank's interest rate risk position.

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.

- Yes. Behaviouralisation is generally accepted when measuring risk exposures.

- The accounting model should reflect the fact that IRR is managed on an expected cash flow basis (not to be confused with cash flow hedging).

- For risk management purposes, exposures are modeled based on expected cash flows. For example, the interest rate risk in a portfolio with prepayment risk is managed based on the expected cash flows.

- Currently under IAS39.81A, it is already possible to use expected rather than contractual cash flows.

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 early termination, with or without penalty, that is made available to customers. It usually applies to loans, but it also applies to deposits.

- Most risk management approaches regarding prepayment risk can be classified into two categories:

    - Some banks hedge prepayment risk 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 using Interest Rate Swaps 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.

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?

- The EBF considers behavouralisation of exposures a major step by the IASB for consistency with risk management. 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.

- We are of the opinion that when using behaviouralisation in the context of a risk mitigation approach, the unhedged positions should not result in increased volatility in profit or loss. When, for example, core demand deposits are modelled based on their behaviour with a maturity of 10 years and are risk mitigated with derivatives up to the 9-year maturity bucket, then the unhedged 10-year maturity bucket should not result in P&L volatility.

- Model changes that only lead to a change of the unhedged position should therefore not lead to P&L volatility either. As long as the risks of a modelled portfolio are still mitigated, there should be no impact on profit or loss from a change in assumptions.

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.

- Yes.

- Banks are only hedging portions of their (net) exposures. In our understanding, a "bottom-layer" means a method of designating the *portion* of an exposure - *versus* a proportional hedge - which is the more certain and which is intentionally being risk managed.

- The EBF would like to emphasize that the bottom layer approach is one the most important issues considered in the DP.

- If risk management is based on a bottom layer approach, then this should be reflected in the accounting treatment of the related hedges. The bottom layer approach should be permitted and it should be allowed to assume that all prepayments are related to the upper layer until the bottom layer is breached. This would solve the operational difficulties as no tracking is needed until the bottom layer is broken.

QUESTION 8—RISK LIMITS

Do you think that risk limits should be reflected in the application of the PRA? Why or why not?

- Risk limits play an important role in the risk management of a bank but cannot 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?

- Yes, demand deposits should be included on a behaviouralised basis. For banks, demand deposits are an important source of funding. Based on contractual cash flows, there is no interest rate risk, but stable non- or low-interest bearing demand deposits behave as a fixed rate liability, which banks use to hedge a part of the fixed rate assets for a stable interest margin. When these demand deposits are not included in the PRA based on a behaviouralised basis, the P&L will be volatile, which is not a representation of the economics.

- The EBF considers that the inclusion of demand deposits in the managed portfolio (on a behaviouralised basis) when applying the PRA 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 behaviouralization should rely on an entity's actual risk management.

- Changing the behavioral profile will change the exposure, therefore it is important that the behavioral profile represents the economics. As for actual risk management, there should be a periodic review of the used behavioral profile of the demand deposits.

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?

- Yes. Should be included, if it is consistent with entities risk management approach. Not including these sub-benchmark instruments would result in a P&L volatility that does not represent the economics.

- The accounting treatment of sub-benchmark instruments should reflect the rates used in actual management 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?

- If not included in the risk management it is not part of a managed exposure.

QUESTION 11—REVALUATION OF THE MANAGED EXPOSURES

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

- We agree that the revaluation calculations as presented are a reasonable approach to calculate any potential fair value impact of changes to hedged items due to interest rate risk. However, we would reiterate our point that a fair value approach can never faithfully represent *dynamic 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?

- Yes.

- The accounting treatment for *dynamic risk management* should reflect how the IRR is managed. There should be no restrictions as to the rate that is used to manage risks, as long as the curve is based on the underlying risk being hedged.

- In practice there is not one single funding curve. An item is priced from the hedging instrument. The largest PV move stems from the forecasting curve on the float leg (discounting fixed and float are largely offsetting depending on 'off marketness'.
  Situation:
    - 2 year fixed rate asset swapped to floating 3m.
    - Floating funding based on 3m.
    - Collateral swap funded on OIS.

  All cash flows are matched, but when only 1 curve is used for revaluation, there will be volatility, which is not correct. In our opinion multiple curves should be used to revalue the hedged portfolios. The starting point should be the hedged risk represented in the hedging derivatives (source of pricing upon recognition and crucially, pricing of any early-maturities – such that it can be proven that the price of the item is derived from the hedged risks).

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.

- Market funding index. Credit spreads should not be included as they are not part of the managed risk. Most banks do not include credit spreads in current hedge accounting, as, with the increasing collateralization of the deals, credit risk is globally managed by counterparty.

- Based on hedged risks (in hedging instruments banking book) the exposures in the banking book should be revalued based on the market indexes in these hedging derivatives.

(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?

- As long as they reflect the way IRR is actually managed it should be acceptable.

(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 and usually 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.

- Should be allowed with several funding indexes, and definitely at least one per currency. It should be a reflection of the risk mitigation activities; an entity should be able to choose the funding index (indices) that best reflect(s) their risk management activities.

- Reference to example question 11b.

(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?

- 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 (reference to example 11b).

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?

- No, optional.

(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?

- No, optional.

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?

- No, as all exposures in the banking book are included and will be revalued for interest rate risk

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

- No.

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.

- It should be up to each entity to decide when to apply the PRA.
- Reasoning for starting and stopping should be disclosed, and how to treat amortizations.

(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.

- Yes, the principle should be 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.

- No.

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.

- It should be up to each entity to decide when to apply the PRA.
- Reasoning for starting and stopping should be disclosed, and how to treat amortisations.

QUESTION 18—PRESENTATION ALTERNATIVES

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

- Aggregated adjustment in line with hedging instruments. However, the leverage ratio's impact will need to be taken into consideration.

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

- Actual net interest income as it reflects the actual interest payments and it provides the most useful information regarding past and future risk management activities.

(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 believe that unhedged positions should not result in additional volatility in the P&L or comprehensive income and that the disclosures are better suited to provide information regarding the risk positions.

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?

- Yes, as the internal derivatives may be used for hedging purposes in the banking book to manage the interest rate risk. The accrual result of these derivatives is recorded in the banking book and represents the realized interest margin in the banking book. The trading division only hedges the position from the banking book on a macro/net basis, based on its risk limits.

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

- Yes, at some banks all hedging derivatives are internal derivatives, already recorded in the banking book. For these banks it is difficult to present the interest accrual of the external derivatives in the interest margin as there is no distinction between trading and hedging in the external derivatives.

(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?

- No, we are of the opinion that externalisation should not be required, as the effect of no externalisation will be presented in the trading result.

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 actual 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 actual 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.

- 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.

    - o 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. 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 *dynamic 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 involves information on the risk position. We believe that disclosures on sensitivities of net interest margin would provide useful insight to users on these topics. Those would be supplemented with qualitative information around modelling techniques and most significant assumptions, as described in theme 1. The overall objective of these disclosures should be to provide a consistent and relevant set of information to help users understand the actual risk management.

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. (updates in) behavioural assumptions, pipeline transactions, prepayment risk, risk limits. 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 actual risk management on the financial statements.

Theme 4: Quantitative and qualitative information on the impact of actual risk management on the current and future performance of an entity
We support the fourth disclosure theme. However, there are certain information which we believe should not be provided on a quantitative basis as it could undermine a bank's competitive position due to the commercial sensitivity of the information. Such information, instead should be provided on a qualitative basis e.g. descriptive

discussions around the methodology used in modelling prepayment risk and core demand assumptions.

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

- Reference made to 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?

- No, the objective of a future macro hedge accounting standard should be limited to addressing risk mitigation.

(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?

- Reference is made to question 20. Additional disclosures regarding the risk position could be useful information for the users. Although disclosure of organization sensitive information should be prevented.

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?

- Yes, if they are managed together with other exposures to mitigate the IRR. Inclusion of exposures after an entity first becomes a party to a contract should be allowed. Based on changing market conditions banks can change their hedging strategy/objective. When focus is on risk mitigation and the entity decides to hedge a part of the before unhedged position, this should be allowed.

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

- It should be possible to add any exposure as long as they are included in the managed portfolio. The concept of open portfolios should allow for inclusion of existing exposures.

(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 (e.g. 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 IAS 39 and, when in force, 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, the ALM desk can nevertheless hedge it only at the then-prevailing market conditions. Therefore, the internal contract between the customer segment and the ALM desk will also be written at these conditions that can be different from those existing in t0. But, this does not change the amortized cost of the loan, which is also its carrying value. Hence, there should be no non-zero Day-1 P&L in t1.

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?

- No, when the focus is on risk mitigation and the entity decides no longer to hedge an exposure, it should be allowed to adjust the exposure.

(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?

- If due to a change in hedging strategy/objective (a portion of the) exposure is no longer being hedged.

- If some exposures result from instruments to be sold in the near future, operationally, they can become managed separately. The accounting must reflect these 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 propose amortisations instead of recognizing the whole revaluation adjustment in the P&L.

QUESTION 24—DYNAMIC RISK MANAGEMENT OF FOREIGN CURRENCY INSTRUMENTS

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

- Volatility of cross currency basis risk (FX basis risk) is a significant 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.