

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

30 October 2014

Dear Sir,

Re: DP Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*, issued by the IASB on 17 April 2014 (the 'DP').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG commends the IASB's effort in comprehensively analysing banks' dynamic risk management of interest rate risk and developing new thinking in how to best reflect the effects of such practices on a bank's financial position and performance, having regard for practical difficulties.

As rightly mentioned in the DP, dynamic risk management is not only undertaken by banks but by a wide range of entities and for a wide range of risks. Next to those companies which are able to rely on IFRS 9 for their hedge accounting, our outreach during the consultation showed that in addition to banks, other companies (e.g. insurance and utility) face similar difficulties in using current hedge accounting requirements and are also interested in the development of a macro hedge accounting solution covering risks such as commodity price risk, exposure to duration mismatches, longevity and liquidity risk.

EFRAG acknowledges the needs of insurance and utility companies as important and asks the IASB to consider their specific situation in further developing a macro hedge accounting solution. We encourage 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 is required to address these different needs. We doubt whether a one-size-fits-all solution would be appropriate to encompass all macro hedge practices in various industries, including the banking industry. Although EFRAG encourages the IASB to continue its work on a macro hedge accounting model, EFRAG believes that it is necessary to finalise the Insurance Contracts project before it is possible to assess how any macro hedge accounting solution, including the Portfolio Revaluation Approach, could apply to the insurance industry.

We note that dynamic risk management is undertaken for open portfolios, in which new exposures are frequently added and existing exposures expire. In macro hedging, hedging instruments are not designated to hedge specific underlying assets or liabilities. Therefore, it is difficult to apply the existing hedge accounting guidance in

IASB Discussion Paper: Accounting for dynamic risk management: a portfolio revaluation approach to macro hedging

IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* to macro hedging given the restrictions on eligible hedged items. The existing hedge accounting guidance is only applicable to closed portfolios, as is acknowledged by the IASB in the Basis for Conclusions to IFRS 9. Therefore, a new hedge accounting model for open portfolios, which are managed on a net risk basis, is needed.

The DP considers various alternatives and we do not support one of those alternatives. We disagree with the proposed scope that focuses on dynamic risk management as we do not believe that revaluing all portfolios that are dynamically managed, regardless of whether or not they have been risk mitigated through hedging, is decision-useful. Also, it would be an overlay to the amortised cost measurement attribute for most financial instruments in the banking book thereby changing the most decision-useful information attribute for these financial instruments. If further information is required regarding the susceptibility of an entity to risks associated with future market movements and how these risks have been mitigated, then we believe that it can only be provided through expanded disclosures.

We therefore urge the IASB to continue developing a hedge accounting solution in accordance with the original objective, which is to address the accounting mismatch caused by fair valuing hedging derivatives and measuring hedged items at amortised cost. Our responses to the questions in the DP, provided in the Appendix to this letter, are given from the perspective of a hedge accounting model - what the DP describes as 'a scope focused on risk mitigation' - as we do not support a widened scope including the accounting for dynamic risk management in general. Relying on a scope focused on risk mitigation has the effect of limiting any revaluation to hedged (or risk mitigated) positions rather than looking at the entire dynamically managed position.

EFRAG notes, however, that restricting the suggested approach in the DP (the 'portfolio revaluation approach' or 'PRA') to mitigated risk may trigger significant difficulties with respect to operationality, such as adding to or removing exposures from a net position, dealing with changes in behavioural assumptions and identifying situations of overhedging. As such a hedging solution might have to consider further relaxations or different models to allow it to be operational.

Furthermore, EFRAG believes that a macro hedge accounting model should remain consistent with IFRS 9 and, in light of its comments above, recommends the IASB to investigate whether IFRS 9 should be the starting point of the future macro hedge model. We recommend that IFRS offers different hedge accounting models in a continuum, so as to help entities best reflect their risk management practices. EFRAG notes that both the general hedge accounting model and any macro-hedge accounting model share the same objectives.

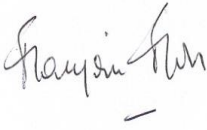
Also, we note that many banks do not manage their interest rate risk on a fair value basis but rather on a cash flow basis, and many of the concepts proposed in the DP would fit more comfortably with a cash flow hedge model than with a fair value model. In this regard, we believe that such a cash flow hedge model should be considered as part of further work on the project. However, since preparers have had concerns with the present model, the IASB should reconsider the possibilities of removing the accounting volatility in equity that the present model causes.

Finally, EFRAG is of the opinion that an impact assessment is needed during further development of the approach. This would have the purpose of identifying the effects the model will have on the financial statements of entities as well as identifying any implementation issues.

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revaluation approach to macro hedging*

If you would like to discuss our comments further, please do not hesitate to contact
Didier Andries, Sebastian Harushimana, Benjamin Reilly or me.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Françoise Flores', with a short horizontal line underneath.

Françoise Flores
EFRAG Chairman

Appendix

PREAMBLE

- 1 *In our view, the scope of the project should be limited to risk mitigation. Therefore, in answering the questions in the DP we have moved Question 15 immediately after Question 2 so as to explain our reasoning for the mitigated risk option. The order of the remaining questions is retained but our answers are determined by this choice of scope. We note some issues that have not been addressed by the DP in our answer to Question 2 and at the end of this 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?

EFRAG's response

EFRAG does not believe there is need for a specific accounting approach to represent dynamic risk management per se, but there is a need to address macro hedge accounting. The objective of a macro hedge accounting model should therefore be limited to addressing risk mitigation. In the context of interest rate risk management in banks, the particular challenge that arises is due to the mixed measurement model used to represent the results of the banking book and the hedging instruments used in dynamic risk management. It is this challenge that the proposals should address.

EFRAG also notes that it is not possible for any measurement regime to represent adequately an entity's susceptibility to future risks (i.e. its risk profile) and management thereof. This must therefore be dealt with through appropriate disclosures of those risks and how these are being mitigated.

Question 1

- 2 EFRAG acknowledges that current accounting requirements do not allow banks to recognise the effect of their dynamic risk management. The current absence of an accounting solution results in a situation whereby banks use a patchwork of accounting techniques which may in their case not always faithfully reflect the effects of dynamic risk management actions. Companies from other sectors may face similar challenges.
- 3 The current accounting model is a mixed measurement model under which some financial instruments, specifically derivatives, are measured at fair value and the majority of financial instruments are measured at amortised cost. If derivatives are used to hedge exposures from items that are not measured at fair value, an accounting mismatch arises. Due to that accounting mismatch:
- (a) the economic effect of hedging is not faithfully depicted; and
 - (b) reported financial performance is distorted.
- 4 Hence, a mechanism is needed to address these challenges – which is hedge accounting.

- 5 We are therefore of the opinion that the objective of a macro hedge accounting model should equally be to eliminate accounting mismatches and to provide information which is decision-useful for users. The hedge accounting model should give users insight into the effectiveness and the impact of the dynamic risk management policy and strategy on the financial position and the performance of the entity. Consequently the project scope should be limited to risk mitigation. The DP explores wider objectives that are not appropriate as they create unacceptable side effects such as volatility in profit or loss unrelated to the entity's performance or business model without achieving the goal of faithfully representing the effectiveness of the entity's risk mitigation activities.
- 6 We do acknowledge that many banks' business practice for dealing with open portfolios of hedged items is not appropriately reflected in current accounting requirements. This business practice relies on a dynamic risk management approach. Since market conditions change, dynamic risk management within banks adapts its hedging actions in order to fulfil the common strategy of protecting net interest income. Dynamic risk management is also used within other sectors, but there the strategy does not appear to be identical to the one in the banking sector.
- 7 The dynamic risk management approach of some banks is not to manage fair values or current values, but is aimed at protecting net interest income irrespective of the profile of future interest rate cash flows. Thus, the interest cash flow profile generating the portfolio revaluation adjustment is actually what is being dynamically managed, not the resulting discounted calculation of the identified cash flows. This is further discussed in our answer to Question 2.
- 8 Some banks have another strategy, they aim at locking in an economic net interest margin on new loans made, taking into account the cost of funding of items classified as equity. Such an approach is frequently taken by banks that extend funding to lending business units on a marginal cost basis, and the transfer prices therefore include an explicit marginal cost of equity, even though such cost of equity is not reflected in the Statement of Comprehensive Income. The cost of equity may change over the lifetime of the assets and, therefore, the cost of equity may be modelled as a variable rate exposure. EFRAG is concerned that the proposals with respect to the equity model book and core demand deposits assume that these are modelled as fixed rate liabilities, which is consistent with protecting net interest income but is not consistent with the approach for those banks who want to lock in an economic net interest margin. The proposals contained in the DP do not appear to have been developed with these banks in mind. EFRAG is of the opinion that the final standard should accommodate different types of macro hedging practices.

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

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

EFRAG's response

Although the model is predicated on the objective of risk management being to manage fair value exposure which in our experience is often not the case, EFRAG agrees that the DP has identified and discussed many of the main issues. We note that, at this stage, the DP has focussed on interest rate risk management of banks and, therefore, has not really explored the nature of other risks and the way they may be managed by banks and other entities.

Questions 2 (a) and 2 (b)

- 9 EFRAG welcomes that the DP identifies and discusses some of the issues that banks are struggling to present faithfully under the current literature – in particular the sub-LIBOR issue, the reliance of banks on core deposits, the use of the equity model book and the use of bottom layers.
- 10 In addition to these important issues discussed in the DP we identify other issues worthy of consideration below.

The source of risks being managed

- 11 During our outreach we have learned that the interest rate risk being dynamically managed arises from two distinct sources. They are both based on 'behaviouralised' assumptions, but we believe that making an explicit distinction between the two sources would assist in discussions around the problem and in establishing principles to make any macro hedge accounting solution of use beyond banks. For the purpose of this comment letter, we describe the sources of these risks as being 'contractual' and 'structural' mismatches.

- (a) Contractual interest rate risks arise from mismatches between contractual fixed rate positions. Some of these contractual fixed rate positions will result in prepayments that banks may or may not be compensated for. The prepayments either arise from specific contractual rights or because of the wider economic and legal environment.

An example of contractual fixed rate positions being prepaid due to the wider economic and legal environment is that, in some European countries, there is an absolute right to prepay a retail loan and move to another lender. In such countries banks will frequently renegotiate retail loans to avoid the borrower moving to another lender.

Both types of prepayments happen more frequently when interest rates are significantly below the level at which the loan was initially made. Prepayments do not always take place when it is economically advantageous for the borrower to do so, and so the level of future

prepayments in a portfolio (i.e. customer behaviour) is estimated using a number of variables.

- (b) Structural interest rate risk arises from differences between the volume (notional amount) of loans made, which produce interest income, and the volume (notional amount) of interest-bearing liabilities, which cause interest expense.

A bank will most often have a greater volume of interest bearing assets than interest-bearing liabilities because of regulatory requirements for risk capital (equity) and, for deposit-taking banks, balances due to the bank's role in the payments system (core demand deposits).

Interest rate risk from structural sources that is included in dynamic risk management has two major components, which are accurately described in section 3.9 of the DP: volume and 'deemed term'.

The volume of the structural mismatch is dependent upon a number of macro-economic, customer behavioural and regulatory factors and can sometimes be reliably estimated.

The 'deemed term' of the structural mismatch is fundamentally different. This deemed term is the period over which the bank wishes to stabilise interest income deriving from the structural mismatch. As described in paragraph 3.9.8 of the DP, this stabilisation of interest income happens over a rolling period that is based on the period of time over which an entity wishes to stabilise net interest income. This period of time is likely to change depending upon the predicted profile of future interest rate cash flows but is inherently a question of management choice.

Since the deemed term is based on management choice rather than on wider economic or regulatory factors, it cannot be defined by a standard in the same way as calculations of structural volume or contractual prepayment estimates.

- 12 Interest rate risks arise from both contractual and structural sources, are included in dynamic risk management and, for many banks, are managed together.
- 13 EFRAG believes that explicitly distinguishing between these two sources of interest rate risk is helpful, both for identifying the boundaries of a macro hedge accounting model for interest rate risk in banks, and for determining the application to other industries in general and utilities in particular.
- 14 The structural – timing – mismatch between interest-bearing assets and liabilities in banks is comparable to the mismatch between electricity generated from hydroelectric and nuclear power plants and sales contracts for that electricity. Hydroelectric and nuclear power plants have economic lives measured in decades and low or negligible marginal cost of production, but sales contracts are much shorter.
- 15 During our outreach activities we have learned that energy generating companies engage in dynamic risk management activities very similar to banks managing interest rate risk from their structural mismatches, particularly with respect to core demand deposits and the equity model book. The pricing of electricity generated is fixed over a period of time, with a volume based on an entity's estimate of its structural capacity (including estimates of maintenance requirements) and for a

period of time equivalent to the medium-term planning horizon (i.e. a period of time that is solely at the choice of management).

- 16 EFRAG suggests that, in further developing the macro hedge accounting model, the distinction between contractual and structural mismatches is considered by the IASB.

Accounting for dynamic risk management on an accrual basis

- 17 The PRA does not appropriately recognise that many banks base their dynamic management of interest rate risk on an accrual (stabilised net interest income) basis and not on a revaluation basis. The revaluation adjustment can represent different risk profiles depending on the time buckets the cash flows are assigned to and the discount factors being used. A different interest profile of interest rate cash flows over time implies that risk mitigation cannot be based on a constant number and static characteristics of dynamic risk management instruments to achieve offset. As a consequence, some banks choose to manage their interest rate risk profiles on a cash flow basis rather than on a valuation basis. In doing so, those banks recognise the interest cash flows and the corresponding interest income from dynamic risk management instruments in profit or loss as rights to them arise, i.e. as they are accrued.

Measurement of derivatives and impact on offset with the revaluation adjustment

- 18 EFRAG notes that the market practice for measuring derivatives has changed. This change in market practice may lead to an offset between the portfolio revaluation adjustment and the external derivative(s) that is less than perfect. Although this is due to a cause independent of the portfolio revaluation approach, it would affect its outcome.
- 19 For example, assume that the business unit grants a loan that is not collateralised. The corresponding revaluation adjustment is calculated using an interest rate curve taking the absence of collateral into account. We further assume ALM transfers the interest rate risk of the loan to the trading function with an interest rate swap. The trading function externalises the position and collateralises the interest rate swap. As a consequence, the external derivative of the trading function may not fully offset the revaluation adjustment from the loan in profit or loss.
- 20 Before the financial crisis the standard market practice in valuing derivatives was based on a single interest curve. This single curve was used to price and hedge interest rate derivatives in a given currency. This approach is no longer consistent with current market practice for the following reasons:
 - (a) Pricing of external derivatives takes into account differences in tenors resulting in different tenor-specific interest rates (tenor basis spread);
 - (b) Currency basis spreads have become important;
 - (c) Adjustments for credit risk valuation (credit risk on the counterparty) and debt risk valuation (own credit risk) are taken into account;
 - (d) Collateralised derivative positions are discounted at the overnight interest rate curve. Non-collateralised derivative positions will be discounted differently; and

(e) The use of day count conventions to calculate interest e.g. 30/360 or actual/actual.

21 Derivatives are therefore now measured using multiple interest rate curves. This could lead to 'noise' in offsetting the fair value of the external derivative with the revaluation adjustment to be recognised in profit or loss as trading result.

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?
- (b) Please provide comments on the usefulness of the information that would result from the application of the PRA under each scope alternative. Do you think that a combination of the PRA limited to risk mitigation and the hedge accounting requirements in IFRS 9 would provide a faithful representation of dynamic risk management? Why or why not?
- (c) Please provide comments on the operational feasibility of applying the PRA for each of the scope alternatives. In the case of a scope focused on risk mitigation, how could the need for frequent changes to the identified hedged sub-portfolio and/or proportion be accommodated?
- (d) Would the answers provided in questions (a)–(c) change when considering risks other than interest rate risk (for example, commodity price risk, FX risk)? If yes, how would those answers change, and why? If not, why not?

EFRAG's response

EFRAG does not believe the PRA should be applied to all managed portfolios. As outlined in our response to Question 1, EFRAG is of the opinion that a macro hedge accounting model should ensure that the reported performance of an entity is not distorted by the accounting mismatch arising from accounting for hedging instruments at fair value and hedged items at amortised cost. Providing a current value measure of all of the interest rate risk included in managed portfolios would not meet the objective of eliminating the accounting mismatch, and in fact would result in reconsidering the amortised cost attribute for a number of financial instruments being hedged. For this reason EFRAG supports a scope focussed on risk mitigation, which is designed to mitigate the effects of the accounting mismatch.

Question 15 (a)

- 22 EFRAG supports a scope focussed on dynamic risk mitigation and does not believe a focus on dynamic risk management, as defined in the DP, is appropriate.
- 23 A model bringing an overlay of current value on all managed portfolios would, de facto, contradict the conclusion reached in IFRS 9 *Financial Instruments* that the major part of banking books' financial instruments are best measured at amortised cost and that such measurement results in decision-useful information.
- 24 Furthermore, a scope based on dynamic risk management would result in the revaluation of all net open risk positions, which goes far beyond the objective of

the project, which is to eliminate the misrepresentation resulting from the accounting mismatch between the fair value measurement of the hedging instruments and the amortised cost measurement of the hedged items. Revaluing all open net risk positions would not assist in understanding the performance of the entity and would introduce irrelevant, and potentially significant, volatility in net interest income that would not be decision-useful as it would negate the amortised cost measurement attribute. Given that one of the key reasons for dynamically managing interest rate risk exposure is to reduce volatility unrelated to business performance, revaluing all open net positions would not be a fair representation of the effects of risk mitigation. Retaining the amortised cost for unhedged positions would be consistent with the measurement attribute of such positions.

- 25 Conversely, a scope focussed on risk mitigation reflects one of the goals of dynamic risk management, being to protect net interest income.

Question 15 (b)

- 26 EFRAG does not believe that the information presented would provide useful information, if the scope was based on dynamic risk management (as defined in the DP). Although the approach may reflect the extent to which dynamic risk management has decided to close open net risk positions included in dynamic risk management, it would provide limited information that is useful for predicting future net cash inflows (providing information to enable this being an objective of financial reporting as defined in the Conceptual Framework for Financial Reporting), i.e. projecting future net interest income. This is because:

- (a) some exposures are notional exposures (the equity model book and core deposits) which, as EFRAG understands, are included in dynamic risk management to the extent they fund interest-bearing assets;
- (b) a focus on dynamic risk management would reflect the extent to which identified exposures have not been mitigated: This in itself does not provide insights into future cash flows, as a revaluation does not provide more than a value at a point in time. It would not provide any information on how well the entity has identified and measured risk exposures, including those measured using behavioural techniques. Such information can only be conveyed through appropriate disclosures, which are required whatever measurement basis is used;
- (c) it would substantially eliminate the amortised cost basis of accounting by providing for revaluation of such instruments, thereby negating the decision-usefulness achieved by such measurement attribute;
- (d) analysis of net interest income may become difficult given the volatility generated when revaluing the entire net open positions; and
- (e) tenor and any basis risk that is not included in dynamic risk management are not included in the macro hedge accounting model.

Question 15 (c)

- 27 EFRAG believes that the PRA as proposed by the IASB presents operational challenges regardless of the scope chosen.
- 28 The scope based on dynamic risk management would require tracking individual exposures since, for example, the model requires amortisation of the valuation adjustments related to risk exposures that are expired or disposed of. The behavioural cash flows under dynamic risk management would also require some tracking to reflect changes in customer behaviour or changes in assumptions made in layering approaches. Another example of tracking mentioned in the DP is

the need to amortise day one revaluation adjustments if risk exposures were allowed to be transferred to dynamic risk management after they have been originated. Also, tracking would be required when catch-up revaluation adjustments arise from changes in behavioural estimates.

- 29 A scope focussed on risk mitigation as defined in the DP would equally require tracking given the need to reflect, in profit or loss, revaluation adjustments related to extinguished exposures that were being hedged and to track the hedged items. We elaborate on this further in our answers to Questions 6, 7, 22 and 23.

Question 15 (d)

- 30 EFRAG's answers to questions 15(a) to 15(c) are equally valid for other managed risks. Therefore, we encourage the IASB to develop the model further to accommodate other risks and industries.

All questions below are answered based upon our preference for a risk mitigation approach.

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?

EFRAG's response

EFRAG agrees that many of the characteristics accurately depict dynamic interest rate risk management within banks. However, it is unclear whether these characteristics also cover dynamic risk management in other sectors.

Question 3

- 31 EFRAG agrees that many of the characteristics describing dynamic interest rate risk management accurately reflect dynamic interest rate risk management within banks. However, EFRAG believes that some of these characteristics do not reflect how dynamic risk management strategies are carried out in some banks, nor do they reflect the strategies employed in other sectors. EFRAG acknowledges that the IASB is planning to investigate whether and how the portfolio revaluation approach could be applied to banks using a different strategy to manage net interest rate risk as well as to other industries, such as insurance, and to other risks.
- 32 For example, insurance companies manage their portfolios of assets and liabilities by duration of the cash flows. The investment strategy is, to a large extent, liability driven. The main source of risk for life insurance liabilities is the interest rate risk exposure due to minimum guaranteed returns to policyholders. Traditional life insurance products provide long-term guaranteed benefits, which create an exposure to declining interest rates, as insurers earn lower returns on their reinvestments of premiums and maturing financial assets. In life insurance, assets typically have shorter maturities than the liabilities they support – in some jurisdictions, liabilities have expected cash flows of up to 80-100 years. This duration gap is managed on a portfolio basis. It is partly narrowed by the use of derivatives.

- 33 Under current IFRSs, the economic asset and liability management tools lead to accounting mismatches, as derivatives are always measured at fair value and insurance liabilities are currently measured at cost in some countries, as IFRS 4 has grandfathered previous GAAP. Just like banks, insurers require a macro hedge accounting solution to reflect their dynamic risk management, in particular management of the interest rate risk exposure.

Question 4 – Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

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

EMB

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

Behaviouralisation

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

EFRAG's response

Dynamic risk management employs risk management instruments which, for accounting purposes, are measured on a different basis than the risk mitigated items. EFRAG considers that any approach that aims at representing faithfully the impact on performance of dynamic risk management actions should be targeted towards limiting accounting mismatches to the extent feasible.

EFRAG therefore believes 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 only, a hedge accounting model would have to incorporate all items that contribute to the identification of the managed risk exposure that serves as a basis for the identification of hedged positions.

EFRAG acknowledges the concern that including the equity model book in the PRA would, in essence, mean a (partial) remeasurement of equity, which would be in conflict with the current literature, especially the Conceptual Framework and IFRS 9. However, we believe that it should be considered if the PRA is to deliver on its promise of reflecting hedging activities.

EFRAG also supports the inclusion of pipeline transactions in the model but thinks it is necessary to have clear criteria distinguishing these from forecast transactions.

When developing a macro hedge accounting model for dynamic interest rate risk management in the banking sector, and even when some banks include forecast transactions in their dynamic interest rate risk management as part of their structural mismatches, EFRAG thinks, on balance, that forecast transactions should not be included in the scope of the PRA, as doing so could affect significantly the verifiability of the resulting information.

However, EFRAG currently has insufficient insight into the reasons why other sectors would include future transactions in the scope of the PRA. Therefore EFRAG asks 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 thinks forecast transactions could be included in the scope of the model.

Finally EFRAG agrees with the inclusion of core demand deposits in the scope of the model subject to additional safeguards.

Question 4 (a)

- 34 EFRAG agrees with the view that exposures from pipeline transactions are eligible for inclusion for hedge accounting purposes. Pipeline transactions are forecast volumes by banks of draw-downs on fixed-rate products at advertised rates. Although these forecast volumes do not yet contain a contractual commitment by any party, EFRAG agrees that, once the terms and conditions are advertised, an exposure to interest rate risk is borne by the bank based on the commitment to enter into transactions on the basis of a general public offer. This is the case where the issuer has historically honoured its commitments under advertised offers to the extent that the issuer now finds no realistic alternative but to accept applications made on the basis of the offer. This is similar to the proposal in the ED *Insurance Contracts* defining the boundary of insurance contracts based on the existence of a substantive obligation to provide coverage.

- 35 EFRAG acknowledges that the revaluation approach is different from a general cash flow hedge in that it focuses on the part of value change of underlying items attributable to a specific risk, such as an interest rate risk, while the cash flow hedge focuses on the exposure to cash flow variability. Therefore, including pipeline transactions in the revaluation approach would presume the existence of revaluation risk for exposures with no revaluation risk from an accounting perspective. It would result in recognising items of income and expenses that are not derived from changes in recognised assets and liabilities. Furthermore, EFRAG notes that the revaluation approach for pipeline transactions is different from the fair value hedge of a firm commitment, which is based on a fixed interest rate risk of contractual rights.
- 36 However, on the basis that such offers have created valid expectations in customers or prospective customers (as with constructive obligations in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*), EFRAG supports the inclusion of pipeline transactions as hedgeable items under the revaluation approach.
- 37 Many banks include forecast transactions (new production) within their dynamic risk management portfolio, including banks which specifically match funding, and regard these as part of their structural mismatches. 'New production' is, however, different from pipeline transactions as there are no terms offered, i.e. the entity has not committed itself in any way. Also, EFRAG does not support the inclusion of forecast transactions in hedge accounting for dynamic risk management in the banking sector as doing so would provide a considerable degree of freedom, and the underlying assumptions would be difficult to challenge as they relate to future commercial decisions based on an assessment of future macro-economic factors. Hence, their inclusion would significantly affect the verifiability of the PRA.
- 38 However, EFRAG notes that, in other industries there is not a clear consensus on how to define 'forecast transactions' and EFRAG thinks that further research is necessary before concluding on the application of macro hedging to other risks and other sectors.
- 39 Finally EFRAG notes that there would not be any impediment to including forecast transactions when a cash flow hedge accounting model would be considered.

Question 4 (b)

- 40 EFRAG acknowledges that some banks include the impact of equity model book exposures when dynamically hedging interest rate risk. EFRAG notes equity is defined as a residual category in the Conceptual Framework. Equity can be composed of financial instruments of a different nature. In addition to shareholders' equity instruments, some interest-bearing fixed rate financial instruments can be classified as equity under IAS 32 *Financial Instruments: Presentation*. While the latter generate "interest" cash flows, the former do not. Including the equity model book in the scope of the PRA would thus result in (partially) revaluing the own equity of an entity.
- 41 EFRAG considers that one of the goals of a macro hedge accounting model is to produce useful information on the performance of an entity during the reporting period. Excluding the equity model book from the scope of the model would have an influence on the value of the hedging derivatives in the model and thus on the performance of the entity, making the resulting information less relevant and reliable. Hence EFRAG thinks that the conceptual concern over revaluing the own equity of an entity is outweighed by the advantage of including it in the scope of the model, as it contributes to the usefulness of the information which results from

doing so. Therefore EFRAG is of the view that the equity model book should be eligible as a hedged item if it was considered by an entity as such in its interest rate risk management.

- 42 Should the hurdles for including the equity model book in the risk mitigation model be too high to be overcome, EFRAG encourages the IASB to search for an alternative hedge accounting solution that addresses the conceptual concerns.

Question 4 (c)

- 43 EFRAG agrees 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 increases operational feasibility, as the identification of the cash flows is done already within the entity; and
 - (b) Doing so also increases 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.
- 44 The Discussion Paper related to the Conceptual Framework discusses how cash-flow measures other than estimates of current prices could be considered as being consistent with the Conceptual Framework. Behavioural estimates are nothing more than estimations of when and to what extent cash flows will occur. Therefore, EFRAG is of the opinion they are consistent with the Conceptual Framework definition.
- 45 EFRAG notes that, where changes in behavioural assumptions affect the Statement of Comprehensive Income, it would be possible to change the assumptions to reflect a particular outcome and hence lead to earnings management. Therefore, EFRAG thinks additional safeguards such as internal controls are necessary when including behavioural assumptions as part of the portfolio revaluation approach. Such safeguards could be similar to what is foreseen in insurance accounting for surrender options.
- 46 Notwithstanding the above, EFRAG does not believe that rules based guidance, in addition to what already exists for regulatory purposes, would be helpful in describing how behavioural assumptions ought to be developed. Practices differ from entity to entity and estimations require extensive judgement: there is no single behavioural outcome for all entities. For example: one bank may estimate its core deposits to have a maturity of five years, while another bank may estimate the maturity to be six years.
- 47 In order to address any diversity in practice, disclosures could help users understand the assumptions being used by the entity and the internal control procedures that overlay dynamic risk management.

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.

EFRAG's response

Risk management instruments with optionality that are used in a risk mitigation approach should be considered as a protection against a decrease in interest income. Any gains resulting from the use of risk management instruments with optionality are not the result of trading and should remain part of interest income.

Question 5

- 48 The objective of macro hedging within banks includes securing the desired level of net interest income. Unexpected prepayments will generally take place in an environment of declining market interest rates as customers will want to take advantage of lower interest rates to replace their existing – more expensive – loans with less costly ones.
- 49 EFRAG considers that banks may rely on risk management instruments with optionality to protect themselves against the potential loss of interest income when loans are being prepaid in a declining market rate environment. There is no need to protect the upside of the interest rate margin as this would result in an additional profit. Even if such an unexpected profit were to occur, EFRAG does not consider this to be a trading position. Consequently, EFRAG is of the opinion that the use of such risk management instruments with optionality can contribute to the results from dynamic risk management and should be fully regarded as genuine hedging instruments.

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?

EFRAG's response

Changes in expected customer behaviour should not be included in the revaluation adjustment until dynamic risk management decides to hedge these changes. Consequently, EFRAG agrees that they should be recognised in profit or loss when they are being hedged and included in the revaluation adjustment.

Question 6

- 50 Changes in expected customer behaviour might not necessarily be hedged by the entity. In this case, EFRAG sees no reason why these changes should affect the performance from risk mitigation in profit or loss. Once dynamic risk management decides to hedge the changes in expected customer behaviour, for example because the change has become material, EFRAG supports their inclusion in the revaluation adjustment.

- 51 However, EFRAG is concerned that permitting changes in behavioural assumptions to affect the Statement of Comprehensive Income could lead to earnings management as discussed in our answer to Question 4 (c).

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 believe 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.

EFRAG's response

EFRAG believes that both a bottom layer approach and a proportional approach lead to operational complexity and will require tracking although relying on a bottom layer may be less burdensome. Therefore, EFRAG supports reliance on a bottom layer approach.

Question 7

- 52 EFRAG supports an approach based on risk mitigation as explained in our answer to Question 15. EFRAG does not believe that any risk mitigation approach will eliminate tracking though, as cash flows relevant to the managed risk will need to be identified, included in dynamic risk management, and removed from dynamic risk management as the bank's exposures change.
- 53 One may argue that when a bottom layer of a portfolio of prepayable assets is part of a net position and only a proportion of the net position is being risk mitigated, it may be difficult to identify whether the full bottom layer is included in that hedge or not. EFRAG agrees that such situations would create operational complexity because, in this example, the proportional approach of the net position overrides the bottom layer approach applied to a part of the net position, i.e. a portfolio of prepayable assets, and will thus require tracking.
- 54 If an entity used a bottom layer approach, only this bottom layer would be considered to fall within the scope of the PRA based on risk mitigation. This solution would avoid any tracking and amortisation issues unless the prepayments become so significant that the bottom layer is breached. Such a breach should be recognised immediately in the profit or loss as it represents ineffectiveness.
- 55 Breaching a bottom layer leads to a situation whereby the entity may be overhedged. EFRAG notes that in such cases any lack of offset should be recognised in profit or loss immediately as such a situation could be seen as taking a position on the underlying risk. However, when dynamically risk mitigating, entities may address a situation of overhedging in different ways. Some entities may choose to remove a layer of risk management instruments to the hedged position, others may choose to add similar risk exposures to the net position being hedged. Both situations would require tracking.
- 56 When an entity uses a proportional approach, changes in the proportion being hedged would require tracking and increase the complexity of the model.

Question 8 – Risk limits

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

EFRAG's response

EFRAG acknowledges that entities apply internal risk limits in their hedging strategy and does not agree with the reflection of externally imposed risk limits. We believe that qualitative disclosures should be used to provide transparency on the use of risk limits.

Question 8

57 EFRAG recognises that dynamic risk management does not only consider *how* to mitigate risk positions but also *the extent to which* a risk position needs to be mitigated. EFRAG considers the use of internal risk limits as defined by the asset and liability management function to be subject to internal control processes and regulatory oversight. Therefore, EFRAG sees no reason why accounting should reflect additional risk limits on the dynamic risk management activity.

58 Qualitative disclosures could be used to provide insight for users on the use of risk limits.

Question 9 – Core demand deposits

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

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

EFRAG's response

EFRAG believes that behaviouralised exposures from core demand deposit portfolios should be eligible for inclusion in hedge accounting.

Selection and identification of a core demand deposit portfolio requires extensive judgement rather than the application of accounting concepts with associated guidance. EFRAG therefore believes appropriate disclosures are necessary for users to understand both the inclusion of exposures from core demand deposit portfolios and how these have been hedged.

Question 9(a)

59 EFRAG believes core demand deposits should be included in the scope of the model on a behaviouralised basis. In defining the net position being hedged a bank has a net long fixed interest rate position (which incorporates exposures from loans, borrowings and risk management instruments). Including the notional exposures from core deposits simplifies dynamic risk management in that it enables the objective to be a neutral position with respect to the hedged risk. EFRAG therefore supports its inclusion in the net position.

Question 9(b)

- 60 EFRAG agrees with the DP that the selection and identification of a core demand deposit portfolio requires extensive judgement. EFRAG does not believe that guidance would be necessary for entities to determine the behavioural profile of core demand deposits because this would be inconsistent with reflecting the effects of risk mitigation.
- 61 If banks are dynamically hedging core demand deposits, then they already have methodologies in place. Given the extent and nature of judgements required for determining a core demand deposit portfolio, these may well not be comparable between different companies and guidance is not likely to resolve this position. Disclosures should instead be included to enable users of financial statements to understand how the bank views core demand deposits, including the methodology around estimation, how these methods have changed and the impact of changes in estimates and policies.
- 62 This is important because the revaluation of the notional core demand deposit exposures could have a material impact on reported performance. Unless there are sufficient disclosures around changes in estimates it may be difficult to understand to what extent reported performance is driven solely by changes in an entity's estimates.

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?
- (b) If sub-benchmark variable 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?

EFRAG's response

EFRAG supports Approach 3 as it is consistent with an approach that is based on risk mitigation in that hedged cash flows are those relating to risk exposures that are both managed and hedged by ALM (even if in excess of the actual risk exposures with external parties), and as it does not cause day 1 revaluation gains and losses.

EFRAG thinks embedded floors should be included in the approach based on hedging activities to the extent they are included in the net risk position being hedged by ALM. If they are not included in the net position being hedged by ALM they should not be included in the portfolio revaluation.

Question 10 (a)

63 EFRAG supports Approach 3 as it:

- (a) Is consistent with an approach that is based on risk mitigation in that hedged cash flows are those relating to risk exposures that are both managed and hedged by ALM (even if in excess of the actual risk exposures with external parties); and
- (b) Does not cause day 1 revaluation gains or losses.

64 EFRAG notes that ALM undertakes hedging activities with the objective of protecting net interest income based on risk exposures that it is dynamically managing. These risk exposures may be transferred from business units using a benchmark funding rate, even if the actual risk exposure with the external party consists of a benchmark rate less a spread, i.e. a sub-benchmark risk exposure. ALM would generally hedge that benchmark risk exposure even if it was higher than the actual exposure at the business unit level. EFRAG also notes that ALM may sometimes not be aware of the actual risk at the business unit level, which makes it difficult for ALM to hedge the actual customer margin, either in relation to borrowing or lending.

65 EFRAG observes that excluding sub-benchmark instruments from the portfolio revaluation approach would lead to a similar solution as under IAS 39 where institutions need to use a patchwork of hedge accounting solutions in order to approximate the economically hedged position. Hence, EFRAG believes sub-benchmark instruments should be included in the portfolio revaluation approach to the extent that they are hedged.

Question 10 (b)

66 EFRAG believes that embedded floors in variable rate exposures should be included to the extent they are being hedged by ALM. EFRAG notes that, generally, embedded floors included within sub-benchmark instruments are not separately transferred to ALM, even though these embedded floors may have an impact on the actual cash flows when benchmark rate falls below the floor. Since EFRAG supports the application of an approach that is based on risk mitigation, cash flows that are not relevant to the hedged risk (such as actual customer margin) are excluded from the revaluation of the net position.

Question 11 – Revaluation of the managed exposures

- (a) Do you think that the revaluation calculations outlined in this Section provide a faithful representation of dynamic risk management? Why or why not?
- (b) When the dynamic risk management objective is to manage net interest income with respect to the funding curve of a bank, do you think that it is appropriate for the managed risk to be the funding rate? Why or why not? If not, what changes do you suggest, and why?

EFRAG's response

EFRAG supports the revaluation adjustment resulting from the PRA approach that is limited to the mitigated risk, as it results in an effective offset of the changes in fair value of the hedging instruments and, hence, helps to eliminate or at least

significantly reduce accounting mismatches.

EFRAG is of the opinion that a macro hedge accounting model should reflect the effects of risk mitigation faithfully. As customer margins are not being hedged, they should not be included in the hedged position.

Question 11 (a)

67 EFRAG thinks that the calculation of the revaluation adjustment is an appropriate way to overcome the accounting mismatch arising from hedged items being measured at amortised cost and hedging derivatives being measured at fair value. The revaluation adjustment allows an effective offset of the changes in the fair value of the hedging instruments. However EFRAG thinks that the revaluation calculation is not, for all banks, a faithful representation of their dynamic risk management as not all banks apply a fair value approach.

Question 11 (b)

68 EFRAG is of the opinion that a macro hedge accounting solution should reflect the effects of hedging activities faithfully. In banks, dynamic interest rate risk management is often carried out with the objective of securing the level of net interest income. However, what is not normally included in the hedged risk is the customer margin, neither in relation to borrowing nor lending. Requiring a special treatment for the margin earned from borrowing activities is not consistent with either the overall focus on dynamic risk management activities, or the exclusion of the margin earned from lending activities. Therefore, EFRAG believes that it is appropriate to include the funding rate in the PRA to the extent that it is being used to estimate future cash flows which are to be hedge accounted for.

69 EFRAG notes that this approach:

- (a) Allows a hedge accounting solution to include core demand deposits as entities would be able to rely on the benchmark interest rate to hedge them;
- (b) Provides a hedge accounting solution for only a part of the full interest margin, i.e. the transformation margin; and
- (c) Ignores the fact that an entity is able to earn a margin based on its credit standing that is better than the benchmark as this margin is not being dynamically hedged.

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 purpose 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)?
- (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 believe 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.
- (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?

- (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?

EFRAG's response

EFRAG accepts the use of internal transactions as proxies for risk exposures in portfolios that are being managed and hedged by ALM.

However, EFRAG believes that if such a practical expedient is to be permitted, sufficient discipline and safeguards are needed to provide for audit trails back to the banking portfolio.

Question 12 (a)

- 70 EFRAG recognises that limiting the application of dynamic risk mitigation to hedged items that are under dynamic risk management, i.e. under ALM for many banks, inevitably raises the issue of identifying those risk exposures and distinguishing them from risk exposures that remain in business units, that are not dynamically hedged and that are, thus, outside the scope of dynamic risk mitigation. In the interest of avoiding requirements that are operationally burdensome, EFRAG accepts the use of internal transactions as proxies for risk exposures in portfolios that are being managed and hedged by ALM.
- 71 However, EFRAG believes that if such a practical expedient is to be permitted, sufficient discipline and safeguards are needed to provide evidence of the existence of those risk exposures in the form of audit trails back to the banking portfolio. Strong internal controls might serve this purpose. Furthermore, EFRAG believes that incentives and other spreads that influence transfer pricing transactions introduce bias in the measurement of the hedged position and should be eliminated when applying dynamic risk mitigation. EFRAG notes that the identification and the elimination of such incentives and spreads should be operationally feasible where strong internal controls and procedures exist.
- 72 EFRAG believes that transfer pricing mechanisms have the potential to be an appropriate way of identifying the risks that have been transferred to ALM, but only to the extent to which these transfer prices appropriately reflect the hedged risk. EFRAG understands that ALM functions in some banks are able to specifically identify for each transaction with business units the part of the price that relates to the managed and then hedged risk. However, where this is not the case, internal controls and procedures would be needed to ensure transfer prices used as a proxy for the managed and then hedged risk are adjusted to exclude incentives and other spreads before their inclusion into dynamic risk mitigation.

Question 12 (b)

- 73 To the extent that the managed risk is a funding rate, is reflected via transfer pricing and is used to estimate future cash flows that are to be hedge accounted for, EFRAG supports using the market funding index discussed in paragraph 4.2.21 of the DP as it excludes all transfer pricing spreads. As explained in our response to question 10 above, EFRAG accepts the use of the benchmark funding index provided it is being managed and hedged by ALM, even if such an index is higher than the actual risk included in the managed portfolios.

Question 12 (c)

- 74 EFRAG is not in favour of restrictions, other than those on incentives and other spreads as explained above, on the eligibility of indices that can be used in transfer pricing as a basis for identifying the exposures for inclusion in an approach that is based on hedge accounting. Creating restrictions would oblige entities to change their funds transfer pricing system in order to be able to implement a macro hedge accounting approach.

Question 12 (d)

- 75 EFRAG believes that the use of transfer pricing is appropriate only to the extent that it adequately identifies the hedged exposures. If ongoing linkages are such that transfer pricing no longer adequately identifies the exposures continuously managed and hedged, then transfer pricing is not a suitable proxy. Where strong internal controls and procedures exist, it will be easier for ALM to be informed when hedged risk exposures have expired requiring a reversal of the related revaluation adjustment. As much as there is a need to evidence the existence of external transactions that led to internal transactions, there will be a need to identify which of these transactions have been settled or changed. EFRAG acknowledges that additional disclosures will also be needed to provide more information on how internal transactions are monitored against external transactions that led to them.

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

EFRAG's response

EFRAG holds the view that entities should be able to choose the funding index (or indices) that best reflect(s) their risk mitigation within the boundaries of internal risk management controls. EFRAG does not agree with mandatory criteria for selecting suitable funding indices.

Question 13 (a)

- 76 EFRAG is of the opinion that funding rates can be chosen on the basis of different parameters such as the nature of the funding, i.e. equity or liability, the time for which funding is sought, i.e. short or long-term, the moment at which the funding is acquired and the currency it is acquired in.
- 77 Not allowing entities to choose the funding index (or indices) would oblige entities to use a funding index which does not reflect how they have financed transactions, thereby misrepresenting the net result of those transactions in the financial statements.
- 78 EFRAG notes that institutions may use different methods for defining funds transfer prices. Additionally, managed portfolios are open portfolios, whereby new items are added and old items disappear frequently. For such portfolios, entities may choose to determine the funds transfer price of the managed portfolio on the average funding rate of all the items in the portfolio at a given moment in time.

Further, institutions may choose to assign an incremental funding rate to new items being added to the open portfolio. In both cases, an institution needs to rely on more than one funding index. The choice to use one, or more than one, funding index is related to the internal risk management system. Consequently, EFRAG agrees that institutions should be able to use more than one funding index within a managed portfolio. Entities should also be able to select a single funding index even if funding is based on more than one funding index if they consider that that approach is the best reflection of their risk mitigation activities.

Question 13 (b)

- 79 The choice of an institution to fund itself either on the long term or the short term or by using equity or liabilities is part of the overall strategic risk management system and should not be steered by accounting. Consequently, EFRAG thinks that entities should be free in their choice of a suitable funding index or indices, albeit within the boundaries of internal risk management controls.

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 believe 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 risk management activities when the pricing index is used in dynamic risk management? Why or why not?

EFRAG's response

EFRAG has no information about situations whereby net positions are identified and subsequently hedged based upon a pricing index.

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 the risk mitigation? Why or why not?

EFRAG's response

EFRAG believes that the scope should be based on risk mitigation and, consequently, should remain optional. Such an option would allow entities to make a choice between applying the general hedge accounting model to certain risk exposures and using the option to apply the macro hedge accounting model to the remaining dynamically hedged items.

Questions 16 (a) and (b)

- 80 EFRAG believes that the scope should be based on risk mitigation and, consequently, should remain optional.
- 81 If the approach were to become mandatory, we believe this would create cross-cutting issues with IFRS 9 *Financial Instruments* that are discussed in paragraphs 125 and 126 of this Appendix.
- 82 Mandatory application would create problems for entities who seek to combine interactively both the macro hedge accounting approach and the general hedge accounting provisions of IFRS 9, as well as the application of the fair value option. For example, an entity that holds both fixed and floating rate portfolios may choose to apply macro hedge accounting to the hedged fixed rate portfolios and cash flow hedge accounting to the hedged floating rate portfolios, or an entity may choose to apply general hedge accounting provisions to specific significant individual items and apply macro hedge accounting to the remaining hedged portfolios under dynamic risk management. A mandatory application would deprive the entity of the possibility to reflect the effects of its hedging strategies in the financial statements.
- 83 EFRAG believes that there should be no hierarchy between the macro hedge and the general hedge accounting models; however both models should not be applied to the same risk exposure simultaneously. We do not believe mandatory application would ensure comparability, since dynamic hedging strategies are different from one entity to another, which inevitably leads to the lack of comparability that cannot be overcome by a mandatory application of the model.
- 84 However, EFRAG considers that, consistent with IFRS 9, once an entity has chosen to apply the model to a particular hedged position, it should not be permitted to stop applying the model until the hedged position ceases to exist. As it may be difficult to prove this under a dynamic hedge accounting model, EFRAG believes that this should be addressed in the internal controls supporting the hedge accounting model.
- 85 In addition, EFRAG notes that natural economic hedges should remain untouched by the approach. EFRAG considers no hedge accounting is needed for economic hedges where both sides of the economic hedge are recognised on the same measurement basis, as in those cases no accounting mismatch arises.

Question 17 - Other eligibility criteria

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

EFRAG's response

EFRAG supports an approach based on risk mitigation. EFRAG is of the opinion that the following eligibility criteria should be considered in developing the approach: i) being dynamically managed, and ii) the general hedge accounting model under IFRS 9 is not applied to the hedge relationship.

All questions

- 86 EFRAG has considered the following additional criteria in responding to this question:
- (a) Being dynamically managed;
- (b) Effectiveness testing; and
- (c) The general hedge accounting model under IFRS 9 is not applied to the hedge relationship.
- 87 EFRAG agrees that the criterion 'being dynamically managed' should be an eligibility criterion for application of the portfolio revaluation approach.
- 88 EFRAG is of the opinion that effectiveness testing should not be considered as an additional criterion in the application of the portfolio revaluation approach. Such a criterion would bring back a large part of the complexity in designation and de-designation of risk management instruments required by IAS 39 and IFRS 9.
- 89 EFRAG believes that entities should be able to rely on IFRS 9 general hedge accounting when they do not dynamically hedge their financial risk exposures or hedge non-financial risk exposures. Hence, such hedge relationships should not be part of the scope of the macro hedge accounting solution. On the other hand, EFRAG is of the opinion that the same risk component should not be hedged

twice, i.e. once as part of a macro hedge relationship and once as part of a static hedge relationship by applying IFRS 9. Even if such a principle seems straightforward, we think that its application in a group may not be easy. For example, a subsidiary may apply a static hedge relationship to a particular risk component. The asset and liability management function at group level may be unaware of this and include the same risk component in a dynamical hedge relationship.

- 90 The DP assumes that all entities have a centrally organised asset and liability management function. EFRAG notes that not all entities are organised in this way, which may affect how the net position is determined and, thus, how it can be hedged.
- 91 For the reasons mentioned above, EFRAG thinks that two eligibility criteria should be retained, i.e. being dynamically managed and the general hedge accounting model under IFRS 9 is not applied to the hedge relationship.

Question 18 – Presentation alternatives

- (a) Which presentation alternative would you prefer in the statement of financial position, and why?
- (b) Which presentation alternative would you prefer in the statement of comprehensive income, and why?
- (c) Please provide details of any alternative presentation in the statement of financial position and/or in the statement of comprehensive income that you believe 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.

EFRAG's response

EFRAG believes that presenting the revaluation adjustment in a separate single net line item in the Statement of Financial Position is the best way to limit the effect of hedge accounting applied to dynamic risk management. EFRAG believes that the actual net interest income approach in the Statement of Comprehensive Income provides the best information for users.

Question 18 (a)

- 92 EFRAG believes that presenting the revaluation adjustment in a separate single net line item in the Statement of Financial Position is the best way to reflect hedge accounting activities, because dynamic risk management addresses net portfolios of assets and liabilities. Hedge accounting activities do not address the risk of assets alone or liabilities alone. Using separate lines for aggregated adjustments to assets and liabilities would not provide a good representation of the dynamic risk management undertaken. Additionally, it would require entities assigning the revaluation adjustment to assets and liabilities separately, which involves tracking.

Question 18 (b)

- 93 EFRAG is of the opinion that the actual net interest income approach provides the best information for users for the following reasons.
- 94 The actual net interest income approach enables net interest income accrued over the reporting period to be distinguished from mismatches in anticipated future net

interest income. By separating the two, the impact of hedge accounting is recognised without touching upon the recognition of actual interest income.

- 95 The stable net interest income approach is based on the assumption that net interest income is stable over time which is an artificial assumption. Changing market conditions or dynamic risk management failures lead to changes in net interest income. The stable net interest income approach would thus lead to a misrepresentation in the profit or loss account.

Question 18 (c)

- 96 EFRAG is not in favour of an alternative presentation in the Statement of Financial Position or 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 believe that a gross presentation enhances the usefulness of information provided on an entity's dynamic risk management and trading activities? Why or why not?
- (b) Do you think that the described treatment of internal derivatives enhances the operational feasibility of the PRA? Why or why not?
- (c) Do you think that additional conditions should be required in order for internal derivatives to be included in the application of the PRA? If yes, which ones and why?

EFRAG's response

EFRAG supports the grossing up of internal derivatives in the Statement of Comprehensive Income as a practical expedient that does not affect the quality of financial reporting. We believe that grossing up internal derivatives would enhance understandability in that users would be able to assess the performance of different business activities, while at the same time respecting the core financial reporting principle that it is not possible for an entity to profit on transactions with itself.

All questions

- 97 EFRAG recognises that grossing up internal derivatives in the profit or loss account is a practical expedient with the sole aim of separately reflecting the performance effects of using internal derivatives by allocating these effects to different line items and, hence, different business activities. EFRAG supports it as we believe it increases the quality of financial reporting and results in more understandable information by portraying separately the income effects resulting from separate business activities.
- 98 EFRAG acknowledges that even under a risk mitigation approach this may lead to open positions attributable to the trading unit as the model does not require externalisation of the risk exposure which is being hedged. Instead the model makes a clear difference between the profit or loss resulting from the ALM activity on the one hand and the profit or loss resulting from the trading activity on the other hand. Grossing up the internal derivatives in profit or loss will close the ALM position but will not close the position of the trading unit unless the position is

externalised. As such, the open risk positions are deemed to reflect those risk positions the trading unit has decided to retain as open as part of the entity's trading activities.

- 99 However, the proposal would allow a better understanding of how different business activities (hedging activities and trading) have resulted in gains and losses. It is not possible for an entity, either conceptually or economically, to make a gain or loss on transactions with itself, and gross presentation of internal derivatives in profit or loss is not consistent with this. EFRAG believes that this is outweighed by the greater understandability and relevance gross presentation would bring, but only to the extent there is no overall material effect on reported profit or loss.
- 100 EFRAG notes that there may be issues such as functional currency differences, valuation methodology and timing that could cause such an overall effect, but that these issues are not caused by the gross presentation but are common across intra-group transactions and eliminations in general.
- 101 In addition, we note that entities do not solely rely on derivatives to transfer interest rate risk from ALM to the trading function and that any eventual standard would need to reflect these different ways of transferring interest rate risk out of ALM.
- 102 It should also be noted that there are differences between the present value of cash flows required by dynamic risk management and derivatives transacted with the market, as IFRS 13 *Fair Value Measurement* requires that the fair value incorporates, for example, credit risk. This means that, irrespective of whether external derivatives are entered into by trading or ALM directly, there will be some 'noise' in profit or loss caused by differences between the valuation of the external derivatives and the revalued portfolio.

Question 20 – Disclosures

- (a) Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views.
- (b) If you think an identified theme would not provide useful information, please identify that theme and explain why.
- (c) What additional disclosures, if any, do you believe would result in useful information about an entity's dynamic risk management? Please explain why you believe these disclosures would be useful.

EFRAG's response

EFRAG believes that most of the proposed disclosure themes provide a good starting point for providing information to users on an approach that is based on risk mitigation. Nevertheless, EFRAG thinks that only some disclosure themes are essential and makes its own proposal. If a comprehensive disclosure package for the approach is considered, we believe that there is a risk of duplication of disclosure requirements. Therefore, we advocate disclosing information about all risks, highlighting those risks that were mitigated and describing ways in which they are mitigated together with the impact of risk mitigation actions. Finally, EFRAG disagrees with some of the proposed disclosures.

Question 20 (a), 20 (b)

Overall comments

- 103 EFRAG believes that the four identified disclosure themes provide a good start for providing information to users on the portfolio revaluation approach. However, in our view, only the following disclosure themes are essential and should replace those proposed in the DP:
- (a) A description of the risk exposure of an entity being risk mitigated and how it is mitigated;
 - (b) Information needed to understand the effects of hedge accounting in the financial reporting of an entity; and
 - (c) A description of the dynamic risk management processes and how risks are being managed, including governance arrangements supporting the identification, measurement and risk mitigation of the exposures. In addition, disclosures should clarify which tests are being performed to qualify macro-hedging derivatives as risk mitigating derivatives.
- 104 EFRAG recommends the IASB to carry out a holistic review of the present disclosure requirements regarding financial assets and liabilities. In doing so we believe that the IASB will find it useful to look at information that is already provided by banks as part of the regulatory disclosure requirements. As not all entities applying macro hedging are regulated and regulatory disclosure requirements are not necessarily accessible to users, a simple cross-reference to such disclosure requirements may be insufficient. Nevertheless we believe that regulatory disclosure requirements can be a starting point in defining disclosure requirements under IFRS in order to avoid duplication of the need to prepare disclosures for financial reporting purposes.

- 105 On the second disclosure theme in paragraph 103, we agree that IFRS 7 *Financial Instruments: Disclosures* currently does not provide sufficient information and could be complemented with disclosures of information regarding the effects of hedge accounting. In addition, we believe that disclosures should provide information on the effects of hedge accounting on future reporting periods.
- 106 If the IASB decides to develop a comprehensive disclosure package for the approach based on risk mitigation regardless of already existing disclosures, we believe that disclosure requirements are likely to be duplicated. We see merit in disclosing information about risks and ways in which those risks are mitigated. This is regardless of whether the entity has chosen to use the approach based on risk mitigation or not. Otherwise, the disclosures risk being on a piecemeal basis depending on each entity's choice between different accounting solutions (i.e. fair value option, fair value hedges, cash flow hedges and economic hedges).

EFRAG's comments on the disclosure themes proposed in the DP

- 107 Were the IASB to retain the four disclosure themes as developed in the DP, our comments on these themes would be as follows.
- 108 The first disclosure theme requires information on the objectives and policies for the performance of dynamic risk management. EFRAG agrees that this information would be useful for the following reasons:
- (a) The identification of risks is different to the identification of contractual cash flows, the latter being more familiar to users of financial statements. Risks could be identified within pipeline trades and behavioural exposures, which are concepts that may be new to users of the financial statements; and
 - (b) The objective of dynamic risk management is not to eliminate risk completely (i.e. without risk there would be little performance), but rather to reduce it and protect the performance of the entity. This crucial difference should be understandable for users of the financial statements.
- 109 Alternatively, the content related to this disclosure theme could be presented in the Management Commentary. If information was already available elsewhere, EFRAG thinks entities should be allowed to rely on cross-referencing to fulfil the disclosure requirements, insofar as the cross-referenced information is easily accessible to users, at the same time as the financial statements.
- 110 The second disclosure theme requires information on the risk position and its impact on application of an approach based on risk mitigation. Although EFRAG considers the information useful, we are of the opinion that, subject to our comment made in paragraph 104, for regulated institutions, much of it is already available through regulatory reporting. Therefore, cross-referencing should be permitted in these cases insofar as the cross-referenced information is easily accessible to users, at the same time as the financial statements.
- 111 EFRAG does not think that a breakdown by class of financial instruments is useful as this would bring back the designation rules of IAS 39 and IFRS 9 for disclosure purposes and, hence, remove much of the attractiveness of the model.
- 112 By definition, dynamic risk management evolves continuously, and EFRAG believes that disclosures on how exposures have evolved during the reporting period could potentially be of use. The nature and extent of any such disclosures

should be consistent with overall disclosures of financial risks and be appropriately targeted.

113 The third disclosure theme requires information on the application of an approach that is based on risk mitigation. EFRAG agrees that this information would be useful for the following reasons:

- (a) The accounting policy could provide a useful insight into the reasons why and to which extent an approach based on risk mitigation has been applied;
- (b) An implementation of an approach based on risk mitigation would require overcoming conceptual differences between accounting and dynamic risk management. Some of the differences may be difficult to incorporate such as the identification of risk in future transactions. However, that does not imply that an entity will or should stop managing such risks. For this reason, EFRAG is of the opinion that disclosing such information could be useful; and
- (c) The choice of the indices used for determining risk cash flows and discounting them is an important element in representing dynamic risk management in financial reporting. Also, it enhances comparability between entities. When entities rely on different indices to measure their risk, the outcomes are, by definition, not comparable. For this reason, EFRAG is of the opinion that this information is useful for users.

114 The fourth disclosure theme requires information on the impact of dynamic risk management on the current and future performance of the entity. EFRAG agrees that this information would be useful for the following reasons:

- (a) EFRAG favours the actual net interest income approach as this not only provides information on the actual interest margin, but also provides information about net interest income before and after dynamic risk management. In other words, it provides information on the success of the risk management undertaken; and
- (b) EFRAG is of the opinion that users could benefit from information on the sensitivity of an entity's net interest income to future changes in interest rates after dynamic risk management. EFRAG notes that net interest income may change because of a change in business undertaken (i.e. more or less interest bearing products are sold), and/or by the change in market interest rates.

Question 20 (c)

115 EFRAG proposes the following specific disclosures:

- (a) An entity's susceptibility to future risks (see our answer to Question 1);
- (b) Behavioural assumptions (see our answer to Question 4 (c));
- (c) Changes in behavioural assumptions (see our answer to Question 4 (c));
- (d) Risk limits (see our answer to Question 8);
- (e) Core demand deposits (see our answer to Question 9); and
- (f) The use of transfer prices (see our answer to Question 12 (d)).

Question 21 – Scope of disclosures

- (a) Do you think that the scope of 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 believe would be an appropriate scope for the disclosures, and why?

EFRAG's response

EFRAG supports an approach based on risk mitigation but believes that disclosures on the totality of risk exposures of an entity would provide useful information to users of financial statements.

Question 21 (a) and (b)

116 EFRAG is of the opinion that disclosures could be used to provide information on the totality of risk exposures of an entity, how (some of) these are being risk mitigated and how this risk mitigation is being addressed in the accounting. In developing such disclosures EFRAG believes that the disclosures should be aligned with what is already required by IFRS 7 *Financial Instruments: Disclosures* and, for regulated institutions, the disclosures which are already available through regulatory reporting.

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

- (a) 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 the contract? Why or why not? If yes, under which circumstances do you believe it would be appropriate, and why?
- (b) How would you propose to account for any non-zero day 1 revaluations? Please explain your reasons and comment on any operational implications.

Question 23 – Removal of exposures from the managed portfolio

- (a) Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?
- (b) Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from the managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?
- (c) If exposures are removed from the 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.

EFRAG's response

EFRAG believes that the portfolio revaluation approach is not sufficiently developed to answer these questions.

Questions 22 and 23

117 EFRAG believes that it is too early to answer these questions as the answer will depend on the final model and the reasons why exposures have been added to or removed from the hedged portfolio.

Question 24 – Risk management of foreign currency instruments

- (a) Do you think that it is possible to apply the PRA to the dynamic risk management of foreign exchange risk in conjunction with interest rate risk that is being dynamically managed?
- (b) Please provide an overview of such a risk management approach and how the PRA could be applied or the reasons why it could not.

EFRAG's response

EFRAG notes that interest rate risk and foreign currency risk are managed together by some entities and separately by other entities. EFRAG thinks that the final model should accommodate both practices.

Questions 24 (a) and 24 (b)

118 EFRAG notes that some entities manage interest rate risk and foreign currency risk separately, and other entities manage those risks together. A final macro hedge accounting model should address both these practices. As mentioned in paragraph 124 below, we note that, given the currency translation in IAS 21 *The Effects of Changes in Foreign Exchange Rates*, an application of the revaluation approach to foreign currency risk could be seen as redundant.

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 believe it would be appropriate? Please explain your fact patterns.
- (b) For each fact pattern in (a) please explain whether and how the PRA could be applied and whether it would provide useful information about dynamic risk management in entities' financial statements.

EFRAG's response

While EFRAG believes that a macro hedge accounting model should be applicable to other industries and other risk types and that for that analysis is needed on what macro hedge accounting could mean in terms of other sectors and other risks.

Questions 25 (a) and (b)

- 119 EFRAG believes that, based on feedback received, a macro hedge accounting model could be of particular interest to industries such as insurance and utilities and to other risks, such as commodity price risk, exposure to duration mismatches, longevity, liquidity and foreign exchange risk in addition to banks and interest rate risk. However, we received insufficient information on fact patterns that could be used in order to develop such proposals.

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 portfolio revaluation approach, how could the conceptual and practical difficulties identified with this alternative approach be overcome?

EFRAG's response

EFRAG thinks it is too early to decide whether a macro hedge accounting through OCI could be appropriate. It is necessary to have a view on the final outcome of the future insurance accounting standard in order to see how a macro hedge accounting model can help in addressing the remaining accounting mismatches.

If a cash flow hedging model is developed using some or all of the principles proposed in the DP then EFRAG considers the use of OCI is appropriate as the PRA does not recognise that many banks do not manage their interest rate risk on a valuation basis but rather on a cash flow basis. EFRAG recommends the IASB to work closely together with prudential regulators in order to avoid any distortion in the prudential equity of banks.

Question 26

- 120 EFRAG has considered whether the use of OCI could usefully contribute to the PRA applied to risk mitigation only. As such a model is aiming at offsetting the revaluation adjustment of the hedged position with the changes in value of the hedging instruments, there is no disconnect (or accounting mismatch) expected other than ineffectiveness and basis risk of hedging instruments. This analysis is valid for situations in the banking sector where the interest rate risk of the banking book is being dynamically managed and the hedged items are measured at amortised cost in accordance with the business model.
- 121 However, the outcome of the analysis may be different for the insurance sector when considering risk mitigation of interest rate risk of insurance liabilities. Depending on the final outcome of the insurance contracts project, a dynamic risk mitigation approach through OCI may be appropriate. This could reduce the accounting mismatches between the measurement of the different building blocks of insurance liabilities and the risk mitigating instruments used to hedge these. Consequently, we believe it is too early to completely rule out a macro hedge accounting model through OCI.
- 122 As mentioned in our answer to Question 2, the PRA does not recognise that many banks do not manage their interest rate risk on a valuation basis but rather on a cash flow basis. The revaluation adjustment can represent different risk profiles depending on the time buckets the cash flows are assigned to and the discount factors being used. Notwithstanding this, EFRAG acknowledges the lack of

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appetite by some banking constituents for a cash flow hedge model that is explained by the uncertainty of how changes to OCI will be treated by regulators.

- 123 Therefore, if a cash flow hedge model were to be developed, EFRAG recommends the IASB to work closely together with prudential regulators in order to avoid any distortion in the prudential equity of banks.

Other issues that are not addressed in the DP

Cross-cutting issues with other IFRS

IAS 21 The Effects of Changes in Foreign Exchange Rates

124 IAS 21 requires an entity to translate its foreign currency items into its functional currency. One could argue that considering financial instruments as the underlying item on the Statement of Financial Position makes the application of the portfolio revaluation approach to foreign currency risk redundant as the exposures are expressed at current value. However, IAS 21 only takes into account the exchange rate at period end and not expected future changes in this rate.

IFRS 9 Financial Instruments

125 A model bringing an overlay of current value on all managed portfolios would, de facto, contradict the conclusion reached in IFRS 9 *Financial Instruments* that the major part of banking books' financial instruments are best measured at amortised cost.

126 Relying on risk limits may interact with the business model. If the portfolio revaluation model were to require revaluation of exposures at a benchmark rate, entities may have an incentive to hold financial assets and collect their cash flows instead of holding them for sale as this would avoid remeasuring the basis spread. When risk limits apply without limitation, one could argue that significant risk exposures would remain within the entity as the portfolio revaluation approach requires no externalisation.

IFRS 13 Fair Value Measurement

127 EFRAG notes that the change in market practice of measuring external derivatives may have as an effect that the offset between the revaluation adjustment and the external derivative(s) is less than perfect. Although due to a cause independent from the portfolio revaluation approach, it would affect its outcome. The difficulties related to the new market practice are discussed in paragraphs 18 to 21 of this Appendix.

Negative interest rates

128 In January 2013, the IFRS Interpretations Committee discussed negative interest rates and decided to refrain from finalising the tentative agenda decision until the IASB had completed its re-deliberations on the Exposure Draft *Classification and Measurement*. EFRAG welcomed that decision as we were concerned that "the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification" is currently not an explicit requirement and was thus interpretative in nature (EFRAG letter of 17 January 2013 to the IFRS Interpretations Committee).

129 EFRAG is of the opinion that entities should be able to reflect the effect of dynamically hedging negative interests when such exposures are part of the overall interest exposure an entity has.

Hedging credit risk and insurance risk

130 As the portfolio revaluation approach in the DP does not focus on dynamic risk management of cash flows, extending its scope to other risks types may be

difficult especially for those risks where changes in current value are not the main drivers of risk – for example, when considering credit risk and insurance risk.

- 131 When credit default swaps are used to hedge the ultimate credit risk of an exposure, the credit spreads on credit default swaps and underlying cash instruments do not move together, i.e. the correlation coefficient in market prices movements is less than one. Consequently, the offset under the portfolio revaluation approach would be less than perfect, thus leading to volatility in profit or loss.
- 132 A similar issue arises when hedging insurance risk by relying on re-insurance. Also here, the pricing of both items are not fully correlated, which could lead to a less than perfect offset under the portfolio revaluation approach even though the reinsurance contract may be a perfect hedge of the insurance risk in the insurance contract.

Unit of account

- 133 The DP does not address the unit of account to be used as part of the approach. The choice of the unit of account has operational consequences as it will define the level of breakdown to account for the risks being mitigated.
- 134 EFRAG is of the opinion that the unit of account should be the one considered by ALM in transferring risk positions to the trading function. It is ALM that decides to transfer the risk exposure of an individual financial instrument, of a risk component or of a portfolio to the trading function. Therefore, any final standard should allow the flexibility for the unit of account to depend on how ALM has decided to transfer the risk.