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

Dear Ms Flores,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's due process. ESMA has considered EFRAG's draft response to the IASB's Discussion Paper ('DP') *Accounting for dynamic risk management: a portfolio revaluation approach to macro hedging*. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of financial statements.

Like EFRAG, ESMA welcomes the IASB's initiative to explore the possibilities to facilitate application of hedge accounting principles to open portfolios as there is a genuine need to address the long standing problem of divergent accounting practices and lack of transparency of reporting for management of interest rate risk of open portfolios. This issue is particularly relevant for the banking sector in the European Union (EU) considering the carve-out of certain requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (the carve-out). Following this rationale, ESMA believes that the objective of the model should be kept narrow in order to address the issues that led to this carve-out. In this context, we suggest to explore whether an extension of the general hedge accounting model in IFRS 9 *Financial Instruments* could be an alternative to the approach proposed in the DP.

ESMA considers that in developing a macro-hedge accounting model, the IASB should find a balance between the benefits brought by achieving an alignment with risk management strategy/policy and the complexity and difficult conceptual issues it will bring into accounting. While we see the macro-hedging model as an exception to general accounting requirements, we believe the IASB should still try to limit as much as possible deviations from established accounting conceptual principles. In contrast, EFRAG is more concerned that the suggested risk mitigation approach may trigger significant difficulties with respect to its application and therefore it explored possible alternatives to the model proposed in the DP. ESMA believes that those alternatives are too ambitious in their scope and are unlikely to lead to improved

benefits considering their drawbacks over the proposed model and could result in a conflict with some established conceptual principles.

Similar to EFRAG, ESMA considers that unless the Portfolio Revaluation Approach (PRA) addresses effectively the issues of core demand deposits, treatment of prepayment risk at the portfolio level and designation of sub-benchmark instruments, it will not fulfil its aim. However, contrary to EFRAG, ESMA disagrees with the introduction of specific features in the PRA, and in particular inclusion of the equity model book, in view of its incompatibility with the existing Conceptual Framework and the availability of other solutions as indicated in the DP.

ESMA agrees with EFRAG that the interest rate risk arising from the dynamically managed exposures must be the starting point for accounting for dynamic risk management activities. Consequently, any practical expedients used in the PRA could only be used to the extent that they represent a faithful proxy to the managed exposures and any changes to the managed exposures shall be exercised only on the basis of the actual data and linking it to the risk management strategy.

Unlike EFRAG, at this moment, ESMA does not support the general application of the PRA to other types of risks or other industries as the introduction of those risk exposures and risk techniques in the financial statements may create a range of audit and enforcement challenges as well as conceptual issues. Possible broadening of the scope to other risks or industries could be explored at a later stage taking into account experience with the application of the model.

Similar to EFRAG, ESMA considers that neither of the proposed approaches, dynamic risk management or risk mitigation, is fully satisfactory. We believe that the focus should be on the faithful representation of the underlying economics of events in the financial statements. While EFRAG supports a model aligned with risk management practice, e.g. including forecast transactions, ESMA considers that financial reporting has its own limitations and the IASB should assess to which extent risk management can be fully reflected in financial reporting as well as whether development of accounting standards could unintentionally influence some risk management practices.

Furthermore, ESMA is of the view that the interaction of the macro-hedging model with IFRS 9 as well as with other IFRSs (e.g. IAS 37 *Provisions, Contingent Liabilities and Contingent assets* in the view of the definition of pipeline transactions) should be carefully assessed.

Regarding disclosures, ESMA agrees with EFRAG that any macro-hedging model shall be accompanied by a robust and transparent set of disclosure requirements to enable users to understand the effects of dynamic risk management on financial statements and the underlying assumptions and judgements made. Besides, definitions used in those disclosure requirements shall be made consistent with those included in IFRS 7 *Financial Instruments: Disclosure*.



Finally, similar to EFRAG, ESMA disagrees with the development of the PRA through other comprehensive income (OCI) as it sees no reason to defer the recognition of ineffectiveness in profit or loss. However, ESMA disagrees with EFRAG's suggestion to explore a macro cash flow hedge accounting alternative.

Our detailed comments on the DP are set out in the Appendix I to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

A handwritten signature in blue ink, appearing to be "S/M", written over a light blue horizontal line.

Steven Maijor
Chair
European Securities and Markets Authority

Appendix I – ESMA’s detailed answers to the questions in the Discussion Paper *Accounting for dynamic risk management: a portfolio revaluation approach to macro hedging*

Question 1 –Need for an accounting approach for dynamic risk management

Do you think that there is a need for a specific accounting approach to represent dynamic risk management in entities’ financial statements? Why or why not?

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?

1. ESMA welcomes this DP as there is a need to improve hedge accounting principles to be applied to open portfolios. ESMA acknowledges that the application of hedge accounting to open portfolios requires specific solution in addition to the general hedge accounting model developed in IFRS 9. In its report on financial statements of financial institutions¹, ESMA concluded that the absence of an appropriate accounting solution, in combination with the carve-out applicable in the EU, leads to divergent accounting practices and decreases the transparency of financial reporting of financial institutions. Therefore, ESMA welcomes the possible alternatives explored by the IASB in the DP.
2. The mixed measurement model in IFRS 9 has consequences when entities try to reflect in their financial statements the economic consequences of their risk management activities. To address accounting mismatches, the IASB has developed a hedge accounting model in IFRS 9 that is more closely aligned to risk management principles than the current requirements in IAS 39. Yet, the new general hedge accounting model in IFRS 9 may not be entirely suitable to reflect dynamic risk management activities of financial institutions, such as hedging of the interest rate risk of open portfolios.

Focus on the carve-out in the EU

3. The designation of a net amount in a fair value hedge of interest rate exposure of a dynamically risk-managed net portfolio is not permitted by the current requirements of IAS 39. In the EU, the carve-out relaxed the restrictions on designation of core demand deposits, bottom layers and sub-LIBOR instruments as those restrictions could prevent banks from reflecting the economic consequences of their hedging activities. ESMA believes that any hedge accounting model for open portfolios needs to address at a minimum these issues.

¹ Report: *Comparability of Financial Statements of Financial Institutions*, ESMA, Paris, November 2013 (ESMA/2013/1664)

4. However, ESMA believes that the IASB is too ambitious in developing a broad model that aims to fully reflect all the consequences of the dynamic risk activities. Considering that financial reporting has its own conventions² and limitations, ESMA considers the IASB should assess to which extent it should align the macro hedge accounting model with the risk management. Indeed, if so, some risk management practices that will be reflected in financial reporting might be unintentionally influenced by accounting standards instead of a genuine desire to manage financial risks. The risk of such practices being developed might be reduced in regulated industries, where risk management practices are constrained by (prudential) regulation. Further, ESMA believes the full alignment of the accounting model with the dynamic risk model will result in too many conceptual conflicts.
5. To conclude, even if it is conceptually difficult to justify the limitation of PRA to the interest rate risk, we nevertheless believe that it is important to focus on this objective in order to address the issues that have led to the carve-out in the EU. Accordingly, ESMA does not believe the PRA should be generalised as suggested in the DP, but should be seen as an exception and therefore its scope should be kept narrow and limited to interest rate risk management for open portfolio(s). Should the IASB proceed with the PRA, ESMA is of the view that the model should be sufficiently robust to enable issuers to apply it consistently and prevent from enforceability issues.

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?

6. Based on our general knowledge of risk management and hedging activities, we understand that the DP addresses only the current dynamic interest rate risk management practices in banks. This does not mean that the analysis is complete for other types of financial institutions, such as insurance companies. However, financial institutions might be in a better position to answer this question.
7. Considering the description of the dynamic risk management in the DP, ESMA doubts whether its boundaries are properly defined. In particular, we consider that the characteristics included in paragraph 2.1.2 of the DP are too broad and general to appropriately define dynamic risk management.
8. In this respect, ESMA suggests the IASB to explore whether an extension of the general hedge accounting model in IFRS 9 to allow hedge accounting of interest rate risk in open portfolios could be an alternative to the proposed approach in the DP. However, the DP did not indicate whether and to what extent this alternative has been explored.

² As defined by the IASB in the *Conceptual Framework for Financial Reporting*

9. Furthermore, we believe that, while developing the PRA, the IASB should further explore and address a number of issues. These include, in particular, the interaction with the general hedge accounting requirements in IFRS 9, especially if the IASB opts for a mandatory application of the PRA, and the clarification of the unit of account, as it might significantly impact the way accounting mismatches are reduced and influence the timing of recognition of effects of interest rate changes in profit or loss.

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).

Equity Model Book (EMB)

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

Behaviouralisation

(c) For the purposes of applying the PRA, should the cash flows be based on a behaviouralised rather than on a contractual basis (for example, after considering prepayment expectations), when the risk is managed on a behaviouralised basis? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework.

Behaviouralisation

10. Overall, since the concept requiring cash flows to be based on a behaviouralised rather than on a contractual basis ('behaviouralisation') is a pre-condition for a number of features of the PRA, ESMA agrees that in certain circumstances, such as core demand deposits, pipeline transactions or prepayment risk, it should be included in the PRA.
11. The concept of 'behaviouralisation' is described in the DP by referring to two examples rather than by an explicit definition. ESMA notes that the concept of behaviouralisation, when applying the PRA, would be consistent with the accounting treatment under current IFRS for portfolio fair value hedges of interest rate risk on fixed-rate prepayable assets and liabilities that are modelled on a behaviouralised expected cash flow basis, rather than on a contractual basis.
12. ESMA suggests that the IASB to elaborate in the ED on the definition of the concept of 'behaviouralisation' and explain the differences and similarities with the concept of 'expected' value in IAS 37 *Pro-*

visions, Contingent Liabilities and Contingent Assets. More specifically, some differences may be identified, including between the guidance in IFRS on measuring liabilities with a contingency feature at the amount payable discounted from the earliest or most likely repayment date and scheduling those demand liabilities for hedging purposes using a behaviouralised approach.

13. Furthermore, considering the need to use additional assumptions and significant judgment to identify the behaviouralised managed exposures, we are concerned how those would be disclosed in the financial statements.

Pipeline transactions

14. As indicated in the DP, 'pipeline transaction' is a colloquial term that includes transactions of potentially different nature. Accepting the inclusion of pipeline transactions in the PRA would increase the operational feasibility and usefulness of information provided in the financial statements, as the published interest rate risk associated in the pipeline transactions modifies the interest rate risk profile. However, we agree with the IASB that there are conceptual difficulties in revaluing pipeline transactions for interest rate risk, even if such transactions are considered to be highly probable.
15. Therefore, we believe that the notion of 'pipeline transaction' should be clearly defined. When describing pipeline transactions, the IASB should consider aligning their definition to the extent possible to the concept of constructive obligation defined in IAS 37³ and, if appropriate, explain any differences between those terms. From an enforceability perspective, ESMA considers that any model proposed in relation to 'pipeline transactions' should include robust criteria that would help in clearly distinguishing 'pipeline transactions' from 'forecast transactions'.

Equity model book (EMB)

16. Considering that equity is defined as a residual interest category in the Conceptual Framework, ESMA is opposed to include the EMB in the PRA, as that would result in revaluing the own equity of an entity. Furthermore, we believe that it is conceptually incorrect to consider the dividend payment as a liability in the PRA.
17. If the IASB believes that the EMB could result in useful information for a limited number of issuers using this practice in a limited number of industries, ESMA considers that providing information on EMB in the notes will strike a better balance between providing useful information and maintaining consistency with the Conceptual Framework. Moreover, as indicated in the DP, issuers can make use of the existing cash flow hedge accounting requirements and 'replication portfolio' without having to revalue equity directly in order to depict the effects of the interest rate risk in the financial statements.

³ and currently being revised as part of the review of the Conceptual Framework

Question 9—Core demand deposits

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

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

18. ESMA agrees that inclusion of core demand deposits in the managed portfolio on a behaviouralised basis is consistent with the risk management focus of the PRA and we consider that their inclusion in the PRA is essential for aligning the model with risk management as well as allowing to adjust position mismatches.
19. However, ESMA understands that it is difficult to assess whether changes in core demand deposits are the result of changes in customers' behaviour, the reflection of a bank's actions responding to its assessment of interest rate risk or the effect of other factors such as the liquidity risk. In light of the assumptions, estimates and judgements required for identification of core demand deposits, ESMA emphasises the importance of disclosures related to the core deposits especially in relation to the basis of the assumptions made and their changes when identifying core demand deposits (please see also answer to question 21).
20. ESMA would appreciate if the IASB will include in the ED a clear definition of 'core demand deposits' (and will explore its relationship to the prudential definition) and additional application guidance so that assumptions in the PRA are adapted to reflect changes in the market conditions prevailing at the date of assessment. We are concerned that without appropriate guidance on the definition, even extensive disclosures may fall short of providing a sufficient level of transparency in this area.

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.

21. ESMA believes that it is important to include risk management instruments with optionality used to manage prepayment risk in the PRA, because options can be seen as a specific protection against the decrease in net interest income of dynamically managed portfolios (e.g. in a declining market rate environment). At the same time, the model shall include guidance to avoid the possibility of including strategies that do not lead to protection of the interest rate risk margin.
22. Even though inclusion of risk management instruments with optionality in the management of prepayment risk might add complexity to the model, ESMA believes their addition is important to faithfully reflect hedging activities.

Question 6—*Recognition of changes in customer behaviour*

Do you think that the impact of changes in past assumptions of customer behaviour captured in the cash flow profile of behaviouralised portfolios should be recognised in profit or loss through the application of the PRA when and to the extent they occur? Why or why not?

23. Similar to the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* that require immediate recognition of a change in an accounting estimate in profit or loss, we believe that all the impacts of changes in past assumptions of customer behaviour captured in the cash flow profile of behaviouralised portfolios should be recognised in profit or loss when they occur.
24. However, given that the shift of behaviour can occur over a longer period of time and considering the usual time lag between the change in behaviour and its identification, we believe that it will be challenging to reflect the effects of changes in customer behaviour in the PRA. From the perspective of securities regulators, ESMA is concerned that the identification of changes in customer behaviour and modelling the related cash flows could lead to a reduced comparability of financial reporting. Therefore, ESMA would recommend the IASB to introduce clear principles for the assessment of behavioural assumptions and their changes.
25. Furthermore, as the identification of changes in customer behaviour can be highly judgemental, the proposed model could be easily misused to achieve targeted outcomes. Despite the proposed principles, we are concerned that as recognition of changes in customer behaviour relies merely on behavioural assumptions there might be a bias not to recognise all the relevant changes due to their impact on profit or loss. Therefore, we believe issuers should be required to base the recognition of the changes on actual verifiable data.

Question 7—*Bottom layers and proportions of managed exposures*

If a bottom layer or a proportion approach is taken for dynamic risk management purposes, do you think that it should be permitted or required within the PRA? Why or why not? If yes, how would you suggest overcoming the conceptual and operational difficulties identified? Please explain your reasons.

26. We are of the view that both bottom layers and proportion approach could be accepted as a way to reflect risk management practices in the PRA as long as they do not hide ineffectiveness that should be recorded in profit or loss when it occurs. ESMA acknowledges that there might be operational complexities linked to the measurement of ineffectiveness that can arise whilst determining the revaluation adjustment for the bottom layer or proportion approach, unless all exposures making up the portfolio can be considered homogenous.

27. We note that certain issuers who don't use bottom layers, tend to use behavioural assumptions, optimisation scenarios or under-hedging without accurately tracking all managed exposures. In this context, we question whether the PRA would require significant changes in the current risk management in order to avoid prepayments leading to breaches of bottom layers. Therefore, we believe that using bottom layer and proportion approach within the PRA should not be required but rather be only permitted for those entities that can accurately track the managed exposures and use these approaches in their risk management.
28. Consequently, ESMA believes that restricting the use of the PRA only to dynamic hedges of interest rate risk under the above-mentioned conditions may achieve the best balance between allowing the inclusion of bottom layers and proportions in the PRA and minimising the conflicts with the Conceptual Framework.

Question 8—Risk limits

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

29. ESMA agrees with the IASB's preliminary view not to incorporate risk limits into the PRA, as these are representative of the risk management strategy of the entity that should not be directly recognised in the financial statements. ESMA believes that risk appetite should be reflected in financial reporting by providing sufficient information on the actual risks and the way they were managed (i.e. in form of disclosures) rather than directly incorporating risk limits in the PRA. In this context, quantitative and qualitative disclosures could be required to enable users to understand the effects of risk limits.
30. ESMA also believes that including risk limits in the PRA could be counterintuitive: the wider the risk limit is set, the less ineffectiveness will be reported in the profit or loss. ESMA agrees with the IASB's concerns that banks could set suitably wide risk limits for the PRA, not necessarily reflecting the actual risk limits used, if it resulted in limited volatility in profit or loss.
31. As different issuers have different risk appetites and risk limits, we are concerned that identification of a proper risk limit would be left at the discretion of management and would require extensive management judgement which should be disclosed in detail in the financial statements. This would not lead to a better comparability of IFRS financial statements among financial institutions (please see also our answer to question 21).

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

32. Issuers applying the IAS 39 as endorsed in the EU (i.e. subject to carve-out) may already be treating sub-benchmark instruments as benchmark instruments. Accordingly, ESMA believes that the macro-hedge model shall explicitly address this issue. In particular, if core demand deposits are allowed to be included in the managed exposures, it would be consistent to also include sub-benchmark instruments in the managed exposures because the demand deposits typically either pay no interest or pay nominal interest at a rate below the benchmark rate.

Alternatives for calculating the revaluation adjustment for sub-benchmark instruments

33. ESMA sees varying benefits in each of the proposed approaches for calculating the revaluation adjustment for sub-benchmark instruments presented in paragraph 3.10.15 of the DP. As approaches 1 and 2 are based on actual deposit rates, they could be less prone to subjective judgements. However, ESMA is concerned by the rationale and effects of day-one revaluation differences in approach 1. Therefore, ESMA encourages the IASB to further explore how these approaches could faithfully represent risk management practices and how they could be made operational.

Embedded floor

34. ESMA believes that embedded floors should be included in the PRA to the extent that they are also included in the net risk position being hedged. ESMA understands that cash flows that are not relevant to the managed risk, such as customer margin, both on lending and borrowing sides, are not part of the revaluation of net position. Because of the focus on dynamic risk management, there is no direct connection between individual instruments and risk exposures. The embedded floor in sub-benchmark borrowings is part of the bank's margin, even though it directly relates to the managed risk. Some entities may choose to incorporate an embedded floor as a dynamically managed risk (using swap options) but that is a choice about which risks are dynamically managed. Thus, we believe that embedded floors in variable rate exposures should be included in the portfolio revaluation approach to the extent they are included in the net risk position being hedged.

35. Finally, we would encourage the IASB to clarify that embedded floors in sub-benchmark instruments do not always exist, as for example in case of negative interest rates. When there is no embedded floor in the sub-benchmark instrument, the revaluation amount would be fully offset by changes in the benchmark rate, even if the benchmark rate is below the absolute value of the negative spread.

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?

36. ESMA believes that the revaluation approach can be a good proxy for reflecting risk management, provided that sufficient application guidance including, clear criteria, will be developed. However, as the revaluation adjustment reflects the interest rate risk exposure of an entity not only for the reporting period but also for future periods, it could override the amortised cost measurement basis. The DP notes that recognising the revaluation adjustment upfront in profit or loss may create volatility that is inconsistent with risk management objectives. Thus, we recommend the IASB to develop application guidance including clear criteria for the revaluation calculations to address this risk.

37. Although most banks dynamically manage the benchmark interest rate, normally the funding rate cannot be managed dynamically. Therefore, management of the interest rate risk is done with respect to a target variable, e.g. net interest income or economic value of own funds. Assessment of the revaluation adjustment should be closely related to the objective of the project. Accordingly, we agree that the margin earned from lending activities shall not be included in the funding rate used for the revaluation of managed exposures, unless it is being managed as part of the dynamic risk management. Furthermore, we are of the view that it should not be possible to include own credit risk when revaluating the managed portfolio while using a benchmark index or the funding curve(s).

38. Finally, market participants are currently facing difficulties regarding the use of funding valuation adjustments in measuring the fair value of derivatives. Permitting the managed risk to be an issuer's own funding rate would increase the tensions between the funding rate of market participants and issuer's own funding rate. Additionally, in these circumstances the way the issuer manages its risks may not be aligned with the way other market participants view those risks.

Question 12—Transfer pricing transactions

(a) Do you think that transfer pricing transactions would provide a good representation of the managed risk in the managed portfolio for the purposes of applying the PRA? To what extent do you think that the risk transferred to ALM via transfer pricing is representative of the risk that exists in the managed portfolio (see paragraphs 4.2.23–4.2.24)?

(b) If the managed risk is a funding rate and is represented via transfer pricing transactions, which of the approaches discussed in paragraph 4.2.21 do you think provides the

most faithful representation of dynamic risk management? If you consider none of the approaches to be appropriate, what alternatives do you suggest?

In your answer please consider both representational faithfulness and operational feasibility.

(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 on-going linkage?

39. ESMA believes that actual external (market) interest rates should be favoured over the use of internal transfer prices since IFRS generally favour use of actual market prices. In ESMA's view, the use of transfer price (TP) transactions could be acceptable as long as they reflect the actual market risk or to the extent it could be seen as its faithful proxy. We believe that the actual risk arising from the managed exposures should be the starting point for accounting for dynamic risk management activities. However, as TP transactions are often heavily influenced by other incentives and considerations (e.g. stemming from tax law, tax planning opportunities or regulatory limits), ESMA doubts whether the TP can be seen as a reliable proxy to actual market transactions in all circumstances.

40. We note that in practice large banks frequently apply TP rates in managing the interest rate risk. Determination of these rates is complex and can require significant judgement. Hence, ESMA would welcome further analysis on this matter before developing the ED, in particular by clarifying how the PRA could be applied when the ALM is not centralised but operated at local (subsidiary) level. Furthermore, ESMA believes that banks using actual market rates in their ALM should be able to use them in the PRA rather than being mandated to use the benchmark index.

41. ESMA prefers the approach that limits the use of TP to interest rate risk management described in paragraph 4.2.18 of the DP, instead of permitting multiple approaches which would result in a lower comparability among issuers⁴. In particular, ESMA believes that changes in the bank's own credit risk are typically not part of the dynamic risk management for interest rate risk that should be accounted for in the PRA. Therefore, we question how the PRA would reflect the increase in the transfer rate caused by the changes in the bank's external funding spread driven by the market's perception of the bank's own credit risk.

⁴ e.g. if one issuer uses its funding cost while another issuer uses a benchmark rate.

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 would those criteria be, and why?

42. The choice of a funding index is part of the overall strategic internal risk management system and this should not be determined by accounting requirements. ESMA observes that most banks use a number of indices. In our view, a ‘one size fits all’ approach would not be appropriate for such a diverse and complex area. Therefore, we believe that the objective of a PRA should be to faithfully represent the actual funding indices that a bank has incurred and that it dynamically manages, even if this would imply using multiple indices. Consequently, as long as the funding indices reflect the underlying interest rate risk, and to the extent the funding indices are verifiable and comprehensive, we believe it is acceptable to select one or more suitable funding indices and that there should be no limitations on their number or choice.

43. A single funding index could not be suitable for the proper functioning of the model and we would encourage the IASB to clarify what are the elements that form part of the interest risk management. In particular, regarding the various elements of the overall basis risk, the IASB should clarify to which extent it reflects interest rate risk or liquidity risk.

Question 15—Scope

(a) Do you think that the PRA should be applied to all managed portfolios included in an entity’s dynamic risk management (ie a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (ie a scope focused on risk mitigation)? Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

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

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

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

44. ESMA believes that the scope of the PRA depend on the IASB decisions in relation to key dimensions that need to be jointly considered, such as:
- objective of the project (please see question 1);
 - definitions of the two suggested scope alternatives including the assessment of which portfolios would be included in the PRA;
 - accounting for additions and removals (please see questions 22-23);
 - decision whether the model is mandatory or optional;
 - applicability of the model to other risks beyond the interest rate risk; and
 - interaction of the model with the general hedging model in IFRS 9.
45. We believe that neither the approach focused on dynamic risk management nor the one focused on risk mitigation are fully satisfactory. ESMA believes that the objective of the PRA should focus on the faithful representation of the underlying economics of events in the financial statements and not only on reducing the volatility presented in the statement of comprehensive income.
46. While the dynamic risk management approach could lead to more transparent and more relevant financial reporting (by showing full effects of un-hedged positions as well as exposures to certain types of risk on the financial position and financial performance), it could also lead to significant volatility being recognised in profit or loss in relation to net open risk positions that have been left un-hedged.
47. While the risk mitigation approach could better address the issues that led to the carve-out in the EU, it is operationally challenging and somewhat artificial when compared to the way risk management is done in practice. Moreover, it does not provide information about the effects of the decisions not to hedge certain exposures.
48. In our view, as both approaches would bring specific enforceability issues, the IASB should pay particular attention to the consistent application of the model when developing the ED.

Question 16—Mandatory or optional application of the PRA

(a) Do you think that the application of the PRA should be mandatory if the scope of application of the PRA were focused on dynamic risk management? Why or why not?

(b) Do you think that the application of the PRA should be mandatory if the scope of the application of the PRA were focused on risk mitigation? Why or why not?

49. ESMA believes that requiring mandatory application will result in more faithful representation of the economic effects of risk management and could equally improve comparability among entities, despite the diversity in risk management practices would make comparability more difficult to achieve.

50. However, ESMA believes that mandatory application could cause significant inconsistencies with IFRS 9. The IASB includes in the DP an example of a bank which would not manage its interest risk at all. Our understanding is that all banks have a dynamic risk management, hence if the PRA is mandatory, all banks would have to apply it, which could be considered to be in contradiction with the classification and measurement criteria in IFRS 9 that require amortised cost measurement for certain financial instruments.
51. Irrespective of the scope chosen, mandatory application of the PRA would create significant challenges for entities whose risk management combines micro and macro hedge accounting practices (e.g. portfolio of fixed and floating rate assets with significant large exposures hedged individually in accordance with the general hedge accounting model of IFRS 9). In such circumstances, application of the PRA could limit entities when accounting for implemented individual hedges. Furthermore, this would introduce a significant change in hedge accounting as until now hedge accounting has been voluntary.

Question 17—Other eligibility criteria

(a) Do you think that if the scope of the application of the PRA were focused on dynamic risk management, then no additional criterion would be required to qualify for applying the PRA? Why or why not?

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

(ii) If the application of the PRA were optional, but with a focus on dynamic risk management, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

(b) Do you think that if the scope of the application of the PRA were to be focused on risk mitigation, additional eligibility criteria would be needed regarding what is considered as risk mitigation through hedging under dynamic risk management? Why or why not? If your answer is yes, please explain what eligibility criteria you would suggest and, why.

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

(ii) If the application of the PRA were optional, but with a focus on risk mitigation, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.

52. When determining additional eligibility criteria, ESMA believes that the IASB should further consider how an entity shall demonstrate that a portfolio is being dynamically managed and provide further guidance on starting and stopping the application of the PRA.
53. ESMA believes that, if the PRA reflects the actual market (interest rate) risk or if it can be seen as its faithful proxy, specific effectiveness test should not to be considered as it would bring back the com-

plexity of the hedge model included in IAS 39. However, the PRA should be based on recognition of any ineffectiveness in profit or loss when is incurred.

Question 18—Presentation alternatives

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

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

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

54. In assessing the proposed presentation alternatives, ESMA considers the understandability as the most relevant criterion. We thus favour the presentation approach that is presented in paragraph 6.1.4 (c) of the DP ('single net line item approach') for the statement of financial position and the approach detailed in paragraph 6.1.13 (a) of the DP ('actual net interest income approach') for the statement of comprehensive income.

Statement of financial position

55. ESMA supports the 'single net line item approach' as a line-by-line presentation would conflict with the open portfolio approach. Furthermore, ESMA doubts about the added value of assigning a revaluation adjustment to each individual portfolio, notwithstanding the complexity and arbitrariness of such assignment.

56. ESMA believes that the IASB should clarify the unit of account when developing the PRA as it would affect presentation. ESMA supports a presentation consistent with the offsetting principles included in IAS 32 *Financial Instruments: Presentation* and aggregation principles from IFRS 15 *Revenue from Contracts with Customers* (aggregation of portfolios with a debit balance and a credit balance should not be offset unduly). We also acknowledge that portfolios can be composed of both assets and liabilities, and assigning the revaluation adjustment to both categories separately would require tracking.

Statement of comprehensive income

57. ESMA supports presentation of the revaluation adjustment using the 'actual net interest income approach' as it reflects the impact of dynamic risk management and maintains presentation of recognised actual interest income. Furthermore, the stable interest income presentation is based on an artificial assumption that net interest income is stable over time despite changes in market conditions or any risk management ineffectiveness.

Question 19—Presentation of internal derivatives

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

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

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

58. In ESMA's view, internal derivatives should not be included in the PRA as the financial statements should reflect only transactions with external parties and assets and liabilities these transactions generate. ESMA believes that the gross presentation of internal derivatives in the statement of comprehensive income would increase the complexity and lower the understandability of financial statements. Furthermore, such presentation would be inconsistent with the existing consolidation principles that require elimination of intercompany income and expenses.

59. ESMA agrees with the objective of improving the usefulness of information about risk management in the financial statements. ESMA, however, believes that it may be more appropriate to reflect internal derivatives in the notes to the financial statements and in particular in segment reporting prepared according to IFRS 8 *Operating Segments* that can reflect assigning of internal derivatives to different units of the same reporting entity. In the example included in paragraph 4.2.13 of the DP the ALM earns an internal margin creating possibilities for earnings management between the segments solely on the basis of management decisions. We would expect different impacts on the segment reporting depending on the specific revaluation adjustment model used⁵.

60. Should the IASB decide to allow gross presentation of internal derivatives in the statement of comprehensive income, ESMA would suggest further clarifications on the scope, such as for example whether such gross presentation could also apply to non-derivative financial instruments (such as internal deposits and loans used to transfer position from ALM to trading). Furthermore, when presenting internal derivatives, externalisation of internal derivatives might be required in order to reflect the risk management activities at the level of the reporting entity,

⁵ Referring to the three approaches presented in paragraphs 4.2.18 – 4.2.20 of the DP.

Question 20—Disclosures

(a) Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views.

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

(c) What additional disclosures, if any, do you think would result in useful information about an entity's dynamic risk management? Please explain why you think these disclosures would be useful.

Question 21—Scope of disclosures

(a) Do you think that the scope of the disclosures should be the same as the scope of the application of the PRA? Why or why not?

(b) If you do not think that the scope of the disclosures should be the same as the scope of the application of the PRA, what do you think would be an appropriate scope for the disclosures, and why?

61. Overall, ESMA supports the proposed disclosures categories, but we are of the view that it is difficult, if not impossible, to discuss specific disclosure requirements before the overall objective of the model, its scope and basic features are fully developed in the ED. In light of the complexity of the PRA that would require the use of numerous assumptions and significant judgement, we believe that entity-specific disclosures are critical for providing useful information to users of the financial statements (please refer also to answers to questions 8 and 9).

62. We recommend the IASB, when developing disclosure requirements in the ED, to ensure that definitions used in relation to the PRA are consistent with those used in IFRS 7 *Financial Instruments: Disclosure*, and that those two sets of disclosure requirements do not overlap. Furthermore, we encourage the IASB to analyse which disclosures are already required by other reporting frameworks for regulated entities (e.g. Pillar III reports for credit institutions) and, if these are aligned, to explicitly allow cross-references or incorporation by reference to the information provided outside the financial statements in order to avoid disclosure overload.

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

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

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

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

Question 23—Removal of exposures from a managed portfolio

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

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

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

63. ESMA notes that as the PRA addresses dynamically managed open portfolios, it needs to allow changes to exposures in managed portfolios. Apart from the conceptual issues mentioned earlier, ESMA considers there is a need to balance out the benefits of reaching alignment between risk management and hedge accounting and the drawbacks brought into accounting when the model would become too complex.

64. The risk which is initially not included in dynamic risk management may later be included as a result of a risk management strategy. We believe that whenever such inclusion leads to a non-zero day one valuation, this should be recognised in profit or loss when occurred and disclosed appropriately.

65. Even though the assumption that once exposures are included within dynamic risk management they usually remain there until derecognition is valid, changes in the overall risk profile or changes in risk management strategy may lead to their removal from managed portfolios before derecognition. In these circumstances we believe that these exposures should be removed from a managed portfolio in order to continue to reflect dynamic risk management and the corresponding revaluation adjustment should be recognised in profit or loss when incurred and disclosed appropriately.

66. In addition, the relationship between the PRA and the general hedge accounting model in IFRS 9 should be clarified as the eligibility criterion for exposure's inclusion and removal from managed portfolio could favour optional application of the PRA and increase complexity of hedge accounting.

67. We encourage the IASB to explore whether the guidance developed for the ALM could be used as criteria when items should be included in or removed from the PRA.

Question 24—Dynamic risk management of foreign currency instruments

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

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

Question 25—Application of the PRA to other risks

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

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

68. The proposed PRA in the DP is focused on interest rate risk management within banks. As already stated in the response to questions 1 and 2, ESMA does not believe that at this moment, the PRA should be generalised. Instead, it should be understood as an exception and kept narrow and limited to interest rate risk management for open portfolios. Its extension could be considered following the post-implementation review of the PRA in the case this model proves to be efficient and effective.

69. With regards to dynamic risk management of foreign currency instruments, ESMA believes that the principles of IAS 21 *The Effects of Changes in Foreign Exchange Rates* could make the application of some of the aspects of the PRA inapplicable or even redundant. Furthermore, in other cases, general hedge accounting model in IFRS 9 (e.g. the cash-flow hedging) might be more appropriate for hedging of the foreign exchange risk.

Question 26—PRA through OCI

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

70. In the absence of a clear definition of the OCI and when it should be used, ESMA does not support the use of the OCI for the PRA. We note that neither the Conceptual Framework nor the DP address the definition of performance, what is the conceptual difference between the profit or loss and the OCI and under which circumstances recycling from OCI to profit or loss is appropriate.

71. As differences between the revaluation adjustment and the fair value of the hedging instruments in the PRA can only be caused by ineffectiveness or basis risk of the hedging instruments, ESMA does not see any reason to defer their recognition in profit or loss.

Question 14—Pricing index

Please note that ESMA does not respond to this question.