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13 October, 2014

Dear Françoise,

**IASB Discussion Paper 'Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging'**

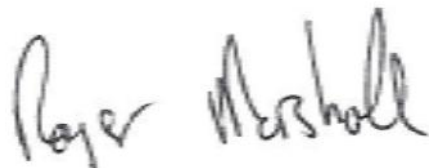
Thank you for providing the Financial Reporting Council (FRC) with the opportunity to comment on your draft comment letter (DCL) to the IASB on the Discussion Paper (DP) 'Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging'.

We broadly support the EFRAG DCL. In particular, we agree that the scope of a model for dynamic risk management should be limited to risk mitigation. However, as we believe there are areas of the DP, for example the equity model book, that we consider go too far in aligning hedge accounting with risk management, some of our views differ from those expressed in the EFRAG DCL.

We welcome that EFRAG is exploring alternatives but we consider that the IASB will need to develop and field test any alternative models further to determine whether they are suitable for broader application. Our response to the IASB is included for your information.

If you would like to discuss these comments, please contact Deepa Raval on 020 7492 2424.

Yours sincerely



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**Roger Marshall**  
**Chair of the Accounting Council**  
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30 Cannon Street  
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13 October 2014

Dear Mariela,

**IASB Discussion Paper ‘Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging’.**

This letter sets out the comments of the UK Financial Reporting Council (FRC) on the Discussion Paper (DP) ‘*Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*’.

We believe that the paper is a welcome contribution to the debate around accounting for dynamic risk management. The paper is helpful as it clearly articulates the risk management approach adopted by some banks in practice and considers the difficult issues around the accounting for core demand deposits, pipeline transactions and the equity model book (EMB).

However, we do not agree with the approach in the DP. We believe that it is inappropriate to develop a generally applicable model for macro hedge accounting in isolation from existing accounting principles. Instead of developing an entirely new and revolutionary approach aimed at fully reflecting bank’s risk management practices, the IASB should identify the barriers that exist in the current framework that prevent more meaningful and flexible macro-hedge accounting and then consider which of these barriers can be removed whilst still retaining the overall integrity of the accounting framework.

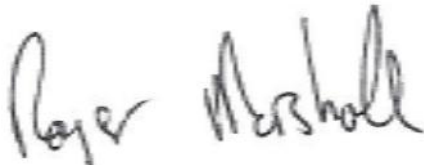
That said, we would encourage the IASB to continue to develop an improved macro hedge accounting model particularly as one of the weaknesses in the current IAS 39 macro hedge accounting model is that it does not reflect risk management in practice. However, we believe that the development of a macro hedge accounting model should be an evolutionary process that begins with identification of the problems with the IAS 39 macro hedge accounting requirements and is developed in such a way that builds on the principles in the general hedge accounting model in IFRS 9.

We recognise that all hedge accounting models are likely to involve making exceptions to generally applicable accounting principles; and there will always be a trade-off between consistency with these principles and more fully reflecting risk management processes. We believe that the Portfolio Revaluation Approach (PRA) is a step too far in aligning the accounting with an entity’s risk management activities.

Our overarching comments are set out on pages 3-5. We have also included detailed responses to selected questions in the DP in the Appendix. As we do not support the PRA, we have not commented on specific questions relating to the application of the approach.

If you would like to discuss these comments, please contact me or Deepa Raval on 020 7492 2424.

Yours sincerely

A handwritten signature in black ink that reads "Roger Marshall". The signature is written in a cursive style with a horizontal line underneath it.

**Roger Marshall**  
**Chair of the Accounting Council**  
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## Overarching comments

### *General approach*

1. We disagree with the approach that the IASB has taken in developing a solution for macro hedge accounting. In our view, we consider that a more appropriate starting point would be to identify the problems with the current IAS 39 fair value macro hedge accounting requirements. Following this analysis, we consider that the general hedge accounting model in IFRS 9 may provide a suitable basis for delivering improvements to the IAS 39 macro hedge accounting requirements.
2. We note that the problems with the IAS 39 macro hedging requirements are that they:
  - are inconsistent with existing risk management practice;
  - do not capture the dynamic nature of risk management, therefore open portfolios are forced into closed portfolios;
  - require specific hedge designation so there is a need to link hedged items to hedging instruments;
  - place restrictions on eligible hedged items (e.g. core demand deposits, pipeline transactions);
  - are limited to interest rate risk;
  - are operationally complex (e.g. tracking, amortisation); and
  - require gross designation where risk positions are managed on a net basis.
3. We believe that the IASB should develop a solution that focuses on relaxing some of the restrictions but one that also maintains some consistency with the IFRS 9 general hedge accounting model. Examples of areas where concessions could be made include:
  - core demand deposits;
  - accommodating open portfolios within IFRS 9; and
  - relaxing some of the requirements around designation.

### *General principles*

4. Although the IASB has positioned the PRA as a 'new model' for fair value macro hedge accounting, there are some general principles in the PRA that are consistent with the hedge accounting principles in IAS 39 and IFRS 9. We would support a model for fair value macro hedge accounting where the:
  - portfolio is the unit of account;
  - hedged item is re-valued for changes in a risk component only; and
  - changes in the fair value of the risk component are recognised in profit or loss.

### *Focus on risk mitigation*

5. We believe that the IASB should focus on developing an accounting solution for macro hedging rather than extending the scope to include unhedged exposures that banks include as part of their DRM.
6. We therefore disagree with the full scope PRA as it requires revaluation of all exposures (for the managed risk) that are dynamically risk managed regardless of whether the risk is offset by hedging instruments. This approach is likely to create artificial volatility in the

profit and loss account and in our view, is unlikely to result in meaningful information as it reflects in the profit and loss account the fair value changes relating to one risk only.

#### *Restrictions on eligible hedged items*

7. We recognise that hedge accounting will often require a need to depart from the general recognition, measurement and presentation principles in IFRS. However, we believe that a macro hedge accounting model needs to strike an appropriate balance between conceptual consistency, reflecting an entity's risk management activities and ensuring the approach is practicable.
8. Fully reflecting a bank's risk management processes might result in financial statements based on management's expectations, intentions or possibly even hopes for the future whilst undermining the reliable presentation of what has actually happened. The DP does not explain why such significant derogations from normal accounting principles are justified when considering a bank's approach to interest rate risk when they would not be appropriate when considering a non-financial institutions approaches to managing its operational risks.
9. We recognise that the inclusion of core demand deposits and pipeline transactions may be necessary steps towards ensuring that macro hedge accounting is closely aligned to a bank's risk management strategy.
10. However, before finalising a macro hedge accounting solution that incorporates some or all of these transactions, we believe the IASB should:
  - identify the barriers that exist in the current hedge accounting models;
  - consider the exceptions from normal accounting rules that would be necessary to remove these barriers; and
  - consider the impact of such exceptions on the comparability of the financial statements with those of other entities.

#### *Scope of the DP*

11. We believe that the scope of the DP and the IASB project is too narrow. The paper does not address macro cash flow hedge accounting which a number of banks currently use. In addition, whilst the DP acknowledges that the PRA is not restricted to interest rate risk or to banks, without further discussion of hedging activities in other areas it is difficult to see how the approach could apply to other commonly hedged risks (e.g. foreign exchange or price risk) or industry sectors.

#### *Reflecting risk management in the financial statements*

12. We believe that the IASB should not focus on a single solution for macro hedge accounting. We therefore do not support mandatory application of any fair value macro hedge accounting model particularly as hedge accounting itself is optional. In practice, entities currently use a range of techniques to reflect their risk management activities (e.g. macro cash flow hedge accounting, fair value option). We consider that companies should continue to have the flexibility to select the accounting tools that best reflect their risk management strategy.

### *Enhanced disclosure*

13. Hedge accounting is a complex area of financial instruments accounting and it will be difficult for the IASB to find a solution that provides relevant information to users on the effectiveness of its hedging strategies through recognition and measurement alone. We therefore recommend that the IASB supplements the macro hedge accounting model with enhanced disclosures for hedge accounting that provide users with a holistic picture of an entity's hedging activities.

### *Operational complexity*

14. We recommend that the IASB develops a simpler solution for fair value macro hedge accounting than set out in the DP.
15. In our view, the PRA as set out in the DP is just as complex as the existing IAS 39 fair value macro hedge accounting requirements and as a result is unlikely to lead to an improvement to the current accounting. We understand that banks have expressed the view that the PRA is likely to be difficult to operationalise due to the tracking and documentation requirements.
16. Paragraph 2.2.4 notes that for banks the PRA "would be less burdensome than current hedge accounting requirements". We are not convinced that this would be the case as there would be costs associated with banks becoming familiar with a new approach.
17. We note that a model which has fewer restrictions would be easier to implement. That said, we believe that there is a need for some boundaries between those transactions that qualify for hedge accounting and those that do not distinguish, at the very least, risk management from speculation.

### *Location for new hedge accounting requirements*

18. We would welcome some clarity from the IASB on the location for any new macro hedge accounting requirements. We are unclear as to whether the requirements will be included in a new macro hedge accounting standard or whether they will be included as part of IFRS 9, which would be our preference.
19. Currently entities have an option to apply the hedge accounting requirements in IAS 39 or IFRS 9; this option was made available in response to a concern that existing practice for macro cash flow hedge accounting (based on the implementation guidance in IAS 39) could no longer continue. It would be helpful to understand whether the IASB intends to re-visit this issue prior to the finalisation of any macro hedge accounting requirements.

## Appendix: responses to selected questions set out in the DP

### Question 3—Dynamic risk management

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

Yes. We broadly agree with the description of dynamic risk management (DRM) but we believe that a description of macro hedging and an objective for macro hedge accounting are necessary to set the discussion on DRM in context.

We suggest that macro hedging is simply described as ‘a risk management approach where a group of transactions are hedged on a portfolio basis’. A hedged item in this context could be a group of gross items or a net position.

A possible objective for macro hedge accounting is ‘to demonstrate in the financial statements, the extent to which hedging instruments offset the identified risk inherent in a portfolio’.

A key feature of DRM that is not included in the list in 2.1.2 is that the open portfolios often include management of net risk positions.

### 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 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.

(a) In order to bring hedge accounting closer to an entity’s risk management strategy, we can see an argument for providing an exception for pipeline transactions certainly for macro cash flow hedge accounting.

We do find this difficult to justify on a conceptual basis as these transactions do not meet the criteria for recognition as assets and liabilities. We also believe that there should be some consistency with the general hedge accounting model and we are unclear as to the justification for a lower hurdle for recognition of pipeline transactions compared to the general hedge accounting requirements where only 'highly probable forecast' transactions qualify.

A rules based approach, identifying particular types of transactions within a particular industry for which exceptions from the Conceptual Framework will apply, should only be followed with great care. There are limits to what financial statements can be expected to present, due in part to the unreliability of forecasts of the future and the need for comparability across entities and sectors. We recognise that, ultimately, pragmatic decisions will need to be taken about the scope of transactions for which macro hedge accounting can be applied. However, these should not be made by looking at bank's management of interest rate risk in isolation. Instead, the IASB should consider what analogous transactions or risk management processes exist in other industries before justifying any extensions to the scope of macro hedge accounting that reduce comparability.

(b) No. We do not support the inclusion of the EMB in a macro hedge accounting model as we disagree with the principle of including equity as a hedged item. In the absence of any broader process of justification, we consider that this is a step too far in aligning hedge accounting with an entity's risk management.

(c) Yes. We can support an exception to the general recognition and measurement principles in IFRS for core demand deposits. However, we reiterate the need for the IASB to perform a broader comparative analysis and to set out detailed justifications.

There are already precedents in financial instruments accounting for including cash flows on a behaviouralised basis. These include the requirements in IAS 39 that require analyses of the portfolio based on expected repricing dates and the expected loss impairment model.

### **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?

Yes. We consider that it would be appropriate to recognise the impact of changes in past assumptions of customer behaviour in profit or loss. This approach would be consistent with the accounting treatment for other changes in estimates e.g. loan loss provisioning, prepayments.

### **Question 8—Risk limits**

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

No. We do not consider that risk limits should be reflected in any accounting approach for dynamic risk management as banks use risk limits as an internal control to determine the level



of risk that is acceptable. All entities are willing to take on some level of risk in running their business but we are not convinced that this should be reflected in the accounting.

### **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 (ie Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (ie 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?

(a) We would recommend that the IASB re-visits the requirements in IAS 39 and IFRS 9 that restrict hedge accounting for interest-rate risk exposures at sub-LIBOR. This is an issue for banks as hedging the sub-LIBOR component of an interest bearing financial asset or financial liability is a risk management strategy applied by banks in practice. The inability to hedge sub-LIBOR exposures is one of the areas of the EU carve-out.

(b) No specific comments.

### **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.

(a) Our preference is for the single net line item presentation in the statement of financial position. Banks usually hedge net positions, therefore, this presentation would more closely reflect risk management activities. It also results in clearer presentation of the degree of offset between the change in fair value of the hedged risk and the derivatives used to manage the risk.

We do not support the line-by-line gross up, where assets and liabilities are adjusted for changes in the fair value of the hedged risk. Whilst we support for measurement purposes revaluation for the hedged risk, we consider that making adjustments to line items for changes in the fair value of the hedged risk results in presentation of assets and liabilities that are neither at amortised cost or fair value. In practice, where entities hedge on a portfolio basis, there may also be difficulties in allocating fair value changes between separate classes of financial assets and financial liabilities.

(b) We prefer the actual net interest income presentation in the statement of comprehensive income as this separately presents actual interest revenue/expense and the profit and loss impact of risk management activities. Whilst stabilising net interest income may be one of the objectives of risk management in a bank, presenting information in this way can obscure the actual transactions.

(c) N/a

### **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.

(a)-(c) At a high level, these disclosure themes are likely to provide relevant information for users. Once the IASB has further developed its model for macro hedge accounting, it would be helpful to see examples of disclosures for the purposes of assessing whether these are likely to result in useful information.

### **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?

(a) & (b) No. We believe that there is a need for the IASB to review disclosures relating to risk management activities comprehensively. We note that in its re-deliberations on the general hedge accounting model, the IASB decided to restrict the scope of the disclosures only to those exposures where hedge accounting is applied.

We consider that in order for disclosures in this area to be meaningful, they need to cover both general and macro hedge accounting as well as providing information on hedged exposures where no hedge accounting is applied or unhedged exposures that an entity considers as part of its risk management process.

### **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.

(a) Yes. Whilst we do not support the PRA, we believe that any model that the IASB develops for macro hedge accounting should have broader application. Some commodities firms for example have significant hedging activities which may be conducted on a portfolio basis. We have heard that commodities firms and insurance companies would like to make use of macro hedge accounting if an appropriate solution can be found.

(b) No specific comments.

#### **Question 26—PRA through OCI**

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

No. We do not support reporting fair value gains and losses relating to DRM through OCI as this would be a departure from the general principle of recognising fair value gains and losses on financial instruments in fair value hedging relationships through profit and loss. It would also be inconsistent with the treatment of revaluation gains and losses when fair value hedge accounting is applied under the general hedge accounting model.

We welcome that the IASB is considering the use of OCI as part of its Conceptual Framework project as this will be helpful in determining the basis for including items in OCI.