

STAFF PAPER

February 2015

IASB Meeting

Project	Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging		
Paper topic	Comment letter analysis		
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Purpose of paper

1. This paper summarises the main themes raised in the 126 comment letters received from respondents on the following sections of the Discussion Paper, *Accounting for Dynamic Risk Management – a Portfolio Revaluation Approach to Macro Hedging (DP/2014/1)*:
 - Section 1 Background and introduction to the Portfolio Revaluation Approach (PRA)
 - Section 2 Overview
 - Section 5 Scope
 - Section 3 The Managed Portfolio
 - Section 9 Alternative approach – PRA through other comprehensive income
2. This paper does not provide a quantitative analysis of the comments received or capture a complete record of all issues and recommendations raised in the comment letters. The paper is provided for information only, and no decisions are required from the IASB. The staff will present a more detailed analysis of each issue when it asks the IASB for decisions.

Section 1 Background and introduction to the portfolio revaluation approach (PRA)

Is there a need for an accounting approach for Dynamic Risk Management? (Question 1)

Responses to this question were mixed. Overall, many respondents suggested that there is a need for an accounting approach which addresses the difficulties arising in *the application of hedge accounting* when risk management is dynamic. However, this does not mean that they believe that there is a need for an accounting approach to represent dynamic risk management (hereafter 'DRM') *per se*.

3. Many respondents felt that the Discussion Paper (hereafter 'DP') was not clear about whether the ultimate purpose of the project is:
 - (a) to represent DRM *per se*; *or*
 - (b) to address the accounting mismatches which arise between assets and liabilities accounted for at amortised cost and derivatives accounted for at fair value through profit or loss (hereafter 'FVTPL'), which have been difficult to address through the application of hedge accounting when risk management is dynamic in nature.
4. Many respondents answered 'yes' to this question, saying that there is a need for a specific accounting approach to represent DRM in entities' financial statements. However, the staff found that at least some of those respondents supported the project only in the sense of 3(b) above.
5. Many other respondents answered 'no' to this question. However, some of those respondents mentioned that a specific accounting approach is not needed to reflect DRM *per se*, assuming that the intention of the IASB is 3(a) above. Therefore, despite answering 'no', the basic message is in fact similar to the some of the respondents who answered 'yes' (as described in the paragraph 4).
6. The staff observe that overall, respondents seemed to support the project in the sense of 3(b). This view is consistent with the view of many respondents about the scope of

the application of the PRA, ie that a scope focused on risk mitigation is preferred to a scope focused on DRM.

7. The reasons why many respondents support the objective set out in 3(b) can be summarised as follows:
- (a) while a full alignment of DRM and financial reporting could arguably be desirable in theory, it is extremely challenging to develop a single accounting approach to represent DRM, taking into account the diversity of DRM activities and techniques among entities. If the IASB wishes to do so, it needs to accept significant departures from the *Conceptual Framework for Financial Reporting* (hereafter ‘*Conceptual Framework*’). Enforceability, auditability and the possibility of earnings management were also cited as concerns;
 - (b) IFRS 9 requires that the majority of the banking book assets (eg loans) and liabilities (eg deposits) are measured at amortised cost, *regardless of* any net open risk positions between assets and liabilities. Consequently, under IFRS 9, any impact arising from net open risk positions is presented in profit or loss on an accrual basis. Respondents did not think that only a process of managing such exposures dynamically should result in complete remeasurement of the banking book exposures at current value in order to represent DRM in the financial statements;
 - (c) Hedge accounting has limitations when risk management is dynamic. As a result, entities have developed accounting approaches to accommodate their DRM activities with so-called ‘proxy hedge accounting.’ Proxy hedge accounting generally introduces a significant level of operational complexity, for example, treating open portfolios as a series of closed portfolios. Therefore it has resulted in the need for significant processes and systems to frequently re-designate hedge relationships. In addition, entities may not have sufficient qualifying hedged items to be able to designate proxy hedges under the general hedge accounting requirements. Hence, some entities have had no choice but to stop applying hedge accounting, which has led to a further disconnect between DRM and financial reporting.

These difficulties have also resulted in the EU carve-out, which is a sub-optimal solution. In addition, the multiple options for hedge accounting currently available under IFRS 9 and IAS 39 are not sustainable in the long run;

- (d) the application of the PRA to all dynamically managed exposures could lead to disclosure of information that could be considered as commercially sensitive.
8. Therefore, many respondents felt that there is a need for the IASB to resolve these issues. In their view, the IASB should also accept departures from the *Conceptual Framework* and accounting principles in the existing requirements to the extent that it achieves the aim of addressing accounting mismatches.
9. The staff observe, however, that suggestions on how the approach set out in 3(b) could be implemented under a dynamic environment, where no one-to-one relationship between the hedged item and the hedging instrument exists, were not sufficiently detailed in the comment letters.

Other Risks

10. The need for an accounting approach which addresses problems arising when risk management is dynamic was also raised by industries other than banks. For example respondents representing the utility and commodity sectors as well as insurance companies commented that they also undertake DRM activities and face similar issues to banks.

Insurance Companies

11. Insurance companies commented that they dynamically manage open portfolios of insurance contracts where new insurance contracts are added and existing policies are fulfilled or expire on a regular basis. However, they commented that it is uncertain how the approach proposed in the DP could be applied in the context of insurance contracts, as the DP is mainly focused on developing accounting approach which appropriately reflects the dynamic interest rate risk management in banks where the majority of assets and liabilities are accounted for at amortised cost while the hedging instruments (derivatives) are accounted for at FVTPL. According to them, the approaches discussed in the DP are not applicable to them, because the problems of

accounting mismatches that could arise from IFRS 4 phase II, which proposes current fulfilment value measurement for insurance contracts, are different from those for banks. Examples of accounting mismatches mentioned that could be created when applying proposals of IFRS 4 Phase II included:

- (a) if the Contractual Service Margin (hereafter ‘CSM’) is adjusted by changes in the financial guarantees embedded in insurance contracts, as recommended by some respondents, accounting mismatches may be created when those guarantees are hedged by the derivatives. This is because hedging instruments are reported at FVTPL, with no mechanism analogous to adjusting CSM; and
- (b) if the entity chooses to recognise the effect of changes in discount rates of the insurance liability in OCI, there would be an accounting mismatch in presentation between insurance liabilities and derivatives used for hedging purposes.

Some insurance companies suggested specific solutions to those issues:

- (a) an exceptional treatment for adjusting the CSM, which allows an entity to recognise the changes in the value of embedded financial guarantees that are hedged together with fair value changes in derivatives used for hedging purposes;
- (b) when an insurance company chooses FVOCI for financial assets and to recognise the effects of discount rate changes of insurance liabilities in OCI, the PRA is applied to the ‘net open risk position’ that is made up of these financial assets and insurance liabilities, with the revaluation effect with respect to the managed risk (eg interest rate risk) being recognised in profit or loss. This allows the profit or loss effects from the net open risk position to offset some, if not all of, fair value changes of derivatives.

12. Some insurance companies stated that accounting mismatches noted in paragraph 11 should be addressed within the insurance contracts project. If this is not possible, however, they suggested that the accounting for DRM should address these problems. Accordingly, they commented that the next step (eg Exposure Draft) of the project of accounting for DRM should only be after the finalisation of IFRS 4 phase II.

A view that does not support the project

13. Some respondents expressed their reluctance to support the project. According to them, it is too risky for the IASB to develop a new standard that overrides accounting conventions on which existing requirements are based, as entities' intentions and activities that are conducted with the label of DRM are extremely diverse and judgemental.

Has the DP correctly identified the main issues that entities currently face? (Question 2(a))

Many respondents commented that the DP had identified the main issues correctly and accurately. However, there were some comments about aspects that have not been sufficiently captured in the DP.

14. Respondents broadly agreed that in general, the DP had correctly identified the main issues that entities face when applying the current hedge accounting requirements to DRM.
15. Other comments included:
- (a) the analysis set out in the DP focused on dynamic interest rate management in banks. There should be more analysis on other risks and other industries where dynamic risk management is also undertaken as these industries face challenges similar to those faced by banks;
 - (b) the difficulties in the application of hedge accounting do not necessarily arise because risk management is being applied to open portfolios. Some of the restrictions in hedge accounting about eligibility of a hedged item arise regardless of whether risk management is static or dynamic;
 - (c) fact patterns analysed in the DP are not detailed enough for DRM within banks. For instance, the DP should have discussed in more detail issues such as:
 - (i) the use of cross currency interest rate swaps to manage the risks associated with a foreign currency denominated loans; and

- (ii) the use of credit default swaps to hedge the risks associated with credit exposures (eg corporate bonds); and
- (d) the DP has not analysed valuation practices for derivative instruments after the financial crisis (eg Credit Value Adjustments/Debit Value Adjustments, the effect of collateralisation such as Overnight Index Swap discounting and basis risk in foreign exchange (hereafter “FX”) related derivatives) and the resulting problems related to the application of hedge accounting.

Would the PRA address the issues identified? (Question 2(b))

Responses were mixed. Many respondents considered that the concept of the PRA was a positive move towards the alignment of DRM and financial reporting but many others expressed concerns about whether a scope focussed on DRM would be a step too far in pursuit of that alignment.

- 16. The views in support of the PRA included the following:
 - (a) it was a step forward in terms of a better alignment between DRM and financial reporting, thereby ultimately providing more useful information to users of financial statements (hereafter ‘users’). For instance, the PRA would enable users to understand the relationship between the source of profits and corresponding risks more clearly (see paragraph 6 of AP 4C); and
 - (b) eliminating the need for frequent re-designation of hedging relationships will reduce accounting complexity compared with the existing hedge accounting requirements.
- 17. Some of the respondents who supported the PRA, however, pointed out that whether the PRA really leads to improvement will depend on the interactions with topics discussed in the other sections in the DP. For example presentation, disclosure and scope of application of the PRA.
- 18. Other concerns and questions about the PRA included:

- (a) without sufficient and relevant safeguards, the PRA could allow for the ‘cherry-picking’ of exposures to be included which could result in earnings management;
- (b) since the PRA requires revaluations to be reflected in profit or loss, reliability of measurement is critical. The PRA would need to take behaviouralisation into consideration when identifying expected cash flows. Given the nature of behaviouralisation which is largely based on estimations made by an entity itself, there is a concern that revaluations under the PRA might not be reliable enough, which could possibly lead to errors in measurement which disguise the true performance of an entity. Auditability is also a concern;
- (c) the PRA is a valuation model, even if the scope is focused on risk mitigation. This is not always aligned with the objective of Asset and Liability Management (hereafter “ALM”) within banks which focuses on the risk of variability of future cash flows arising from exposures sensitive to interest rate risk with the objective to lock-in Net Interest Income (hereafter ‘NII’). The focus is not on managing the fair value of interest rate risk exposure.
- (d) The interaction between the PRA and cash flow hedge accounting, including so-called ‘macro cash flow hedge accounting’, is not clear. For example, where cash flow hedge accounting uses interest rate swaps to fix the interest coupon receipts from a portfolio of variable rate loans, the purpose is to lock-in interest receipts to fix the margin between assets and liabilities. In this case, the revaluation of the variable rate loans with respect to interest rate risk will not offset the fair value changes in interest rate swaps. Therefore, this project needs to address a wider spectrum of risk management strategies;
- (e) the fundamental distinction between ‘dynamic’ and ‘static’ risk management is not clear. Therefore, a new accounting approach for ‘dynamic’ risk management that is different from existing requirements would give rise to accounting arbitrages;

- (f) the PRA does not seem to be applicable to non-financial institutions, because their risk management broadly covers forecast transactions that do not arise from recognised assets and liabilities. The concept of ‘revaluing’ forecast transactions is not consistent with the *Conceptual Framework*; and
- (g) the PRA is not necessarily operationally easier than existing hedge accounting requirements, because existing risk management systems do not necessarily directly link with the systems for accounting purposes with respect of the hedged risk. In reality, complexities would arise in the application of the PRA, for a number of reasons including:
 - (i) information sets are different between DRM and financial reporting;
 - (ii) different portfolios are managed at different levels and/or sections within an entity due to different risk management objectives.

Section 2 Overview

Is the description of DRM accurate and complete? (Question 3)

Overall respondents stated that in general, the description in the DP of DRM is broadly accurate and complete. Respondents also made some additional comments.

- 19. Respondents mentioned that in general, the description in the DP of DRM is broadly accurate and complete. However, many respondents also made additional comments. These comments can be grouped in to three main categories, described below.
- 20. The first category of comments related to the fact that there are some additional aspects that characterise DRM. For instance:
 - (a) not only external exposures but also internal ones are included in DRM in many cases. Derivatives used for DRM purposes may be external and/or internal;
 - (b) DRM is undertaken not only by using derivatives but also by using non-derivative instruments; and

- (c) another important aspect of DRM is the ongoing transfer of risk between books (eg the banking book and the trading book in a bank).
21. The second category of comments highlighted concerns that the description of DRM may be too broad and generic to be applied in financial reporting. For instance, in respect of the description set out in 2.1.1 (a) of the DP ('risk management is undertaken for open portfolio(s), to which new exposures are frequently added and existing exposures mature'), respondents made the following points:
- (a) the meanings of words such as 'frequently' need to be more strictly defined;
 - (b) section 2.1.1 (a) could be interpreted as implying that the PRA cannot be applied to portfolios for which there are no expected new exposures to be added; and
 - (c) the word 'mature' should be replaced with 'are removed' because the word 'mature' does not cover prepayments.
22. The third category of comments raised concerns about the attempt to describe or define DRM itself. For instance:
- (a) the approach to describe or define DRM and then to develop an accounting model that is 'ring-fenced' from existing accounting requirements (eg hedge accounting) will be challenging;
 - (b) to describe or define DRM in a generalised way is fundamentally difficult, because different entities apply different strategies and techniques;
 - (c) in practice there is no clear distinction between 'dynamic' and 'static' risk management. Rather, there is a continuum of risk management strategies from purely static where a one-to-one designation is expected to last for the life of the hedging instrument and the hedged item to strategies that continuously and frequently change; and
 - (d) DRM is not only undertaken for open portfolios. For instance, some aspects of DRM explained in the DP (eg behaviouralisation, sub-benchmark instruments and risk limits) could be applied to an individual item (eg prepayment risk of a callable bond) and closed portfolios.

Section 5 Scope

Should the scope of the PRA be focused on DRM or risk mitigation? Should the application of the PRA be mandatory or optional? Is there a need for other eligibility criteria? (Question 15, 16 and 17)

Among those who supported the PRA, most respondents preferred a scope focused on risk mitigation and an optional application. Few touched upon the disadvantages of such an approach such as the aggravation of patchwork solutions and reduced comparability.

A scope focused on DRM or risk mitigation

23. Many respondents preferred a scope focused on risk mitigation to a scope focused on DRM. Their reasons can be summarised as follows:
- (a) the objective of the project should be ‘macro hedge accounting’, which addresses accounting mismatches between assets and liabilities that are accounted for at amortised cost and derivatives that are accounted for at FVTPL. Currently, entities such as banks tend to rely on proxy hedge accounting in order to address accounting mismatches due to the limitations in the current hedge accounting model when applied to DRM scenarios. The purpose of the project should be to address this problem. Revaluing all dynamically managed risk exposures is inconsistent with this objective;
 - (b) many banks manage current and future NII based on an accrual (or cash flow) basis. This means that interest rate risk in the banking book assets and liabilities and the effects of DRM on future NII should be reported in profit or loss in the future periods, as they unfold over time. They say this view is consistent with IFRS 9 *Financial Instruments*, which requires both financial assets and liabilities to be accounted for at amortised cost for the majority of the banking book exposures (eg loans and deposits), regardless of the existence of the net open interest rate risk positions between assets and liabilities;

- (c) even though the profit or loss under a PRA with a scope focused on DRM presents the effect of DRM on future NII, this is merely ‘point-in-time’ information;
 - (d) under a PRA with a scope focused on DRM, the profit or loss of a bank that dynamically manages interest rate risk in the banking book, may report more profit or loss volatility than another bank that does not manage interest rate risk at all. This is counterintuitive; and
 - (e) for the purpose of conveying useful information about the ‘holistic’ picture of interest rate risk for future NII, including the effects of both hedging and non-hedging for the net open positions, appropriate disclosures would be a more suitable mechanism than altering the reporting requirements for the statement of comprehensive income and statement of financial position. In that respect, some also mentioned that it would be worthwhile for the IASB to consider reviewing *IFRS 7 Financial Instruments: Disclosure*. For instance, some commented that disclosures of sensitivity of NII before and after DRM would be the best way to convey useful information to users;
 - (f) if the focus is on DRM, then a clear definition of DRM will be necessary, which will be difficult;
 - (g) the PRA with a scope focused on DRM assumes that banks manage interest rate risk at a precise level enough to enable revaluations of all dynamically managed exposures, but it is not the case.
24. Some respondents supported a scope focused on DRM. Their views included:
- (a) the IASB has made progress by recognising that a scope focused only on risk mitigation is not the optimal solution. The appropriate reflection of DRM activities in the primary financial statements is important for the purposes of usefulness of information, comparability and a level playing field;
 - (b) both hedging and keeping open positions unhedged are important drivers of NII, which is the dominant revenue source for commercial banks. The PRA with a scope focused on risk mitigation is similar to the general hedge accounting model based on static one-to-one relationships and is

inconsistent with DRM. This approach could allow for the arbitrary selection of hedged exposures in order to achieve favourable results in profit or loss (see paragraphs 12 and 13 of AP4C);

- (c) in the case of industries such as the banking sector, where entities are under a regulatory obligation to maintain robust risk management processes, the PRA with a focus on DRM provides transparent and comparable information, because these entities are required to apply risk management in the ordinary course of business. Therefore, the counterintuitive scenario explained in 23 (d) of an entity which does not undertake any risk management at all, reporting no profit or loss volatility, is irrelevant;
 - (d) the PRA with a scope focused on DRM is operationally easier than a scope focused on risk mitigation.
25. Some respondents commented that a scope focused on DRM is conceptually superior but that a scope focused on risk mitigation is a more practical solution. Their reasons include:
- (a) a scope focused on DRM would be superior if it could reflect the DRM activities of all banks. If this is not the case, however, a scope focused on risk mitigation is a practical approach, as long as sufficient safeguards are established in order to prevent cherry-picking of exposures to be included in the PRA;
 - (b) a scope focused on DRM makes it easier to conceptually justify some key features of the PRA such as the inclusion of core demand deposits. However, profit or loss volatility that arises from intentionally unhedged positions is inconsistent with how banks describe their objective of DRM. Accordingly, a scope focused on risk mitigation would probably be more appropriate as a compromise.
26. One of the user groups commented that if the purpose of the project is a targeted improvement of hedge accounting, then the scope should be focused on risk mitigation. However, if the purpose is to develop a generic model to be broadly applicable to a business activity that is typical in banks, namely earning profits by

investing deposits taken in assets that carry different maturities or durations, then the scope should be focused on DRM.

27. A concern was raised by the insurance sector that neither a scope focused on DRM nor one focused on risk mitigation is satisfactory, because both alternatives are based on an analysis of banks whose assets and liabilities are mainly amortised cost items, whereas under IFRS 4 Phase II, insurance liabilities are measured at their current fulfilment value. They suggested that accounting solutions need to be developed in order to address problems specific to the insurance industry.
28. The staff observe that few respondents who supported a scope focused on risk mitigation touched upon the disadvantages of that approach discussed in the DP - for example, the possibility that it aggravates the existing challenges resulting from patchwork hedge accounting solutions (see 5.2.24 of the DP).
29. Most respondents who supported a scope focused on risk mitigation also mentioned that an entity should be allowed to apply the PRA in conjunction with IAS 39/IFRS 9 hedge accounting. Their views are that as DRM activities are diverse, different entities should be allowed to choose accounting solutions that they believe better reflect their economic position. Some banks also mentioned that they have a strong incentive to continue to use IAS 39 /IFRS 9 hedge accounting, because they have already developed sophisticated systems to operationalise the application of hedge accounting even under a dynamic environment.
30. Most of the respondents commented that their answers would not change when considering risks other than interest rate risk (commodity price risk and FX risk).

Sub-portfolio approach or the proportional approach when the scope is risk mitigation

31. Not many respondents who supported a scope focused on risk mitigation expressed a preference between the sub-portfolio approach and the proportional approach. The staff observe, however, that banks tended to prefer the sub-portfolio approach to the proportional approach, because the former is operationally simpler. It was mentioned that this is because existing systems are developed based on IAS 39/IFRS 9 hedge accounting which is more consistent with the sub-portfolio approach. A few banks

mentioned that the operational costs of implementing the proportional approach would be higher than those involved with implementing the current hedge accounting requirements.

32. One of the representative bodies of banks commented that if a bank manages interest rate risk of all banking book exposures on the basis of a single portfolio, then the single portfolio should not be broken down into sub-portfolios artificially.
33. On the other hand, some non-preparer respondents commented that the proportional approach is more transparent, because the choice of the sub-portfolios to be included in the PRA is arbitrary.

Operational feasibility of the PRA with a scope focused on risk mitigation

34. Among respondents who supported a scope focused on risk mitigation, it was broadly recognised that the approach is operationally more challenging than that with a focus on DRM. This is due to the following:
 - (a) onerous tracking and amortisation requirements will unavoidably arise due to the fact that risk mitigated exposures can change frequently over time under a dynamic environment;
 - (b) limited linkage between information generated for risk management purposes and financial reporting.
35. However, some banks commented that tracking and amortisation is not a significant concern because they have already developed sophisticated systems to deal with these issues under IAS 39/IFRS 9 hedge accounting.

Mandatory or optional application of the PRA

36. Most of the respondents support an optional application of the PRA, regardless of the scope alternatives. Their views are summarised as follows:
 - (a) as long as the application of IFRS 9 hedge accounting is optional, the PRA also needs to be optional as it is a method of ‘macro hedge accounting’;

- (b) an entity should be given broad flexibilities such as fair value and cash flow hedge accounting, the PRA and fair value option in order to best reflect their business and risk management activities.
37. The staff observe that few respondents who supported an optional application of the PRA commented on the disadvantages of that approach discussed in the DP (5.3.3 of the DP) such as reduced comparability.
38. A few prudential and securities regulators commented that even though mandatory application has advantages in terms of comparability and its ability to prevent a patchwork application of hedge accounting, inconsistency with IFRS 9 hedge accounting which permits voluntary application would be an issue. One of them commented that it would be more practical if the PRA was optional, at least initially. At the same time, they emphasised the importance of discipline in order to ensure the consistent application of the PRA and safeguards that prevent cherry-picking of accounting models in order to achieve favourable accounting results.
39. One bank supported mandatory application in order to achieve better alignment between risk management and financial reporting and enhanced comparability, if pipeline transactions, EMB, core demand deposits and the identification of sub-benchmark instruments as benchmark instruments are all accepted. According to that bank, allowing entities to choose between IFRS 9 and the PRA will not yield a closer alignment between risk management and financial reporting.

Additional eligibility criteria

40. A smaller number of respondents commented on this question than other questions in the section 5.
41. Some respondents mentioned that if the scope is a focus on DRM then no additional eligibility criteria would be necessary.
42. Some others mentioned that once an entity started to apply the PRA, it should not be allowed to stop it unless the entity is no longer engaged in DRM.

Suggested alternative approaches

43. Reflecting concerns about the PRA as described in paragraph 18, some respondents have suggested that the IASB should explore approaches other than the PRA.
44. For example, some respondents suggested that a more realistic approach for the IASB would be to amend the ‘fair value hedge accounting for a portfolio hedge of interest rate risk (AG114 - AG132 of IAS 39)’ to make departures from existing requirements and the *Conceptual Framework* as limited as possible, rather than developing a new accounting approach for DRM. These respondents expressed a number of views, including:
- (a) the new accounting model should be an exception to the general accounting requirements. Therefore, the application of the new model should not be extended to other risks and industries. However, it is important to address the issues that have led to the carve-out in the EU;
 - (b) if the IASB decides to make this project a more limited which only aims to address some of the difficulties in the existing hedge accounting requirements, it would be a more effective use of the resources of the IASB and its respondents rather than embarking on a fundamentally different approach. If the eligibility of hedged items were expanded to, for example, core demand deposits, sub-benchmark instruments and bottom layer approaches, existing hedge accounting would be able to better reflect risk management practices in these important areas and would go some way toward achieving the overall goals;
 - (c) one of the advantages of the PRA is that it allows for designation on a net basis. However, if the scope of the PRA is risk mitigation, designation of a targeted gross position selected from a bank’s assets or liabilities based on existing hedge accounting requirements might be operationally easier.
45. Another respondent recommended to separate the project to a standard-level project on targeting improvements to the ‘fair value hedge accounting for a portfolio hedge of interest rate risk (AG114 - AG132 of IAS 39)’ as a first priority and a research project on the accounting for DRM as part of the on-going work on the *Conceptual Framework*.

46. Others suggested that the IASB should explore accounting approaches that can achieve the removal of accounting mismatches whilst ensuring operational feasibility at the same time. Suggested approaches include:
- (a) If it can be demonstrated that derivatives for risk mitigation purposes do serve to mitigate the risk of say the sensitivity of future NII to changes in interest rates, then the cash flows of those derivatives are used to calculate adjustments to offset fair value changes arising from derivative instruments. For instance:
 - (i) the adjustment to reflect the change in fair value of the hedged item due to a change in the managed risk is the lower of:
 - i. the change in fair value of the hedged item due to a change in the managed risk; and
 - ii. the change in fair value of the derivatives used for the purposes of risk mitigation.
 - (ii) use these derivatives to calculate the revaluations of exposures with respect to the managed risk ie the revaluation adjustment is equal to the change in fair value of derivatives used for the purposes of risk mitigation except for the effects of non-managed risks such as counterparty risk;
 - (b) deferral of fair value changes of derivatives to OCI (but respondents who suggested this approach commented that this approach is worth exploring only if prudential regulators provide a filter which removes volatility in regulatory capital);
 - (c) cost accounting for derivatives.
47. The staff observe that these alternative approaches proposed by respondents were more in the nature of directions to be considered and are not fully developed solutions.

Section 3 The managed portfolio

Should pipeline transactions be accepted in the PRA? (Question 4(a))

Mixed views were expressed about the inclusion of pipeline transactions in the PRA. Respondents who currently include them in their DRM activities supported their inclusion because this enables them to present their DRM activities more directly. In contrast, however, many other respondents have expressed concerns over the inclusion of pipeline transactions because of reasons such as consistency with the *Conceptual Framework*.

48. The respondents who expressed the view that the pipeline transactions should be accepted if it is considered by an entity as part of DRM provided a number of reasons, including:
- (a) as long as the purpose of the project is to achieve a better alignment between DRM and financial reporting, *all* aspects or techniques of DRM should be accepted. Otherwise, an entity will be required to depend on accounting solutions such as proxy hedge accounting, thereby increasing complexity and potentially reducing the usefulness of financial reporting. This also means that an entity may continue to depend on non-GAAP information to convey information regarding DRM to users. For the purpose of a *direct* representation of DRM activities, conceptual concessions need to be accepted;
 - (b) from a DRM perspective, there is no substantive difference between firm commitments (eg loan commitments) and pipeline transactions. Therefore, pipeline transactions should be accepted in the PRA as firm commitments are eligible hedged items for fair value hedge accounting; and
 - (c) periods during which exposures are pipeline transactions are usually short. Therefore, the problem of revaluing them with profit or loss effects would be practically small.

49. Some respondents have expressed the view that even forecast transactions which are not pipeline transactions (eg expected renewals of exposures, expected issues of debt instruments and insurance products) should be included in the PRA. They say that DRM does not necessarily distinguish pipeline transactions and forecast transactions that are not pipeline transactions. Therefore, both types of transactions should be accepted for better alignment between DRM and financial reporting.
50. The respondents who expressed the view that pipeline transactions could be accepted but only under strict conditions provided a number of reasons, including:
- (a) for the sake of comparability among entities, disclosures around the purposes, assumptions and effects of DRM on pipeline transactions are important if the IASB accepts the inclusion of pipeline transactions;
 - (b) if the IASB accepts pipeline transactions in the PRA, it needs to clearly define the boundary between pipeline transactions and forecast transactions. This is critical not only for interest rate risk but also other risks;
 - (c) auditors need to be mindful of derivatives used for DRM purposes to hedge unrecognised items such as pipeline transactions in order to prevent earnings management; and
 - (d) the revaluation of pipeline transactions would be affected not only by the managed risk (eg interest rate risk) but also by other idiosyncratic factors. Therefore, pipeline transactions should be accepted only when the revaluation is proven to be sufficiently accurate.
51. The respondents who considered that pipeline transactions should not be accepted provided a number of reasons, including the following:
- (a) pipeline transactions are not eligible hedged items under IFRS 9 fair value hedge accounting. In their view the proposals in the PRA need to be consistent with the hedge accounting requirements in IFRS 9 and consequently the inclusion of pipeline transactions should not be accepted. It is a step too far in an attempt to achieve better alignment between DRM and financial reporting;

- (b) cash flow hedge accounting already appropriately reflects DRM activities for pipeline transactions when they meet specific conditions;
- (c) disclosures would be a more appropriate way of providing information about DRM activities related to unrecognised items such as pipeline transactions; and
- (d) pipeline transactions are clearly different from firm commitments in that an entity has no contractual obligation to fulfil them.

52. One respondent presented a counter proposal which suggested an accounting mechanism to defer fair value changes of derivatives to OCI rather than revaluing pipeline transactions in order to avoid tensions with accounting concepts. The respondent stated this is not cash flow hedge accounting, in that it does not address cash flow variability risk.

Should Equity Model Book be included in the PRA? (Question 4(b))

Mixed views were expressed about the inclusion of Equity Model Book (hereafter ‘EMB’). Reasons behind these mixed views were in part similar to those given in response to the question on pipeline transactions.

53. Reasons supporting the view that EMB should be included in the PRA if it is considered by an entity as part of DRM included:
- (a) as long as the purpose of the project is to achieve a better alignment between DRM and financial reporting, all aspects or techniques of DRM should be accepted in order to allow a more faithful representation of the DRM activities. This is the same reason outlined in respect of pipeline transactions (see paragraph 48 (a));
 - (b) taking an example of a bank holding only variable rate assets and liabilities, the difference between the assets and liabilities will give rise to NII risk which is funded by equity. As EMB captures that *deemed* fixed interest rate risk more faithfully than proxy hedge accounting applied only to a portion of variable rate assets on a gross basis, it should be included in the PRA.

In addition, cash flow hedge accounting as a proxy cannot address volatility in equity, even if it can address volatility in profit or loss.

- (c) due to the recent regulatory changes which require increasing levels of regulatory capital in the form of equity to be held by banks, many now face difficulties in finding eligible hedged items for proxy hedge accounting (eg cash flow hedge accounting applied to variable rate assets). Therefore, more banks are finding it difficult to achieve hedge accounting under the current requirements. This means that economic hedges using risk management instruments (eg interest rate swaps) to stabilise NII could lead to more profit or loss volatility. In addition, the inability to designate EMB reduces comparability between banks, because some banks cannot depend on proxy hedge accounting due to the lack of eligible items, while others can. Therefore, including EMB in the PRA is a direct way of representing DRM and should be accepted;
 - (d) if the scope of the PRA is focused on DRM, the importance of including EMB increases because proxy hedge accounting can no longer be used;
 - (e) a bank does not necessarily 'revalue' EMB as part of its DRM. However, given the fair value measurement of derivatives used for DRM purposes, revaluation of EMB to offset fair value changes of derivatives would provide better alignment between financial reporting and DRM; and
 - (f) from a DRM perspective, EMB in essence is no different from core demand deposits, in that an entity needs to determine the risk profile of the investments (eg loans) that are funded with non-interest bearing instruments with indefinite terms. Therefore, EMB has sufficient justification to be accepted in the PRA similar to core demand deposits.
54. Some respondents supported the inclusion of the EMB but only with strict conditions (eg disclosures), for the sake of comparability among entities and as a pragmatic compromise between DRM and financial reporting concepts.
55. The reasons supporting the view that EMB should not be accepted included:
- (a) EMB is not an eligible hedged item under IFRS 9 fair value hedge accounting. In their view the proposals in the PRA need to be consistent

with the hedge accounting requirements in IFRS 9 and consequently the inclusion of EMB should not be accepted. It is a step too far in an attempt to achieve better alignment between DRM and financial reporting;

- (b) cash flow hedge accounting applied to variable rate exposures already appropriately reflects DRM activities for EMB;
- (c) disclosures would be a more appropriate way of providing information about DRM activities related to EMB;
- (d) acceptance of EMB would mean a departure from the *Conceptual Framework*, where equity is defined as the residual interest in the assets of the entity after deducting its liabilities;
- (e) even if management includes EMB in DRM activities, EMB is a representation of a *target* of equity return by management. Management has no contractual obligation to compensate equity holders for providing funds to an entity. The return to equity holders is not to be seen as an interest expense. Financial reporting in general should not reflect a mere internal target by management;
- (f) the revaluation of EMB is too judgemental to accept for accounting purposes. For instance, it would be difficult to objectively test the appropriateness and reliability of the management assumptions used. Auditability and enforceability are also cited as concerns, as is the possibility of earnings management; and
- (g) the absence of any fixed or guaranteed return on equity is critical as it is this feature that represents the fundamental nature of equity as a loss absorption function. Thus, assuming a fixed return on equity contradicts with this very nature of the equity and consequently should not be considered for accounting purposes.

56. One respondent presented a counter proposal which suggested an accounting mechanism to defer fair value changes of derivatives to OCI rather than revaluing EMB in order to avoid tensions with accounting concepts. The respondent stated this is not cash flow hedge accounting, in that it does not address cash flow variability risk.

For the purposes of applying the PRA, should the cash flows be based on a behaviouralised rather than contractual basis? (Question 4(c))

There was broad support among respondents for the PRA to be based on behaviouralised rather than contractual cashflows. At the same time, many commented on the need for safeguards, recognising the risks inherent in behaviouralisation such as the lack of comparability, earnings management, auditability and enforceability.

57. The reasons supporting the view that behaviouralisation should be accepted included:
- (a) DRM is in many cases based on behaviouralised cash flows rather than contractual cash flows. Therefore, behaviouralisation should be accepted in the PRA in order for financial reporting to have a better alignment with DRM. It also provides operational relief to preparers;
 - (b) there are already some examples within existing IFRSs requirements that are based on expected cash flows. Examples include;
 - (i) fair value hedge accounting for a portfolio hedge of interest rate risk (AG114-132 of IAS 39);
 - (ii) impairment of revolving credit facilities (5.5.20 and B5.5.38-40 of IFRS 9);
 - (c) concerns about behaviouralisation might be mitigated if the statement of financial position presentation is the ‘single net line item,’ because the location where the effect of behaviouralisation is reflected is more easily identified and understood by users.
58. Some industries outside the banking sector commented that they also use behaviouralisation as a risk management technique. For instance, some insurance companies commented that management of lapse risk is similar to dynamic interest rate risk management of banks for mortgage portfolios. Therefore, behaviouralisation should be accepted for insurance companies as well.

59. Many respondents commented that behaviouralisation can be accepted only if relevant safeguards such as appropriate documentation and guidelines are put in place along with sufficient disclosures in respect of the modelling and assumptions used. Otherwise, problems such as a lack of comparability, earnings management and enforceability would arise.
60. A limited number of respondents commented that the PRA should not accept behaviouralisation. Their reasons included:
- (a) it is difficult to decide whether deviations between previously expected future behaviours and currently observed actual behaviours are caused by changes in behaviours *or* imperfections in previous expectations. This is because there are a large number of unobservable factors that influence behaviours of customers; and
 - (b) the behaviouralisation approach introduces a considerable degree of subjectivity in financial reporting, which will be difficult for auditors to audit and consequently for users to trust. The expected inconsistency of approach across entities may lead to a lack of comparability. These challenges could be partly addressed by detailed qualitative and quantitative disclosures including modelling assumptions. However, these assumptions are likely to appear reasonable until the economic reality suddenly proves them wrong, thereby undermining confidence in financial reporting.
61. Some respondents commented that behaviouralisation alone will *not be enough* to achieve profit or loss stability. Their comments included the following point:
- (a) this project should propose accounting solutions that address any remaining profit or loss volatility that arises from accounting mismatches even after behaviouralisation. For instance, suppose a mortgage portfolio with 20 year contractual maturity is behaviouralised as that with 12 year maturity, that is hedged by interest rate swaps with 8 year maturity. Revaluation with behaviouralisation correctly captures economic risk of the mortgage portfolio. However, profit or loss volatility still remains when the risk management purpose is to hedge only the first 8 years of interest rate risk in the mortgage portfolio using 8 year interest rate swaps, because the

behaviouralised maturity of the mortgage portfolio (12 year) is longer than that of the interest rate swap (8 year).

When risk management instruments with optionality are used to manage prepayment risk, how should the PRA consider this DRM activity? (Question 5)

Some respondents commented that this is not a major issue in practice because many banks do not use risk management instruments (derivatives) with optionality. However, many others commented that, if such instruments are used then there is a need for an accounting solution to cope with this issue whilst acknowledging that it will be difficult for the PRA to address this.

62. Some respondents mentioned that this issue is not a major issue in practice because:
- (a) banks do not usually use risk management instruments with optionality (eg swaptions) due to cost reasons. They typically behaviouralise cash flows based on expected prepayment amounts and in many cases the risk of *changes* in the prepayment amounts and timing is not managed; and
 - (b) in those jurisdictions where loans are primarily variable rate managing prepayment risk is not a major issue; and
 - (c) in some jurisdictions, as the decrease in NII due to prepayment is compensated by a penalty fee hedging for prepayment risk is not considered necessary.
63. Many other respondents commented that, if such instruments are used, the PRA should propose accounting solutions that reflect the hedging of onesided risk when prepayment risk in exposures (eg prepayable mortgages) is hedged with derivatives with optionality (eg swaptions). This would achieve profit or loss stability in line with the risk management view. Suggestions included:
- (a) under a declining interest rate scenario the effect of revaluation of exposures is offset with fair value changes in risk management instruments with optionality, while fair value changes of those risk management

instruments with no corresponding offsetting revaluation under different scenarios should be reflected in NII over time; and

(b) amortisation of the time value of options.

64. However, the staff observe that the above suggestions do not deal specifically with how they might work under a dynamic environment where multiple options with different strikes are used along with derivatives without optionality (eg plain-vanilla interest rate swaps), and where there is no one-to-one relationship between the hedged item and hedging instrument.
65. Some respondents mentioned that if the management of prepayable exposures is based on an option pricing model and the pricing is reasonably accurate in reflecting customer behaviours, option valuations similar to those used to value derivatives with optionality is a good way to represent DRM.
66. Some respondents commented that there was no practically workable solution available to reflect only downside risk with respect to prepayment risk when prepayable exposures are dynamically managed with derivatives with and without optionality. These respondents considered that the only solution would be for the PRA to recognise all fair value changes in derivatives (including the price changes associated with optionality) and revaluations of exposures for both upside and downside, in profit or loss. There was a separate view given which considered that the inability to address this issue was one of the shortcomings of the PRA.

Should the impact of changes in past assumptions of customer behaviour be recognised in profit or loss through the application of the PRA when and to the extent they occur? (Question 6)

Many respondents stated that the impact of changes in past assumptions of customer behaviours should be recognised in profit or loss through the application of the PRA when and to the extent they occur, as long as relevant safeguards are in place to prevent earnings management. Many other respondents, especially banks, expressed a view that a change in behavioural assumptions should not lead to immediate profit or loss volatility.

67. Many respondents expressed views that the impact of changes in past assumptions of customer behaviour should be recognised in profit or loss through the application of the PRA when and to the extent they occur. Their views included:
- (a) this is a natural consequence of the inclusion of cash flows in the PRA on a behaviouralised basis;
 - (b) this treatment is consistent with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
68. However, many who hold the above mentioned view also commented on the need for safeguards such as disclosures in order to minimise the risk of earnings management. Disclosure topics suggested included a description of the changes together with the rationale behind them, the line items affected and their impact (including quantification of the same).
69. Many other respondents, especially banks, stated that this issue is not relevant if the bottom layer approach is applied to behaviouralised exposures such as prepayable mortgages, if the scope is focused on risk mitigation. This is because the changes in assumptions on behaviouralisation do not impact the bottom layer, while upper layers that would be affected, are not included in the PRA. They also point out that the impact of changes in past assumptions should not affect profit or loss, unless the ceiling of the bottom layer is breached, because the entity's risk management view is *not* to hedge the upper layers that are susceptible to changes in customer behaviours.
70. Some respondents, especially banks, stated that the effect of the changes in assumptions that lead to unhedged positions should not increase profit or loss volatility.
71. In the same vein, some respondents mentioned that the effect of changes in behaviour assumptions should be reflected *only when* hedging activities using derivatives have also changed in response. According to them, this treatment is consistent with a scope focused on risk mitigation in that the unhedged positions should not result in increased volatility in profit or loss. In their view, the changes in behavioural assumptions (eg the mortgage prepayment assumption) can be driven not only by the managed risk (eg interest rate risk) but also by other factors (eg divorce). They also

say that as changes in prepayment risk may not be related to the managed risk, the impact should be reflected in NII over time.

72. Some respondents commented that that the effects of behaviour changes should be reflected in NII over time because these effects are captured only in the business units, not in ALM.

If a bottom layer or a proportion approach is taken for DRM purposes, should it be permitted or required within the PRA? (Question 7)

Many respondents commented that a bottom layer approach should be incorporated in the PRA as it is consistent with a risk mitigation view in that it avoids profit or loss volatility arising from unhedged risk positions.

73. Many constituents advocate that the PRA should permit a bottom layer approach (hereafter 'BLA'). Their views are summarised in the following paragraphs.
74. Respondents have argued that the BLA is consistent with the risk management view of many entities, especially banks. Considering the case of a a prepayable mortgage portfolio as an example, many banks use the BLA in their risk management by choosing to hedge only the repricing risk arising from changes in interest rates and not to hedge the prepayment risk in the portfolio. This is achieved through hedging a bottom or residual layer in the portfolio that is not impacted by prepayments. The BLA allows banks to ignore that prepayment risk in the hedged layer, unless the ceiling of the layer is breached. This also explains the prevalence of the use of interest rate swaps without optionality (eg plain-vanilla swaps) in order to dynamically risk manage prepayable mortgages. In their view any accounting approach should not lead to profit or loss volatility reflecting unhedged risk positions. Therefore, the PRA with a focus on risk mitigation should accept the BLA.
75. Many of those who express the above-mentioned view recognise that the BLA cannot avoid operational difficulties, i.e. tracking and amortisation. However, in general, they believe that its benefit (stability in profit or loss) outweighs the operational burdens.

76. However, some respondents have understood the BLA approach in a different way from that which is discussed in the DP. They consider that the BLA provides operational relief to a great extent as it does not need tracking and amortisation, while the DP suggests that this will not be possible. The staff observe that this difference in understanding of the BLA may have arisen because the DP envisages that the bottom layer is revalued in order to present the effects of DRM, while those respondents who have the above-mentioned view see the BLA as a way to allow an entity not to recognise any profit or loss volatility at all, unless the ceiling of the bottom layer is breached. They explained their thoughts saying, ‘no profit or loss should arise in the case of an under-hedge.’
77. A few respondents who support the BLA also commented that the approach is conceptually similar to a ‘first payments made/received’ approach in the context of cash flow hedge accounting. Under the ‘first payments made/received’, an entity will typically consider its total forecast amount of payments for the period when determining the amount of ‘first payments’ to designate in the hedging relationship. However, an entity does not subsequently recognise ineffectiveness if the total forecast (or actual) amount of payments for the period changes from its initial expectations, as long as the designated ‘first payments’ layer is still expected to occur (or actually occurs).
78. Some respondents opposed the BLA. Their views included:
- (a) the BLA neither for economic risk management nor for accounting purposes is able to reflect DRM and its effects correctly. For instance, if a reduced prepayment leads to more unhedged positions, it means the bank is more exposed to interest rate risk. The BLA fails to capture this economic reality. In addition, the BLA contradicts the view that the change in customer behaviour should be captured in the application of the PRA. The BLA would make it more difficult for users to understand the effects of DRM;
 - (b) the BLA ignores prepayment risk. However, this is incompatible with the concept that the PRA should reflect behaviouralisation;
 - (c) the BLA is a ‘work-around’ only for accounting purposes; and

- (d) one of the advantages of the PRA is that it is applicable to net open risk positions that comprise both assets and liabilities. However, the BLA is applicable only to gross positions.
79. Some European respondents commented that the BLA is important as it is one of the aspects of the EU carve-out.
80. Fewer comments were received about the proportional approach. In general, respondents commented that the approach neither reflects DRM views of entities nor provides operational relief to them.

Should risk limits be reflected in the application of the PRA? (Question 8)

Most respondents commented that risk limits should not be reflected in the application of the PRA.

81. Most respondents commented that risk limits should not be reflected in the application of the PRA. The reasons mentioned included:
- (a) if the scope of the PRA is a scope based on risk mitigation, profit or loss volatility can be avoided without risk limits;
 - (b) risk limits are a technique for internal risk management control. It is not appropriate for financial reporting;
 - (c) with risk limits, the wider the risk limits are (reflecting an entity's greater risk tolerance), the less volatility is reported in profit or loss. This is counterintuitive; and
 - (d) different entities use different techniques for risk limits such as sensitivity analysis and Value at Risk. Therefore, it would be challenging for financial reporting to incorporate risk limits in a consistent manner.
82. Some respondents mentioned that disclosures of information regarding risk limits would be useful for users.

Should core demand deposits be included in the PRA? (Question 9(a))

Most respondents were supportive of the PRA including core demand deposits. At the same time the need for safeguards was also broadly shared to ensure the transparency and comparability of information and to prevent earnings management.

83. Most respondents supported the view that PRA should include core demand deposits. Their reasons included the following:
- (a) core demand deposits often represent a significant part of banks' DRM. Given the sticky nature of the core demand deposits, banks generally treat them as fixed interest rate funding and impute a fixed market interest rate for a fixed term for DRM purposes. Since current hedge accounting requirements do not allow banks to represent this common DRM approach, a deviation between actual DRM and financial reporting has arisen (eg proxy hedge accounting). Better alignment between DRM and financial reporting would be achieved if core demand deposits were accepted in the PRA;
 - (b) core demand deposits are one of the most critical aspects in the project. Without it, the purpose of the project would be undermined;
 - (c) even though the inclusion of core demand deposits would lead to substantial judgements around assumptions such as expected maturity, the view that they are deposits with over-night maturity is also too extreme an assumption. Therefore, a PRA that accepts core demand deposits would improve the quality of financial information reported;
 - (d) despite the fact that the revaluation of core demand deposits could include future transactions which is a conceptual challenge, core demand deposits should not be excluded from the PRA because they are critical for banks' risk management for NII;
 - (e) conceptual concerns regarding core demand deposits could be in part mitigated by considering the portfolio as the unit of account;

- (f) in business combination accounting, intangibles that arise from core demand deposits are recognised on acquisition ie the accounting standards require the recognition of the fair value of such core demand deposits. Therefore, there should be enough justification to accept this concept in this project too;
 - (g) if the PRA accepts core demand deposits, it would reduce the necessity among European banks to rely on the EU carve-out.
84. A few respondents expressed concerns regarding the inclusion of core demand deposits in the PRA. Their comments included:
- (a) it is difficult to assess whether (changes in) assumptions for 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 other factors such as liquidity risk, aggressive strategies to attract funds and increased competition;
 - (b) as modelling of core demand deposits is so judgemental, the lack of comparability and the possibility of earnings management are a concern.
85. Even among respondents who support the inclusion of core demand deposits, the need for appropriate safeguards is widely shared in order to secure transparency and comparability of information provided, and to prevent earnings management. Suggestions included:
- (a) Disclosures

Many respondents commented that disclosures are important. Specific disclosure topics suggested included the following;

 - (i) (the changes in) the amounts of core and non-core demand deposits together with the rationale;
 - (ii) (the changes in) the expected duration or maturity including the rationale;

(iii) rolling strategy¹ of core demand deposits; and

(iv) hedging strategy of core demand deposits.

Even though banks support the need for disclosures, they also mention the importance of achieving the right balance between transparency and disclosing information that could be commercially sensitive.

(b) Presentation

A few respondents commented that, considering the specific nature of demand deposits (no contractual maturity and redeemable at demand), core demand deposits should be recorded at the amount due, as opposed to the revalued value, in the statement of financial position, with the revaluation effect being presented separately.

(c) Guidance

The need for guidance to aid the determination of the behaviouralised profile of core deposits was considered appropriate by some respondents. This is discussed in more detail in the analysis of responses to Question 9(b).

86. Some banks commented that the IASB should take into account the requirements of and the interaction with prudential regulations when considering core demand deposits for accounting purposes, including disclosures.

Would guidance be necessary to determine the behaviouralised profile of core demand deposits? (Question 9(b))

Responses were mixed. Banks tended to be of the view that it is neither appropriate nor possible to develop robust guidance because the actual treatment of core demand deposits in DRM varies by entity and jurisdiction. Others tended to suggest that guidance is necessary in order to secure transparency and comparability and to prevent earnings management.

¹ Different banks have different strategies on how they assume that expiring core demand deposits deemed as fixed term (eg 5 year) exposures are rolled-over. An example is that (i) a core demand deposit position with a notional amount of CU 120 that is considered stable for 5 years is split into 60 monthly tranches (5 years times 12 months), with each tranche having the same amount of CU 2, and (ii) a tranche is treated as maturing at the end of each month and is assumed to be rolled-over by a new tranche with a same term (ie 5 year).

87. Those of the view that the IASB should develop guidance in the area provided the following reason:
- (a) in order to enhance comparability of financial statements and minimise the risk of earnings management, principle-based guidance on how to determine the behavioural term of a portfolio of core demand deposits would be helpful as current practices in determining behavioural terms are diverse by the entity and jurisdiction.
88. Those of the view that the IASB should not develop guidance in the area provided the following reason:
- (a) behaviouralised profiles of core demand deposits depend on many factors and are different to a substantial extent by entity and jurisdiction.
Restricting this would be contrary to the aim of reflecting actual DRM practices in financial reporting.

Should sub-benchmark instruments be included in the PRA? (Question 10)

There was broad support that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if it is consistent with an entity's DRM (ie Approach 3 in Section 3.10 in the DP).

89. The views that support Approach 3, which allows an entity to use benchmark pricing cash flows (eg LIBOR) as the numerator and a benchmark index (eg LIBOR) as the denominator, in determining the revaluation, included:
- (a) since the IASB intends that the PRA will overcome some of the shortcomings of current hedge accounting requirements, the PRA should not be based on the present hedge accounting restriction for the designation of risk components when the designated risk component exceeds the total cash flows of the hedged item;

- (b) unless sub-benchmark instruments are allowed to be included in the PRA as benchmark instruments, the revaluation of core demand deposits does not work for reasons such as day 1 revaluation effects, because demand deposits are usually sub-benchmark instruments; and
 - (c) taking recent negative interest rates in market transactions such as EURIBOR into account, considerations on sub-benchmark instruments no longer need to be based on the zero boundary of interest rates.
90. A minority view opposing Approach 3 can be summarised as follows:
- (a) if cash flows of sub-benchmark instruments are included in the PRA as benchmark instruments, then the revaluation adjustment would be based in part on deemed cash flows that exceed actual cash flows ie on cash flows that do not actually exist. This view is inconsistent with the IASB’s conclusions on the treatment of sub-benchmark instruments under IFRS 9 hedge accounting requirements. Different treatments between the PRA and IFRS 9 hedge accounting would create opportunities for accounting arbitrages between the two models.
91. Some respondents recommended that the IASB should revisit the issue of sub-benchmark instruments in the context of IFRS 9 hedge accounting.
92. Many respondents commented that if sub-benchmark variable interest financial instruments have an embedded floor that is *not* included in DRM because it remains with the business unit, it is appropriate *not* to reflect the floor within the managed portfolio. This is because they believe that cash flows to be included in the managed portfolio at the ALM level are reflective of the entity’s DRM policies.

Section 9 Alternative approach – PRA through other comprehensive income (Question 26)

Should the OCI alternative be considered?

Respondents' views were mixed. Many disagreed with the alternative approach because of the conceptual and practical difficulties outlined in the DP. Other respondents stated that the IASB should consider this approach.

93. The respondents who do not support the alternative approach through OCI provided the following reasons:
- (a) there is a concern over how the OCI alternative approach could be justified given the *Conceptual Framework*;
 - (b) it is inconsistent with the assumption underlying the PRA, namely that all derivatives would be measured at fair value through profit or loss;
 - (c) the PRA is more akin to fair value hedge accounting than cash flow hedge accounting so there would be no justification to use OCI for presentation;
 - (d) 'ineffectiveness' that would otherwise be presented in profit or loss for hedge accounting is reported in OCI;
 - (e) if DRM is a core part of the business activities of an entity, the effect should be presented in profit or loss, not OCI;
 - (f) the practical issues discussed in the DP such as treatment of internal derivatives and recycling from OCI to profit or loss are difficult to address. With regards to internal derivatives, a concern was raised that if an entity was able to book losses in internal derivatives in OCI but take profits in those transactions in profit or loss this would present a misleading picture of performance, as outlined in the DP;
 - (g) the OCI alternative approach increases volatility in OCI, given that the default accounting of the assets (eg loans) and liabilities (eg deposits) for banking books is amortised cost. Some banks mentioned that this approach would only be worth exploring if the prudential regulators provided a filter

which allowed them to eliminate volatility that might arise from the application of the model through OCI.

94. Respondents who supported the alternative approach through OCI provided the following reasons:
- (a) the problems of accounting mismatches and volatility in profit or loss for insurance companies which could arise under the IFRS 4 phase II project could be addressed through this approach. For instance, one of insurance industry group in Europe commented that, if the scope of application is focused on DRM, then in their view the OCI alternative approach provides more relevant and comparable information. This is due to the fact that it avoids volatility in profit or loss and therefore serves to separate the underlying performance reported in profit or loss from the holistic picture of net open risk positions which are affected by short-term market fluctuations;
 - (b) reporting the revaluation of managed exposures in OCI would alleviate concerns that a PRA with a scope focused on DRM would increase volatility in profit or loss whilst providing a holistic picture about the effects of DRM on future NII to users;
 - (c) the OCI alternative approach might be more relevant for the non-financial sector, because forecast transactions tend to constitute a substantial part of dynamically managed risk exposures for that sector. OCI presentation of revaluations would be less problematic than profit or loss presentation, taking the nature of forecast transactions into account.
95. Other comments included:
- (a) the IASB should consider the OCI alternative approach in conjunction with the *Conceptual Framework* project;
 - (b) it is too early for insurance companies to comment on whether the OCI alternative approach should be explored, because it is necessary to analyse the final outcome of the IFRS 4 phase II project and how the OCI alternative approach can address the issues of accounting mismatches.