

## STAFF PAPER

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## IASB Meeting

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

1. At the February 2015 board meeting, the staff analysed 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 summarises the main themes raised in comment letters on the remaining sections in the DP:
  - Section 4 Revaluing the managed portfolio
  - Section 6 Presentation and disclosures
  - Section 8 Application of the PRA to other risks

- Section 7 Other considerations
3. 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 4 Revaluing the managed portfolio

### ***Do the revaluation calculations outlined in the DP provide a faithful representation of DRM? (Question 11(a))***

Many respondents commented that the revaluation calculation provides a faithful representation of Dynamic Risk Management (DRM) but many of those respondents considered that this would only be the case if the scope of the Portfolio Revaluation Approach (PRA) is a focus on risk mitigation. Some other respondents did not support the revaluation approach.

4. The staff observe that a number of the comments received in respect of this question overlap with responses to other questions such as question 2 (b) ('would the PRA address the issues identified?') and question 15 ('should the scope of the PRA be focused on DRM or risk mitigation?'). These were covered in AP 4B of the February 2015 Board meeting<sup>1</sup>.
5. Many respondents commented that revaluation calculations based on a present value technique with respect to only the 'managed risk (eg interest rate risk)' would provide a faithful representation of DRM activities of the managed risk. These respondents were of the view that it would not be appropriate to revalue entity specific elements such as customer margin.

<sup>1</sup> <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/February/AP04B-Accounting%20for%20Dynamic%20Risk%20Management.pdf>

6. At the same time, however, many of those same respondents commented that the revaluation would provide a faithful representation only to the extent that it offsets fair value changes of derivatives (ie if the scope is focused on risk mitigation) because future interest rate risk and the effect of DRM thereon should be presented in future periods.
7. Some respondents commented that the PRA needs to address the effect on profit or loss which arises from basis risk that is inherent in the fair value of derivatives such as basis swaps and cross currency interest rate swaps, but not in valuations of managed exposures. One banking industry group suggested that the IASB should consider an approach that incorporates basis risk into the revaluation calculation of the managed exposures.
8. Some other respondents did not support the revaluation calculations because:
  - (a) in the case of variable exposures, interest rate risk is managed with respect to cash flow variability (as opposed to being managed on a fair value or revaluation basis);
  - (b) if DRM activities are to be presented based on a present value technique, it needs to incorporate cash flows from items that are not recognised in the statement of financial position. Therefore, the revaluation inevitably requires conceptual concessions, regardless of the scope of the PRA;
  - (c) inclusion of behaviouralised cash flows that are heavily dependent on an entity's own estimations would give rise to errors in measurement; and
  - (d) there would be practical challenges such as a choice of discount rates (eg LIBOR would be the most appropriate discount rate for loans and deposits whereas Overnight Index Swap would be most appropriate for derivatives).

***When the DRM objective is to manage NII with respect to the funding curve of a bank, is it appropriate for the managed risk to be the funding rate? (Q 11(b))***

Many respondents commented that it is appropriate for the managed risk to be the funding rate, when the DRM objective is to manage NII with respect to the funding rate.

9. Many respondents commented that it is appropriate to revalue managed portfolios with respect to the funding rate, when the DRM objective is to manage NII with respect to the funding rate.
10. One respondent commented that it supported the use of a funding rate if it satisfied the requirement of IFRS 9.6.3.7(a), ie ‘any hedged risk component is separately identifiable and reliably measureable.’

***Would transfer pricing transactions provide a good representation of the managed risk for the purposes of applying the PRA? (Q12(a))***

Many respondents commented that the use of transfer pricing transactions would be a good operational expedient in the application of the PRA but many of those respondents considered that this would only be appropriate if the transfer pricing transactions faithfully represented the risks in the managed exposures.

11. Many respondents commented that the use of transfer pricing transactions would work as a good operational expedient in the application of the PRA.
12. One bank commented that because derivatives for DRM purposes are selected and entered into by ALM based on the risk profiles that result when applying the entity’s established transfer pricing mechanism, it is appropriate to consider the transfer pricing mechanism as an integral part of DRM. This bank further mentioned that risk management, transfer of risk and hedging are closely linked concepts.
13. At the same time, however, many of the respondents who supported the use of transfer pricing transactions as an operational expedient also commented that this would only be appropriate if they faithfully represented the risks in the managed exposures. Some of them mentioned the necessity for safeguards such as robust internal controls, guidelines and disclosures.
14. Some respondents did not support the use of transfer pricing transactions in the application of the PRA. According to them, transfer pricing transactions are so entity specific that they would not provide a faithful representation.

***If the managed risk is a funding rate and is represented via transfer pricing transactions, which of the approaches in paragraph 4.2.21 in the DP provides the most faithful representation of DRM? Are restrictions required on the eligibility of the indexes and spreads that can be used in transfer pricing as a basis for applying the PRA? (Q12(b,c))***

Many respondents supported the approach that a market funding index that excludes any other transfer pricing spreads should be used in the application of the PRA.

15. Many respondents commented that the PRA should only capture market interest risk and not any other aspects such as funding and liquidity spreads.
16. Accordingly, they supported the approach that uses a market funding index (eg LIBOR) for both numerator and denominator in the PRA, ie the first approach in paragraph 4.2.21 of the DP. They also mentioned that one of the advantages of that approach is that it would not lead to a Day 1 revaluation effect.
17. A few respondents mentioned that the IASB needs to consider the practical feasibility of the approach further by evaluating additional examples on the use of transfer pricing transactions.
18. Some respondents commented that it should not be necessary to stipulate overly strict eligibility criteria, other than the requirement that transfer pricing transactions should represent the risk in the managed exposures.

***If transfer pricing were to be used as a practical expedient, how would the issues concerning ongoing linkage be resolved? (Q12(d))***

Some respondents commented that the issues around ongoing linkage with the exposures did not present a problem, but they cited different reasons for their views.

19. Some respondents commented that the issue of ongoing linkage was not a problem giving different reasons for their views:
  - (a) the PRA should accommodate the fact that different actions taken by a business unit will give rise to different accounting results, as the project aims at better alignment between DRM and financial reporting and;

- (b) risk management systems are sophisticated enough in that changes of external exposures (eg prepayment of mortgages) are immediately reflected in transfer pricing transactions between business units and ALM.
20. One bank commented that if approach (a) in paragraph 4.3.2 of the DP is accepted when a bank applies the PRA to an open portfolio of prepayable mortgages, it is effectively equivalent to accepting the bottom layer approach (see paragraphs 73 to 79 of AP4B in February 2015) if the transfer pricing mechanism between the ALM and business units does not reflect changes in prepayment expectations. In this case PRA which depends on transfer pricing will effectively be equivalent to the bottom layer approach that ignores prepayment risk.

***Is it acceptable to identify a single funding index for all managed portfolios if funding is based on more than one funding index? Are criteria for selecting a suitable funding index or indexes necessary? (Q13)***

Many respondents commented that the use of more than one funding index should be allowed. They also commented that no additional criteria for selecting a suitable funding index or indexes should be necessary.

21. Many respondents commented that different funding indexes are used within a single entity depending on currency, jurisdiction, product type and tenor and consequently a requirement to use a single funding index does not reflect actual DRM.
22. They also commented that the selection of funding indexes should be the choice of each entity and that no criteria for selecting a suitable funding index or indexes should be necessary as long as it is proven that they are actually used in DRM.
23. Some other respondents expressed concern over the lack of comparability that might arise if a funding index or indexes could be freely selected by entities and mentioned the necessity of safeguards to prevent against this.
24. Some respondents included examples of how a funding rate or rates are used in actual DRM. Examples included:

- (a) a blended rate such as a combination of a short-term rate (e.g. 1-month LIBOR) and a long-term rate (e.g. 5-year rate) is used;
- (b) a funding index for a long-term rate is calculated as a moving average over the period of the tenor of the rate (e.g. a five-year moving average of 5 year rates calculated on a monthly basis);

***Are there any examples of DRM undertaken for portfolios with respect to a pricing index? (Question 14)***

Most respondents who commented on this question mentioned that that DRM activities are undertaken with respect to a funding index, not a pricing index.

- 25. Most respondents who commented on this question mentioned that DRM activities are undertaken with respect to a funding index, not a pricing index. Accordingly, there was not much interest in considering the application of the PRA with respect to a pricing index.
- 26. A few banks mentioned that DRM with respect to a pricing index (eg a base rate) would be difficult in reality because of the lack of a liquid market for derivatives corresponding to that index.
- 27. Some respondents commented that if an entity undertakes DRM with respect to a pricing index, it should be accommodated in the application of the PRA.

**Section 6 Presentation and disclosures**

***Which presentation alternative is preferred in the statement of financial position? (Question 18(a))***

Most respondents supported a ‘single net line item’ presentation in the statement of financial position.

28. Those who supported a ‘single net line item’ presentation provided a number of different reasons, including:
- (a) it is consistent with DRM based on the ‘*net* open risk exposures’ that include both assets and liabilities;
  - (b) it is operationally less burdensome because an entity does not need to allocate the revaluation adjustment to different line items in assets and liabilities;
  - (c) it provides a clear presentation of the offset between the revaluation of the net open risk position and fair values changes in derivatives used for DRM purposes;
  - (d) it allows users of financial statements (hereafter ‘users’) to identify the amount of each line item on an amortised cost measurement basis;
  - (e) the size of the statement of financial position under a ‘single *net* line item’ presentation would be smaller than other presentation alternatives that require gross presentations of revaluations.
29. Those respondents who did not support a ‘line-by-line gross up’ presentation gave a number of reasons, including:
- (a) each line item represents neither amortised cost not fair value;
  - (b) presentation of pipeline transactions and equity model book presents a challenge, as these items do not appear in the statement of financial position;
  - (c) the amount of revaluation of each line item is commercially sensitive;
  - (d) this approach is operationally burdensome because an entity needs to allocate the revaluation adjustment to each line item.
30. A few respondents commented that a ‘line-by-line gross up’ presentation is the most consistent with IFRS 9 hedge accounting. For instance, one respondent commented that, if the scope of the PRA is focused on risk mitigation (eg sub-portfolio approach), a ‘line-by-line gross up’ presentation is consistent with the existing hedge accounting requirements and that adjusting carrying amounts on a line-by-line basis would result



in more faithfully representing the economics of the assets or liabilities recognised in each line item.

31. A few respondents supported the approach of presenting separate line items for aggregate revaluation adjustments for assets and liabilities on the basis that it would provide more transparency compared to a single net line item presentation.
32. Another respondent commented that ‘separate lines for aggregate adjustments to assets and liabilities’ is the most consistent with the ‘fair value hedge accounting for a portfolio of interest rate risk (AG114-AG132 of IAS39).’
33. One user group commented that ‘separate lines for aggregate adjustments to assets and liabilities’ would be the most relevant for presentation in the statement of financial position, but also that it would be useful if a breakdown of these revaluation adjustments by major line item was disclosed in the notes.
34. A banking industry group commented that it preferred ‘separate lines for aggregate adjustments to assets and liabilities,’ but that the effect on the leverage ratio needs to be considered.
35. A prudential regulator commented that the amount of core demand deposits should be presented at face value with the revaluation effect arising from such core demand deposits being presented separately.
36. Other comments included:
  - (a) it is difficult to comment on the appropriate presentation unless the scope of the PRA is determined;
  - (b) presentation alternatives considered in the DP assume that the measurement of items to be revalued is amortised cost. The IASB needs to consider the presentation alternatives when the managed exposures are not amortised cost items. For example, insurance liabilities, which under IFRS 4 phase II, would be measured at the current fulfilment value with the effect of discount rate changes being presented in either profit or loss or other comprehensive income (hereafter ‘OCI’).

**Which presentation alternative is preferred in the statement of comprehensive income? (Question 18(b))**

Most of respondents supported the ‘actual NII’ presentation. Reasons given included that a line item titled ‘net interest from DRM’ enables a bank to clearly depict how DRM activities using derivatives affected NII (ie NII before and after DRM becomes visible).

37. Those respondents who supported the ‘actual NII’ presentation provided several reasons, including:
- (a) a line item titled ‘net interest from DRM’ enables a bank to clearly depict how DRM activities using derivatives affected NII (ie NII before and after DRM becomes visible);
  - (b) gross presentation of interest income and interest expense is consistent with requirements for amortised cost measurement and effective interest rate;
  - (c) if the scope of application of the PRA is a focus on DRM, presenting the ‘revaluation effect from DRM’ as a separate line item is an excellent indicator of future NII. This presentation is easy to understand and useful for users.
38. One of the reasons cited for not supporting the ‘stable NII’ presentation was that it assumes that the purpose of DRM to stabilise NII is perfectly achieved, but it is not a reality. Therefore, such a presentation provides misleading information to users.
39. The ‘actual NII’ presentation considered in the DP envisaged that the *sum* of the clean revaluation<sup>2</sup> of managed exposures and clean fair value changes of derivatives used for DRM purposes is presented in the ‘revaluation effect from DRM.’ However, a bank commented that the presentation should be done separately for each component.
40. Another respondent suggested a presentation approach where the NII in the current period is broken into two line items, which show customer margin at business units and the effects of maturity transformation between assets and liabilities separately.

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<sup>2</sup> Clean revaluation excludes interest accrual for the most recent interest rate fixing.

According to this respondent, this approach is consistent with the risk management view.

41. Another respondent commented that, if the presentation is ‘actual NII’, information based on ‘stable NII’ presentation could be disclosed in notes. This approach enables users to understand the difference between the stable NII (as the target set by the bank) and the actual NII.

***Does a gross presentation of internal derivatives enhance the usefulness of information and operational feasibility? (Question 19)***

Respondents expressed mixed views. Many respondents commented that a gross presentation of internal derivatives should not be accepted for the purposes of financial reporting whilst others supported a gross presentation of internal derivatives.

42. Respondents who did not agree with gross presentation of internal derivatives provided a number of reasons, including:
- (a) a gross presentation of internal derivatives is against the principle of eliminating internal transactions in the consolidated financial statements. This concept might be relevant for segment reporting but not for consolidated financial statements, because the role of financial reporting should be to represent external transactions;
  - (b) internal derivatives are not binding contracts;
  - (c) different entities use internal derivatives very differently, consequently comparability will be reduced;
  - (d) it is inconsistent with IFRS 9 which does not allow the gross presentation of internal derivatives;
  - (e) if a gross presentation of internal derivatives is permitted, line items within profit or loss are impacted even if the net effect is nil;
  - (f) an entity could disguise net open risk positions by entering into internal derivative transactions that perfectly offset such risk positions.

43. Reflecting concerns over gross presentation of internal derivatives, some respondents commented that disclosures are better placed to represent the use of internal derivatives in DRM activities.
44. Supporters of a gross presentation of internal derivatives in the PRA gave two main reasons.
45. The first being that a gross presentation of internal derivatives would serve as a practical expedient because it is operationally challenging to match external derivatives with internal ones that are being used for the purposes of DRM in a dynamic environment. This is because there is no direct linkage between external derivatives transacted with trading divisions and exposures (eg loans and deposits) dynamically managed within ALM.
46. The second reason being gross presentation of internal derivatives better represents both DRM activities within the ALM and trading activities within trading divisions. For instance, one banking industry group commented that the ‘actual NII’ presentation alternative for the statement of comprehensive income, combined with permitting a gross presentation of internal derivative transactions, would be the most consistent with how banks trade and manage their exposures dynamically.
47. Respondents who are of this view tended to say that a gross presentation of internal derivatives is not a conceptual concern because this is merely an issue allocating risk within an entity with a net nil effect on profit or loss. In addition, they tended to propose that a similar treatment should be permitted within IFRS 9 hedge accounting.
48. Respondents expressed conflicting views regarding the need for conditions to be put in place in order to permit a gross presentation of internal derivatives.
49. One view suggested that a gross presentation of internal derivatives should be accepted only when it is proven that internal derivatives used for DRM purposes are substantially externalised. Another view was that it should be accepted with no additional conditions other than that they are used for DRM purposes.
50. Some respondents commented on the necessity of relevant disclosures such as how internal derivatives are used for DRM and how they are treated in the application of the PRA, if a gross presentation of internal derivatives is permitted.

51. Other comments included:
- (a) even if internal derivatives used for DRM purposes are completely externalised by, some noise may remain within trading profits due to reasons such as the difference in pricing formula between the ALM and the trading divisions;
  - (b) the DP seems to discuss a gross presentation of internal derivatives assuming the scope is focused on DRM. However, gross presentation should be permitted even when the scope is focused on risk mitigation;
  - (c) the internal transactions between ALM and the trading divisions are not necessarily always undertaken using derivatives.

***Would each of the identified themes provide useful information on DRM? What additional disclosures, if any, would result in useful information? Should the scope of disclosures be the same as the scope of the application of the PRA? (Question 20 and 21)***

Many respondents shared the view that robust disclosures are critical and broadly supported the four disclosure themes identified in the DP. Additional disclosure topics suggested included sensitivity analysis of NII before and after DRM and further decomposition of NII. Some respondents suggested that the IASB undertakes comprehensive review of IFRS 7 *Financial Instruments: Disclosures*.

## Disclosure themes

52. Many respondents shared the view that robust disclosures are critical in this project in order to secure transparency and comparability of information because DRM relies so much on an entity's own judgements. Prudential and securities regulators especially emphasised this point. One prudential regulator commented that the more the accounting treatment relies on internal assumptions and models, the more these internal procedures need to be both appropriately documented and made transparent externally in order to avoid a 'black box' phenomena.

53. At the same time, many prepares such as banks also showed a concern about both the overload and commercial sensitivity of disclosures, even though they acknowledge the necessity of robust disclosures.
54. Many respondents generally supported the four disclosure themes identified in the DP, although some respondents expressed difficulties in commenting on disclosure topics given that the purpose of the project is not clear.
55. Some banks identified specific disclosure topics that they do not support, including:
- (a) quantitative information on the net open risk positions (theme 2); and
  - (b) allocation of the revaluation adjustment into specific asset classes.
56. Additional disclosure topics suggested by respondents included:
- (a) sensitivity analysis of NII before and after DRM. Some banks commented that this disclosure is the best way to convey information to users about their DRM activities relating to banking book exposures. A respondent also commented that it would also be useful to disclose the base line scenario of expected future NIIs given the current yield curve;
  - (b) decomposition of NII into (i) customer margin at a business unit level, (ii) the result of taking open interest rate risk position at ALM and (iii) the corresponding volume effects (ie increase or decrease of managed portfolios during the current period) on (i) and (ii). (see paragraph 24 of AP 4C<sup>3</sup> in February 2015). A respondent suggested that customer margin at a business unit level should be further decomposed into that relating to lending business units and fund-raising business units;
  - (c) mismatch in maturity or duration between assets and liabilities;
  - (d) how risk management aspects and techniques that are peculiar to DRM, such as core demand deposits, equity model book, internal derivatives and transfer pricing transactions, are modelled and used in actual DRM and how they have impacted accounting results. One example raised was the estimated duration and the amount outstanding of core demand deposits;

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<sup>3</sup> <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/February/AP04C-Accounting%20for%20Dynamic%20Risk%20Management.pdf>

- (e) impact of (changes) of behaviouralisation on the revaluation adjustment;
  - (f) split of derivatives used by purpose (eg DRM for banking book exposures or trading);
57. Some banks suggested that the IASB needs to consider interactions between disclosures in this project and regulatory guidelines (eg Pillar III requirements under the Basel regulations and the ‘Enhancing the Risk Disclosures of Banks’ by EDTF<sup>4</sup> of the Financial Stability Board).
58. Some respondents suggested that the IASB undertakes a comprehensive review of IFRS 7 *Financial Instruments: Disclosures* in order to provide better disclosures on risk exposures with non-trading purposes.

### Scope of disclosures

59. Views on the appropriate scope of disclosures were mixed. Given that most of the respondents supported a scope focused on risk mitigation in the application of the PRA (see paragraphs 23-30 of AP 4B in February 2015), many respondents supported that the scope of disclosures should be identical to the scope of application of the PRA, while many others suggested that the scope of disclosures should be ‘holistic’ enough to describe DRM activities.
60. The views that supported the same scope between the PRA and disclosures included:
- (a) disclosures are the most useful when the scope is identical to the specific accounting approach used (eg the PRA focused on risk mitigation or DRM);
  - (b) information that would be disclosed under a holistic disclosure scope (ie the revaluation for both hedged and unhedged positions) is commercially sensitive.
61. The views that supported a holistic scope of disclosures included:
- (a) information on both hedged and unhedged positions are useful to users;

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<sup>4</sup> Enhanced Disclosure Task Force.

- (b) a piecemeal approach to disclosures that is linked to a specific accounting approach selected (eg hedge accounting or the PRA) is not useful.
62. There was a broadly shared view among banks that a single number ie the ‘revaluation’ of future NII based on a present value technique is not consistent with their risk management view. Rather, they tended to support holistic disclosures that include information of both hedged and unhedged positions in the shape of sensitivity of NIIs for future periods before and after DRM, as they believe this to be more consistent with their risk management view.

## Section 8 Application of the PRA to other risks

### ***Should the PRA be available for DRM other than banks’ interest rate risk management? (Q25)***

Many respondents commented that the application of the PRA to DRM activities for non-interest rate risks in non-financial industries should be part of the model. Some of them mentioned that risk management activities in certain non-financial industries such as the utility and energy sectors is similar to dynamic interest rate risk management by banks.

Many other respondents, however, did not support the application of the PRA to non-interest rate risks in non-financial industries.

### Views in favour of the PRA being applied to DRM for non-interest rate risks in non-financial industries

63. Many respondents commented that the application of the PRA to DRM activities for non-interest rate risk in non-banking industries should be considered. They commented that only allowing the PRA to be applied to dynamic interest rate risk management in banks would arbitrarily exclude other risks that are similarly managed.
64. Some respondents mentioned that risk management activities in certain non-financial industries such as the utility and energy sectors is similar to dynamic interest rate management by banks. For example, it was noted that the generation and sales of electricity and procurement of commodities necessary for its production are



dynamically managed in terms of commodity price risk. Specific similarities with dynamic interest rate management in banks mentioned included:

- (a) the treasury function of an entity manages entity-wide exposures for commodity price risk or FX risk dynamically and centrally in an integrated manner and on a net basis. In this case, the group treasury function plays a role similar to that of the ALM function of a bank; and
- (b) *expected* cash flows are included in DRM.

65. Other fact patterns of DRM for non-interest rate risk in non-financial industries that were provided by respondents included:

- (a) FX denominated assets (receivables), liabilities (payables) and firm commitments that are dynamically managed as a portfolio;
- (b) FX risk exposures in *net investments* in subsidiaries that are dynamically managed; and
- (c) *lease* assets that are fixed interest rate exposures and are funded through variable rate liabilities.

Views not in favour of the PRA being applied to DRM for non-interest rate risks in non-financial industries

66. Many other respondents were not in favour of the PRA being applied to non-interest rate risks in non-financial industries. These views included:

- (a) an industry group that represents corporate treasury activities commented that only a very small number of non-financial entities manage risks such as commodity price risk and FX risk dynamically;
- (b) some banks commented that the priority of the project should be interest rate risk in the banking industry;
- (c) a few respondents including a securities regulator commented that the PRA should be an exception and its applicability should be limited only to dynamic interest rate risk management in banks due to the conceptual difficulties it presents and the challenges around auditability and enforceability;

- (d) some respondents stated that the improved general hedge accounting under IFRS 9, including the ability to hedge an aggregated exposure (ie including derivatives as part of the hedged item), provides the necessary solutions;
- (e) some respondents commented that the cash flow hedge accounting provisions under IFRS 9 are sufficient and more appropriate than the PRA to reflect risk management activities for non-financial entities because:
  - (i) risk exposures in terms of commodity price risk and FX risk in non-financial entities are predominantly forecast transactions and there are conceptual difficulties in recognising revaluation effects of forecast transactions in profit or loss;
  - (ii) it is common for non-financial entities to have a policy of building up their hedging strategies over time. As the expected date of occurrence of the exposures becomes closer, a higher proportion of the exposure is hedged. For example a risk management policy may target hedging 40 percent of exposures in the 2-3 years band, 70 percent in the 1-2 year band and 100 percent in the next 12 months. If all the identified exposures that are dynamically managed were required to be included in the managed portfolio, the application of the PRA could result in significant volatility in profit or loss arising from the revaluation of such open positions, assuming the scope of the PRA was focused on DRM;
- (f) with respect to commodity price risk, a few respondents noted that entities may prefer to apply so-called own-use contract provisions in IFRS 9 and designate commodity contracts at fair value through profit or loss to avoid an accounting mismatch.

### Other general comments

67. Some respondents noted that the DP had primarily analysed dynamic interest rate risk management in banks and it was therefore difficult to assess the implications of the PRA for other types of risks or industries. As a result, these respondents stated that further research and analysis would be required before it could be ascertained whether the PRA could be applicable to non-interest rate risks for non-financial industries.

68. Some respondents noted that the insurance industry also manages risks such as longevity risk and mortality risk dynamically based on open portfolios. Therefore the PRA could potentially be applicable to those risks. However, the staff consider these comments to be directional in nature and not completely developed. For instance, it is not clear whether these risks are dynamically managed using derivative instruments. These respondents themselves also highlighted that at this point it is difficult to assess the impact of the PRA for insurers since IFRS 4 phase II is not finalised yet.

## Section 7 Other considerations

### ***Should the PRA allow for the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract? (Question 22)***

Many respondents commented that the PRA should allow for the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract. They also supported the amortisation of non-zero Day 1 revaluations that materialise when an entity applies the PRA to such exposures.

69. Many respondents commented that the PRA should allow for the inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract. They raised the example of a risk management scenario where new exposures were either not managed at all or only managed statically for a period after the entity become a party to the contract, but which are subsequently included in the dynamically managed portfolio. According to those respondents, as the PRA aims to achieve better alignment between DRM and financial reporting, the PRA should be flexible enough to allow an entity to choose the timing of inclusion of exposures to the PRA in line with actual DRM activities.
70. Many respondents supported the amortisation of non-zero Day 1 revaluations that materialise when an entity applies the PRA to exposures of this nature, even though they recognise that the amortisation approach is operationally burdensome. Reasons mentioned include:

- (a) recognition of a Day 1 profit or loss which reflects changes to benchmark indexes during a period when the exposure was not dynamically managed does not faithfully reflect DRM activities;
- (b) it could be used as a way of earnings management.

71. Some respondents commented that it is too early to consider technical questions of this nature at such an early stage of the project.

***Once exposures are included within a managed portfolio, should they remain there until derecognition? (Question 23)***

Many respondents commented that the PRA should allow for the exclusion of exposures from the managed portfolios before derecognition, in cases such as a change in risk management strategy. They also supported the amortisation of revaluations from the point at which the exposures are removed.

72. Many respondents commented that the PRA should allow for the exclusion of exposures from the managed portfolios before derecognition, for example due to a change in risk management strategy. They raised the example of a risk management scenario where exposures that were once managed as a part of a dynamically managed portfolio within ALM are removed from the portfolio and managed statically, separate from the managed portfolio. In their view as the PRA aims to achieve better alignment between DRM and financial reporting, the PRA should be flexible enough to allow an entity to choose the timing of excluding exposures from the PRA in line with actual DRM activities.
73. Many respondents supported amortisation of revaluations from the point at which the exposures are removed, even though they recognise that the amortisation approach is operationally burdensome. Reasons mentioned included:
- (a) immediate recognition of these revaluations in profit or loss is not in line with DRM activities that have been undertaken till the time such exposures are removed;
  - (b) immediate recognition could be used as a way of earnings management.

74. Some respondents commented that it is too early to consider technical questions of this nature at such an early stage of the project.

***Is it possible to apply the PRA to the DRM of FX risk in conjunction with interest rate risk that is being dynamically managed? (Question 24)***

Many respondents commented that the application of the PRA to the DRM of FX risk in conjunction with dynamically managed interest risk should be possible.

75. Many respondents commented that the application of the PRA to the DRM of FX risk in conjunction with dynamically managed interest risk should be possible.
76. Some respondents commented that all the examples raised in the paragraph 7.3 of the DP (scenario A, B and C) would be possible scenarios in actual DRM activities.
77. Some banks commented that the IASB should explore an approach that is similar to 6.5.16 of IFRS 9 that defers FX basis spreads on derivatives such as cross currency interest rate swaps to OCI. The staff observe however, that suggestions on how this approach could be implemented under a dynamic environment, without one-to-one relationships between the hedged items and the hedging instruments, were not addressed in sufficient detail in the comment letters.
78. Some other banks commented that the first priority of the IASB should be to address existing issues with respect to interest rate risk only.