

International Accounting Standards Board  
1st Floor  
30 Cannon Street  
London  
EC4M 6XH

17 October 2014

**Ref.: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging DP/2014/1**

Dear Sirs,

The International Swaps and Derivatives Association<sup>1</sup> (“ISDA”) is pleased for the opportunity to respond to Discussion Paper DP/2014/1, Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging, (the DP) issued by the International Accounting Standards Board (“IASB”). In this letter we outline our overall comments in response to the DP and in the Appendix we provide our more detailed responses to the specific questions.

We commend the IASB for seeking to develop an accounting approach that reflects more faithfully the risk management activities carried out by institutions such as banks than the current hedge accounting models contained in IAS 39 and IFRS 9. Many banks are currently able to report a net profit that is approximately consistent with their risk management activities but only by use of the EU ‘carve out’ and/or by ‘proxy hedging’. We support the Board’s efforts to remove the need for the carve-out and the use of proxy hedging, both of which make it more difficult to communicate a bank’s risk management activity in a straightforward and transparent manner.

While the DP sets out the main issues that result from the application of the current static hedge accounting methods to dynamic risk management, our members do not agree with one of the fundamental assumptions on which the DP is based, that the objective of banks’ asset and liability management is to eliminate fair value risk. On the contrary, one of the main objectives of many banks is to reduce volatility of future net interest income in their banking book. Accordingly, an accounting solution that is driven by ‘point in time’ fair values does not faithfully represent this activity. This key concern underlies many of the comments we make in this letter. Because different banks have different risk management objectives, throughout this letter where we refer to dynamic risk management, we use it broadly, to mean activities undertaken to reduce ‘interest rate risk in the banking book’.

Risk management and accounting are somewhat different in their focus and it would be difficult to develop a single accounting solution that communicates effectively both the accounting result and the

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<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 62 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s web site: [www.isda.org](http://www.isda.org).

risk reduction consequences of risk management activity. The DP attempts to do so, by reducing dynamic risk management to the management of fair value risk. As this is not consistent with the way that most banks actually manage banking book risk, it will not, without modification, provide an effective accounting solution. Most importantly, because most banks seek to reduce volatility of future net interest income, rather than to minimise their fair value risk, it is critical that the scope of the dynamic risk management accounting solution is restricted to risk mitigation.

The risk reduction effect of dynamic risk management is most effectively communicated through disclosures. For instance, if the objective is to reduce future net interest income volatility, this is probably best shown by explaining the approach and by disclosing the sensitivity of the future net interest income and the effect of risk management activity on this sensitivity, based on a number of scenarios. IFRS 7 would need to be amended to replace the current market risk disclosures for the 'banking book', so as to streamline the information provided by banks and avoid 'clutter'.

As set out in the DP, in order to reflect dynamic risk management faithfully, the accounting solution should include the behaviouralisation of core deposits, the inclusion of pipeline trades and the equity model book. It should also allow a 'bottom layer' approach for the designation of prepayable assets.

While our members believe that it should be possible to create an effective accounting solution through amendments to the PRA (with a risk mitigation scope), an alternative approach favoured by many of our members would be to build on the hedge accounting model contained in IAS 39/IFRS 9. This would include features such as the behaviouralisation of core deposits, so that it would enable banks more easily to communicate the results of their dynamic risk management. If the chosen solution were to be a variant of the PRA, it would be much easier to make operational if only a targeted gross position were to be required to be revalued, equivalent to the net economic risk position, rather than all the assets and liabilities from which the net position is derived. This would be consistent with the principle set out in paragraph 1.30 of the DP, although not with how it is subsequently illustrated (see our response to Question 2). Such an approach would be easier to apply and would not significantly reduce the information reported to users of the financial statements.

Finally, it would be appropriate to include in the accounting solution the 'cost of hedging' feature of IFRS 9, to allow the effect of FX basis risk to be reported in a manner that more closely reflects actual risk management practices.

Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

David Bradbery  
Barclays Bank plc  
Chair, European Accounting Committee

Antonio Corbi  
ISDA, Inc.  
Risk and Capital

Appendix 1: specific comments on the questions raised in the DP

**Appendix 1: specific comments on the questions raised in the DP****1) Need for an accounting approach for dynamic risk management**

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

The current hedge accounting approaches set out in IAS 39 and IFRS 9 do not represent well the dynamic risk management activities of banks. Because they were designed to address hedges of fair value and cash flow risk, they are not engineered to deal with hedges of future net interest income. Also, because they are restrictive of what can be designated as the hedged item in a fair value or cash flow hedge, many banks use the EU 'carve out' or else proxy hedges, in order to report, as well as they are able, what they believe to be effects of their risk management activity.

Therefore, our members support strongly the IASB's project to develop a better way to reflect dynamic risk management.

**2) Current difficulties in representing dynamic risk management in entities' financial statements**

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

We believe that the DP adequately sets out the main issues that result from the application of the current static hedge accounting methods to dynamic risk management. However, we do not agree with one of the fundamental assumptions on which the DP is based, that the usual risk management objective for banks' ALM when undertaking dynamic risk management is to eliminate fair value risk. It is more normal practice for banks to undertake dynamic risk management with the objective of reducing volatility of future net interest income<sup>2</sup> in the banking book. Accordingly, an accounting solution that is driven by 'point in time' fair values does not achieve the best representation of dynamic risk management.

It is also worth noting that eliminating all volatility of future net interest income (NII) is unlikely to be feasible or even desirable. Accordingly, banks usually operate within predetermined limits and do not expect to achieve a completely stable NII from dynamic risk management. In particular, banks only hedge the risk from exposures that they are reasonably confident will arise. This is largely achieved by incorporating behaviouralisation of customer behaviour and the designation of 'bottom layers', based on currently available information.

These differences between the banks' risk management objectives and the objective assumed in the DP are significant and most of the points that we raise in this response arise from these different perspectives.

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<sup>2</sup> These comments are made with respect to banks' ALM activities and not trading activities for which activities are more focused on a fair value basis

b) *Do you think that the PRA would address the issues identified? Why or why not?*

We strongly support the ability to achieve an accounting solution for hedges of core deposits, sub-benchmark risk, equity model book and pipeline trades. This would go some way to eliminating some of the current difficulties caused by the inability to include valid risk management exposures within the accounting for dynamic risk management. See questions 4 and 6, below.

However, because we do not believe that the PRA, as described in the DP, reflects the actual objectives of most banks' risk management, we do not believe that it is the most appropriate approach to address the identified issues. Our members would require modifications to the approach described in the DP as 'PRA with a risk mitigation scope', to enable banks to reflect their dynamic risk management (DRM) more faithfully and more transparently in their financial statements. Alternatively it might be possible to make amendments to the IAS 39/IFRS 9 hedge accounting model. These amendments would involve many of the ideas discussed in the DP, such as the treatment of core deposits, sub-benchmark risk, equity model book and pipeline trades, as well as the need for a bottom layer for prepayable portfolios. We provide more detail on our views in this Appendix, in the context of our suggested way forward.

One added advantage of amending existing hedge accounting solutions would be to make use of the investment that has already been made in hedge accounting systems and would avoid spending significant amounts on new systems to produce information which may not be what is desired by investors or regulators.

In any event, we would not support application of the PRA to the entire portfolio subject to risk management consideration (described as 'a focus on DRM' in the DP), nor that it should be mandatory, as noted in our responses to questions 15 and 16, respectively. Revaluation should only be applied to the extent that risks are mitigated; recording changes in the valuation of assets and liabilities that are otherwise recorded at amortised cost, regardless of whether they are hedged or not, would not reflect the actual risk management objectives and would not, we believe, be helpful to users of the financial statements. Revaluing all exposures considered within risk management for changes in interest rate would be inconsistent with the business model approach discussed at length within IFRS 9. In summary, if the PRA was applied 'with a focus on DRM', we do not believe that it would provide a better representation of dynamic risk management, than is provided by current methods of hedge accounting.

While we believe that the DP sets out a number of ideas that would improve the accounting for dynamic risk management, we do not believe that the PRA treatment of prepayable assets adequately reflects banks' risk management objective for these exposures. In particular, it is usual practice for a bottom layer approach to be applied to prepayable exposures. The approach in the DP would introduce volatility in recorded profit or loss whenever there is a change in prepayment expectations, whether or not it would have an effect on risk management activity, and so would not be consistent with dynamic risk management. In particular, much of the volatility would be from changes in demographic factors that are not hedgeable in the first place. The resultant accounting would be difficult to explain to users of financial statements without the introduction of 'non-GAAP' adjustments and would not, we believe, be helpful to users of the financial statements. See our responses to questions 5 and 7 below.

If the Board decides to pursue a solution based on the PRA (with a scope based on mitigation), it would be operationally easier to apply if the net risk position that is revalued would be a targeted gross position selected from the bank's assets or liabilities, to represent the net risk, rather than all of the gross assets and liabilities from which the net risk position is derived. So, for instance, if the assets were 90 and the liabilities were 80, the net risk position to be revalued would be selected from the 90 of

assets rather than having to revalue all 90 of assets and 80 of liabilities. This is consistent with the principle set out in paragraph 1.30 of the DP, of revaluing the net risk.

In addition, our members have explored alternative accounting approaches that some feel may more closely align with how risks are actually managed. We recognise these alternatives are not fully developed, but we have set out some initial thinking in Appendix 2 to this letter, should the Board wish to pursue them.

Finally, as mentioned in our response to question 24, if the accounting solution is to reflect actual risk management, it would be appropriate to include in the accounting solution the 'cost of hedging' feature of IFRS 9, to allow the effect of FX basis risk to be reported in a manner that more closely reflects actual risk management practices.

### 3) Dynamic risk management

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

The description of dynamic risk management in the DP is vague, and could encompass many different risk management activities. This would be difficult to apply if the PRA were made mandatory and/or with a scope focus on all of the risks and not just those that are mitigated. For instance, the description is ambiguous as to whether dynamic risk management can only occur where an entity uses derivatives, or whether dynamic risk management could encompass activities that also involve cash instruments. This issue is relevant for both banks and corporates. However, we believe that the activities undertaken by banks in order to reduce the volatility of future net interest income in the banking book would be captured by the description in the DP.

Even if the scope focus of the PRA were focussed on risk mitigation, the existence of dynamic risk management activities would be one of the eligibility criteria for applying the PRA, and so the definition is still important. Without more clarity as to what is meant by dynamic risk management there will be much diversity in application, as each preparer would determine their own definition.

It should be noted that if the IASB's chosen accounting solution was to amend the IAS 39/IFRS 9 hedge accounting models this would avoid the need for a definition of dynamic risk management.

### 4) Pipeline transactions, EMB and behaviouralisation

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

Where pipeline transactions are part of a bank's dynamic risk management, inclusion of such transactions is essential to represent faithfully the consequences of their risk management activities.

If management assesses interest rate risk to arise from pipeline activity, it is because they believe that they have a practical obligation to lend or borrow at a particular interest rate. This will affect future net

interest income and is therefore included within dynamic risk management in the same way as exposures that are contractual. Accordingly, they should be afforded a similar accounting treatment.

As the current hedge accounting requirements prohibit the designation of pipeline mortgages (or deposits) as the hedged item within a fair value hedge, it is common practice for banks to identify proxy floating rate liabilities (or assets) for designation within a cash flow hedge, with derivatives hedging the pipeline. An ability to designate pipeline transactions would reduce the need for proxy hedging to achieve a sensible accounting representation.

The conceptual difficulties highlighted in the DP are most relevant if a line by line presentation is made in the statement of financial position. It is partly for that reason that we would not support a line by line presentation - see our response to question 18a).

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

Many banks undertake structural hedging activity, designed to reduce the volatility of the future net interest income. Structural hedging is undertaken as, although the zero cost of equity funding is not itself a source of interest rate variability in NII, when compared to any variability in interest from the exposures (assets) it is funding, this does affect the sensitivity of future NII. Funding with equity has a similar impact on future interest rate variability as funding with fixed rate liabilities. Accordingly, when trying to reduce future interest rate variability in NII, banks often treat equity funding and fixed rate liabilities in a similar way.

This concept is broadly equivalent to the use of an equity model book (EMB) as described in the DP. However, the description of EMB itself is not consistent with the way that most banks would describe their risk management activity, as most banks do not consider EMB as a way of achieving a target base return for equity holders.

Without structural hedging activity, the NII of banks who hold predominantly floating rate assets in part funded by equity, would be highly volatile.

Where the idea of a target return is relevant for EMB is in influencing the chosen profile of the deemed interest rate risk attached to the equity funding for dynamic risk management purposes (e.g. 5 year, 7 year or other). Accordingly, not all banks will attribute the same deemed interest rate risk profile.

In order to represent this risk management in the accounting it is imperative that deemed interest rate risk positions from EMB are eligible for inclusion in any accounting solution for dynamic risk management.

The ability to account for structural hedging activity as part of an accounting solution for dynamic risk management will significantly reduce the need for proxy hedge accounting for these deemed risk positions. Conversely, if structural hedging is not permitted to be included within the accounting solution for dynamic risk management, existing accounting solutions such as macro cash flow hedge accounting would have to remain available, in order to represent this risk management activity. We note that if the EMB were to be included in the PRA in such a way that the change in its fair value were recorded in equity (instead of in a single line in the balance sheet), the accounting effect would be similar to a proxy cash flow hedge of floating rate assets. Both would entail recording the effective portion of the change in fair value of the hedging instrument in equity.

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

We would strongly support the inclusion of cash flows based on a behaviouralised basis rather than on a contractual basis, if that is how they are considered for risk management purposes. Banks dynamically manage interest rate risk on a behaviouralised basis and so any accounting solution should be based on that premise. To do otherwise would make it very difficult to align the accounting representation with risk management activity.

However, we do have some concerns with the impact of changes in behaviouralised assumptions on application of the PRA, as we set out in our responses to questions 6 and 7.

## 5) Prepayment risk

*When risk management instruments with optionality are used to manage prepayment risk as part of dynamic risk management, how do you think the PRA should consider this dynamic risk management activity? Please explain your reasons*

For the purposes of dynamic risk management of prepayable portfolios, our members do not generally transact risk management instruments with optionality. It is more common practice to behaviouralise the expected level of prepayments within the portfolio and hedge the resultant interest rate risk as if there was no prepayment risk, using vanilla interest rate instruments without optionality.

The ability to behaviouralise portfolios within any accounting solution for dynamic risk management is crucial, as noted in our response to question 4. However, the accounting for any changes in behaviour is also important, as discussed in our response to question 6.

## 6) Recognition of changes in customer behavior

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

As noted in our response to question 4c) it is essential that where cash flows are behaviouralised for dynamic risk management, behaviouralisation is also permitted in the accounting solution. This perspective is appropriately reflected in the DP. However, we do have a concern that changes in estimates of behaviour will result in profit or loss volatility if it is applied as described in the DP.

This issue is particularly relevant for prepayable portfolios. The estimate of prepayment risk within a portfolio is based on the information available at the time, and judgements are applied to that estimate in a prudent manner. The PRA approach discussed in the DP would result in profit or loss volatility whenever there is a change in prepayment assumptions. This would not reflect faithfully the consequences of banks' risk management activity, as banks normally deliberately hedge less than the amount of exposures that are not expected to repay (i.e. a bottom layer – see question 7), in order not to be exposed to any significant uncertainty as to the level of prepayment. Also, changes in prepayment

behaviour may have nothing to do with changes in the hedged risk, as they may arise due to non-financial causes, such as changes in mortality or demographic factors.

Accordingly we do not believe that prospective changes in prepayment behaviour should necessarily result in profit or loss volatility.

To record in income the volatility arising from changes in risk positions due to amendments to prepayment assumptions would give a similar outcome to recording at fair value positions that were intentionally unhedged. Therefore as the outcome from adopting the approach in the DP for prepayable assets is not dissimilar to the outcome of a scope focussed on DRM, we consider that it suffers from the same difficulties. This volatility of recorded income could be confusing to users of financial statements and require 'non-GAAP adjustments to explain the bank's true performance. Furthermore, such volatility could imply that errors were made in the original assumptions, whereas they were only ever a best estimate based on information available at the time, with no actual consequence for the risk mitigation activity.

Additionally, in most cases the incremental interest rate risk from changes in prepayment assumptions remains with the business units transacting the exposure and do not form part of dynamic risk management. This is described well in section 4.3.2 in the DP. For the given fact pattern, most of our members would react to the change in prepayment estimates in the manner described in paragraphs 4.3.2(a) or (b). This means that the effect of updating the prepayment estimates to reflect current circumstances will be reflected over time in NII, rather than immediate recognition in profit or loss. This is consistent with the actual risk management focus on future net interest income sensitivity over time.

The transfer pricing (TP) transactions as described in section 4.3.2(a) and (b) are a good representation of the risk under dynamic risk management from prepayable portfolios, hence it makes sense for these TP deals to be revalued within the PRA in order that the accounting represents faithfully dynamic risk management.

Also, banks' dynamic risk management is generally more forward looking than is described in the DP. Their dynamic risk management usually goes further than just considering firm commitments, pipeline transactions and replacement of homogenous demand deposits, as consideration is also given to the likely future balance sheet, on a going concern basis, as explained further in response to question 7.

The treatment of changes in expected behaviours is also relevant for exposures such as core demand deposits and EMB. Although these exposures are behavioralised for dynamic risk management purposes, the deemed profile is not solely driven by customer behaviour. For example, if a bank concluded that it was appropriate, based on a number of factors, for the deemed EMB profile to be 6 years rather than the current 5 years, it would not be appropriate that this would have an immediate impact on profit or loss.

## 7) Bottom layers and proportions of managed exposures

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

Banks typically manage interest rate risk from prepayable portfolios using a bottom layer approach. In order to fully represent DRM, the ability to accommodate a bottom layer within any accounting



solution for DRM is essential. No prepayment risk is perceived within the bottom layer and therefore prepayment risk is not managed for the bottom layer. Accordingly, unless prepayment occurs within the bottom layer, representation of DRM should not result in profit or loss volatility from changes in prepayment risk outside of the bottom layer.

DRM seeks to mitigate the impact of perceived risks within managed exposures, which may not be the same as the contractual risks within exposures. This aim is noted and accommodated within the PRA as described in the DP in some areas, but not all. For example, behaviouralisation, when applied within dynamic risk management, is accepted as part of the PRA, but use of a bottom layer appears not. An accounting solution for dynamic risk management will not reflect actual DRM unless all risk management practices are included. Similarly, our members believe that it should be possible to use a bottom layer approach in applying the IAS 39/IFRS 9 hedge accounting model.

Furthermore, banks' dynamic risk management is focused only on interest rate risk. An inability to reflect bottom layers within the accounting solution would introduce profit or loss volatility that arises from other factors, such as divorce or death rates, which could not be eliminated through DRM. Inclusion of the impact of these factors within the PRA would detract from communicating the actual impact that DRM of interest rate risk has had.

The DP suggests that the PRA could be applied with a focus on risk mitigation by including proportions of portfolios, as a means of reflecting dynamic risk mitigation. Whilst we believe that PRA with a proportional approach is preferable to a scope with a focus on DRM, we demonstrate below that a proportional approach cannot fully reflect DRM which includes a bottom layer.

For example: a bank expects that 40% of a prepayable mortgage portfolio of £100m will prepay. Of the £60m that is not expected to prepay, the bank chooses to hedge only £55m, leaving a buffer of £5m for unexpected prepayment. The bank economically manages the 55% as if it has no prepayment risk, assuming that all the prepayment risk is contained in the top 45%. The 5% buffer is taken to avoid over-hedging interest rate risk in the portfolio.

The £100m portfolio is made up of mortgages that are expected to behave in a similar way with respect to prepayment, but may be from different origination months or products and so accordingly are not homogenous with respect to their interest rates. The bank does not know which mortgages make up the 40%, the 55% or the 5%.

For example the portfolio may be made up as follows:

£30m receiving 7.5% coupon = 5.5% +2% credit spread  
 £50m receiving 7.1% coupon = 5% +2.1% credit spread  
£20m receiving 7.4% coupon = 5.2% +2.2% credit spread  
£100m

Subsequently, there is a reduction in prepayments, so that it is predicted that 70% are expected not to prepay.

The following accounting alternatives are outlined for comparison purposes:

1. **A focus on risk mitigation** as described in the DP, only the amount of the behaviouralised profile that has been mitigated, e.g. 55% of the £100m portfolio (=92% of £60m) would be revalued. Alternatively, it may be possible to identify a particular £55m of mortgages (e.g. based on vintage) for inclusion within the managed portfolio to be revalued.

Need for tracking	<i>P&amp;L Volatility caused by</i>		
	Unhedged positions	Changes in prepayment risk	Imperfections in hedging strategy
Yes	No	Yes	Yes

According to the DP, applying a proportional approach, the original proportion included in the model was 92%<sup>3</sup> of the 60% of the portfolio that was not expected to prepay. If prepayment expectations change, the 'risk mitigated 92%' would then be applied to the new proportion not expected to prepay, so 92% of £70m in the above example. This would mean that changes in fair value of £55m of derivatives would be 'offset' by changes in fair value due to interest rates of £64.4m of mortgages, resulting in profit or loss volatility from changes in prepayment assumptions.

Similarly, if prepayment assumptions were to change such that only 55% of the mortgages were expected to prepay, then the 92% risk mitigation proportion would be applied to 55%, with the effect that the change in fair value of £55m of derivatives would be 'offset' by the change in fair value due to changes in interest rates of £50.6m of mortgages, again resulting in profit or loss volatility, even though the additional prepayment did not breach the risk mitigated bottom layer.

Alternatively, a sub-portfolio approach could be applied to identify the risk mitigated exposure, perhaps as follows: £50m of mortgages paying 5% and £5m of the mortgages paying 5.2%. The PRA could then be applied to those particular mortgages as the risk mitigated exposures, but if some of those mortgages are actually the ones that do prepay, then that will reduce the exposures to be revalued, even if prepayments were in line with expectations. For example, if all the expected prepayment occurred in the mortgages paying 5%, then only £15m of risk mitigated mortgages would remain for revaluation to offset the effect of revaluing £55m of derivatives. This would not provide a fair representation of DRM.

Going forward, the amount that is risk mitigated (i.e. the 55% or the £55m) may change, in which case tracking will be required to monitor the revaluation adjustments for the risk mitigated exposures since they will not unwind naturally.

It can be seen that application of a risk mitigation approach, would result in profit or loss volatility for all changes in prepayment assumptions, even if the hedged bottom layer is not impacted. This is not a fair representation of actual dynamic risk management which includes a bottom layer.

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<sup>3</sup> 92% = 55/60

2. **A bottom layer approach** – (this approach is not included in the DP) Only the bottom £55m would be selected for inclusion within the managed portfolio to be revalued.

Need for tracking	<i>P&amp;L Volatility caused by</i>		
	Unhedged positions	Changes in prepayment risk	Imperfections in hedging strategy
Yes	No	No** (unless BL breached)	Yes

In this approach only the proportion of the mortgages actually designated in the hedge are fair valued with respect to interest rate risk. In this example that is 55%.

This raises the practical challenge that, because the portfolio as a whole is not homogenous, it will be necessary to determine which mortgages or vintages make up the bottom layer, just so that the revaluation can be performed. This must involve a selection that is consistent from one period to the next except that it excludes any mortgages that are prepaid by the revaluation date. The ability to include a bottom layer means that additional unexpected prepayments will not result in profit or loss volatility, as long as the bottom layer is not breached. This is consistent with view of risk management that the bottom layer risk has been effectively mitigated. If prepayment is less than expected, this too will not result in profit or loss volatility. This is also consistent with the risk management view that when new risks are identified based on current information, prospective risk mitigation activity will be undertaken to include these new exposures as well.

There is an additional question whether newly transacted exposures could be considered in determining whether the bottom layer has been breached or not. However, even if new exposures are deemed to be within the bottom layer and are therefore revalued on application of the PRA, these may not fully offset the revaluation of the existing hedging derivatives, as the new exposures would be entered into at prevailing rates.

Whilst this approach may be closer to risk management than a risk mitigation approach, it does suffer from the need to identify mortgages that make up the bottom layer for revaluation purposes which is inconsistent with a risk management bottom layer approach, as it is not known which mortgages ultimately will make up the bottom layer. For DRM, the bottom layer is just a monetary amount of outstanding mortgages. So even when applying a bottom layer approach, tracking issues will still arise from the need to identify the exposures within it, if the amount of the bottom layer changes over time.

Accordingly, we have considered a third approach for application of the DRM of prepayable portfolios incorporating a bottom layer. We have called it 'bottom layer with components'.

3. **A bottom layer approach with components** – (this approach is not in the DP) the bottom layer is comprised of risk components within the prepayable portfolios that equate to the risks in the risk management derivatives.

Need for tracking	<i>P&amp;L Volatility caused by</i>		
	Unhedged positions	Changes in prepayment risk	Imperfections in hedging strategy
No	No	No** (unless BL breached)	No (except valuation conventions)

This approach utilises some of the risk components method from IAS 39 and IFRS 9 general hedge accounting. The key premise is that it is possible to identify risk components within the managed portfolio that match the risks in the derivatives used for risk management. This is achieved by applying the risk components method to the portfolio such as partial term hedging and components of hedged coupons. This has the effect that the hedging derivatives (excluding features such as their credit risk, see below) are deemed a good representation of the risk perceived in the bottom layer, so there is no need to identify arbitrarily which exposures are in the bottom layer at a point in time.

If a bottom layer approach with components is applied, then an assumption is made that the terms of the derivatives transacted to mitigate the risk in the part of the mortgage portfolio not expected to prepay, would be a good representation of the risk for revaluation (again, excluding the effects of credit risk). For example, if the £55m hedging instrument was a single £55m interest rate swap receiving 3m Libor and paying 4.9%, the revaluation of the bottom layer would be calculated using the same cash flows as the actual hedging swap. As long as it can be proven that there are sufficient mortgages, such that the bottom layer outstanding amount is not breached, and that the fixed leg of the swap is less than all the coupons on the mortgages (i.e. 4.9% is less than 7.5% and 7.1% and 7.4%, or perhaps on a weighted average of the notional values for portfolios of swaps, as it should not be possible to designate a component that is more than the whole), then the swap cash flows (except for credit risk) are considered a good representation of the risks in the portfolio that have been mitigated.

If these requirements are met then, under this approach, the PRA revaluation adjustment would be based on the swap cash flows without the need to identify which mortgages make up the bottom layer. Accordingly, application of a bottom layer approach with components only results in profit or loss volatility from valuation conventions<sup>4</sup> (including the effects of credit and collateralisation of the swaps) and if the bottom layer is breached. This approach would significantly reduce ongoing tracking requirements and is more aligned to dynamic risk management.

Under this approach, there is a question whether it would be acceptable for new exposures to be included in order to determine that the bottom layer has not been breached. For example, assume the bottom layer is £55m (paying 7.5% and 7.1% and 7.4%) which is hedged with swaps paying

<sup>4</sup> Certain valuation techniques relevant for derivatives such as OIS discounting may not be applicable when revaluing derivative cash flows for the purpose of determining the revaluation adjustments for mortgages.

4.9%, but £60m of mortgages prepay in the period as interest rates unexpectedly fall. New business of £20m is undertaken in the period but at a lower customer interest rate of, say, 5%.

Our members believe that new exposures should be considered, as this would be consistent with dynamic risk management. Any interest rate differential from unexpectedly prepaid exposures being replaced by new exposures will impact profit or loss over time, which is aligned with the dynamic risk management focus on future volatility in NII.

Under this approach there would be a need to specify which derivatives were mitigating risk from prepayable portfolios, consistent with the designation made for actual risk management

Although there would not be any requirement to track revaluation adjustments for the exposures within the bottom layer, it would be necessary to identify the population of prepayable exposures considered in determining the behaviouralised bottom layer. Once exposures are considered to be within that population, that determination would need to be consistently applied. Such identification for accounting purposes would not be a major issue as long as it is consistent with risk management processes. This has the benefit of an ongoing linkage between the revaluations and the exposures in the statement of financial position.

If the bottom layer is breached, then no offset would be provided to the proportion of the risk management derivatives that relates to the breach. This will result in P&L volatility.

In summary we do not support the risk mitigation approach as described in the DP for portfolios that are risk managed using a bottom layer approach, as the resulting accounting is not representative of dynamic risk management. One of the prerequisites for our members for any accounting model for dynamic risk management is that it must incorporate bottom layers where assumed for actual risk management. Our members believe that a bottom layer with components approach is the best representation of dynamic risk management. We believe that this could be incorporated into either the PRA with a focus on risk mitigation or as an amendment to the existing hedge accounting model.

## 8) Risk limits

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

Our members believe that risk limits should not be reflected in the application of any accounting solution for dynamic risk management.

## 9) Core demand deposits

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

Yes, the inclusion of core demand deposits on a behaviouralised basis is vital to any accounting model that aims to represent faithfully dynamic risk management. This is true whether the chosen accounting model is a variant of the PRA with a focus on risk mitigation, as we have described earlier in this

Appendix, or an adaptation of the IAS 39/ IFRS 9 hedge accounting model. Without this ability the project is not likely to be successful. Core demand deposits are a crucial part of the managed risk position and excluding them would distort the interest rate risk position.

If core demand deposits can be included within an accounting solution, we believe this would help remove the need for the EU ‘carve out’ and, for banks that do not use the ‘carve out’, would significantly reduce the need for proxy hedge accounting which is currently often undertaken for derivatives hedging core demand deposits.

There is recognition that if the behaviouralised profile of core demand deposits is included within the future accounting solution, then additional disclosures on core demand deposits may be required, as part of the amendments of IFRS 7 to communicate banking book interest rate risk more clearly.

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

No we do not think that additional guidance within an accounting standard is required. It would be very difficult for the IASB to draft any such guidance that would be helpful and relevant to banks without considerable effort. It may be appropriate for the standard to refer to techniques that are generally used in the market.

Banks should be required to disclose how they make the determination and common practice is likely to develop over time.

#### **10) Sub-benchmark rate managed risk instruments**

*a) Do you think that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if it is consistent with an entity's dynamic risk management approach (i.e. Approach 3 in Section 3.10)? Why or why not? If not, do you think that the alternatives presented in the DP (ie Approaches 1 and 2 in Section 3.10) for calculating the revaluation adjustment for sub-benchmark instruments provide an appropriate reflection of the risk attached to sub-benchmark instruments? Why or why not?*

Yes, for instance if sub-benchmark instruments are included within dynamic risk management's benchmark instruments, such that the risk from the negative margin remains with the business unit, any accounting solution for dynamic risk management should allow consistent treatment. Accordingly we support Approach 3 in section 3.10, as this is the best representation of actual risk management.

If one of the aims of the accounting solution is to represent dynamic risk management, it would be inconsistent to have a different treatment for exposures that are sub-benchmark and those that are above a benchmark index if, for risk management purposes, they are deemed to have the same risk. It is an arbitrary rule to automatically exclude sub-benchmark instruments just because there is a negative margin. The negative margin remains the responsibility of the business unit in the same way as does a positive margin, and so neither should be included within the accounting solution.

Neither approach 1 or 2 as described in section 3.10 of the DP provide an appropriate reflection of dynamic risk management for sub-benchmark exposures.

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

We do not believe an embedded floor that is not included within actual risk management, should be included with the accounting for dynamic risk management.

## 11) Revaluation of the managed exposures

a) *Do you think that the revaluation calculations outlined in this section provide a faithful representation of dynamic risk management? Why or why not?*

No, our members do not. Banks' dynamic risk management does not focus on eliminating fair value risk, as depicted by the PRA. The purpose of many banks' risk management activity is to mitigate volatility in future NII, as noted in our response to question 2. Therefore, we do not believe that revaluation of all volatility of future NII in current accounting periods provides a faithful representation of dynamic risk management.

Furthermore, our members do not see any benefit for users from revaluing naturally offsetting amortised cost exposures within an accounting solution for dynamic risk management. What is important is the revaluation of the net residual risk (as determined by risk management) and how well that is mitigated by the risk management derivatives transacted. Accordingly, we would support application of a variant of the PRA with a focus on risk mitigation where the mitigated risk is identified as a gross position that reflects the net residual risk in the portfolio. The calculation methodology set out in this section of the DP would be appropriate to revalue this net risk (represented by the gross position).

b) *When the dynamic risk management objective is to manage net interest income with respect to the funding curve of a bank, do you think that it is appropriate for the managed risk to be the funding rate? Why or why not? If not, what changes do you suggest, and why?*

If banks manage NII for changes in a funding rate as part of dynamic risk management, then any accounting solution should also be based on a funding rate.

The funding rate should be based on the one actually used in risk management, but there should be some guidance for selection of appropriate funding rates to drive comparability and usefulness of information.

## 12) Transfer pricing transactions

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

*b) If the managed risk is a funding rate and is represented via transfer pricing transactions, which of the approaches discussed in paragraph 4.2.21 do you think provides the most faithful representation of dynamic risk management? If you consider none of the approaches to be appropriate, what alternatives do you suggest?*

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

*c) Do you think restrictions are required on the eligibility of the indexes and spreads that can be used in transfer pricing as a basis for applying the PRA? Why or why not? If not, what changes do you recommend, and why?*

*d) If transfer pricing were to be used as a practical expedient, how would you resolve the issues identified in paragraphs 4.3.1–4.3.4 concerning ongoing linkage?*

We believe that using a funding index based transfer pricing (TP) mechanism for revaluation could work as a practical expedient. We would have some concerns using TP if it includes elements other than market interest rate risk that are not managed as part of dynamic risk management (e.g. profit margins to set incentives for parts of the organisation such as business units or margins to provide cost recovery or profit for ALM operations). It is likely there would be a need to isolate the market interest rate index element within the TP, in order to appropriately reflect dynamic risk management.

Accordingly we would only support the market funding index approach as outlined in 4.2.21 of the DP.

If TP is not used, then an alternative mechanism would be required to reflect the managed risk in the external managed exposures for revaluing items. This might be to separately attribute a benchmark rate to exposures for revaluation which may not be fully consistent with DRM. However, such an approach could be costly to implement and to a large extent would replicate existing TP processes.

TP represents the risks that are actually managed, which is what we understand the accounting solution is intended to capture. The use of TP as a practical expedient to capture the managed risk also provides a practical solution to the sub-benchmark issue, as the market finding index used in TP will capture the managed full benchmark risk. This is consistent with our view on sub-benchmark noted in the response to question 10.

We have already touched upon the issues raised in 4.3.1 - 4.3.4 in our response to question 6. We believe that if it is the bank's normal practice for business units to either utilise excess funding from ALM for new exposures or to deposit it back to ALM at prevailing interest rates, then this should be reflected in an accounting model for dynamic risk management.

Some investment in systems may be required to enable TP processes to capture all relevant historical and current funding index data and attribute it to TP deals. Alternatively, extensive ongoing tracking may be required to record the numerator cash flows and associated denominator rates.

### **13) Selection of funding index**

*a) Do you think that it is acceptable to identify a single funding index for all managed portfolios if funding is based on more than one funding index? Why or why not? If yes, please explain the circumstances under which this would be appropriate.*

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



The funding index(es) used within the bank to fund exposures should be used in the accounting solution. To restrict a bank to the use of a single funding index for accounting purposes, when this is not how the business is managed, would not be a faithful representation of those activities. Furthermore, to do so may change the way in which banks manage their internal funding and hence external funding activities.

We believe that the only criteria required is to use the market funding index(es) actually used when managing the business. Banks should disclose the index(es) they have used, which will, over time, help drive common practices.

## 14) Pricing index

a) *Please provide one or more example(s) of dynamic risk management undertaken for portfolios with respect to a pricing index.*

b) *How is the pricing index determined for these portfolios? Do you think that this pricing index would be an appropriate basis for applying the PRA if used in dynamic risk management? Why or why not? If not, what criteria should be required? Please explain your reasons.*

c) *Do you think that the application of the PRA would provide useful information about these dynamic risk management activities when the pricing index is used in dynamic risk management? Why or why not?*

Our members are not aware of any portfolios for which a pricing index would be the best representation of managed risk.

## 15) Scope

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

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

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

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

If the IASB were to continue with a variant of the PRA (as we have described earlier in this Appendix), we believe it must have a focus on risk mitigation, so that revaluation only applies to the extent that the

managed risk is also being hedged. Indeed, we believe that risk mitigation should appear as part of the definition of dynamic risk management. However, as already stated, we also believe that amending the existing IAS 39/IFRS 9 hedge accounting model could be an effective way of producing a suitable accounting solution for dynamic risk management.

An approach based on risk mitigation would mean that the gross financial assets and liabilities that would be revalued with respect to the interest risk would change from one reporting period to the next, if there are changes in the amount of risk that is mitigated. This would probably require banks to select particular portfolios of financial instruments and determine a proportion that should be within scope, consistent with their actual risk management. We recognise that such a stop-start approach would require tracking and so would be more operationally demanding than the DRM scope. However, the benefit should outweigh the cost, in particular if it was undertaken with the ability to exclude naturally offsetting exposures that are not part of the net residual risk position. This increase in complexity would be acceptable given that it would more closely align with risk management and would result in a more faithful representation of dynamic risk management.

We do not support application of PRA with a scope focused on DRM. It would not faithfully reflect the way that interest rate risk is managed and could result in more income statement volatility being recorded by banks that actively manage their risks than those that do not. Numerous non-GAAP adjustments would need to be made to report results that would be useful to users.

Part of the argument for a focus on risk mitigation is that this is core to actual dynamic risk management. It is not the same as short term management of the trading book and so should not be accounted for in the same way. The aim of dynamic risk management is usually not to manage the present value of the portfolio, but to manage future net interest income.

We have not considered the implications of extending the scope to risks other than interest rates.

## 16) Mandatory or optional application of the PRA

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

Should the IASB progress with a PRA, no, we do not believe that a PRA with a scope focused on dynamic risk management should be mandatory.

However, we would not expect anyone to apply the PRA voluntarily to all dynamically managed exposures if application of PRA was focused on dynamic risk management.

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

Similarly, we do not believe that a PRA with a scope focused on risk mitigation should be mandatory.

It would be very difficult to determine criteria to identify the risk mitigation activity that must be included within the PRA. Furthermore, we believe that banks are best placed to determine where the PRA results in an accounting outcome that most faithfully represents dynamic risk management activity. We acknowledge that this may mean not all banks apply the PRA to comparable exposures, but this is true of hedge accounting and the fair value option, and can be mitigated by additional disclosures.

**17) Other eligibility criteria**

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

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

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

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

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

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

We do not believe that any additional eligibility criteria are required.

**18) Presentation alternatives**

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

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

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

If the IASB proceeds with a PRA, we have a strong preference for the actual net interest income presentation alternative, as this will provide more useful information on the impact of actual risk management.

We also have a preference that the revaluation of risk mitigated exposure within the accounting solution should be presented in a single net line item in the statement of financial position. We believe that this is consistent with the net approach to interest rate management undertaken by banks.

**19) Presentation of internal derivatives**

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

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

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

Most of our members support the ability to make use of internal derivatives as part of the accounting solution, without the need to 'externalise' them. If this were the case, then the accounting treatment outlined on page 74 of the DP would be appropriate.

**20) Disclosures**

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

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

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

We concur that additional disclosures are required in order to present useful information on dynamic risk management. In fact, we see the role of disclosures to be critical in providing this information, rather than attempting to fit an accounting framework to dynamic risk management. If sufficient transparent information is provided in the disclosures then, as we have already said, we would see a reduced need for such a wholesale change to the accounting for dynamic risk management as would be required on introduction of the PRA.

The key new disclosure that we would recommend would be the sensitivity of the bank's net interest income to changes in interest rates, both before and after the effects of mitigation. This sensitivity might include a number of scenarios, so that it doesn't capture just parallel changes in the yield curve.

We strongly recommend that the IFRS 7 risk disclosures of non-trading market risk should be rewritten as part of this project, rather than amended to accommodate incremental disclosures. In this way, the market risk disclosures for the banking book and the disclosures of the effects of dynamic risk management could be merged into one relatively succinct and meaningful analysis.

**21) Scope of disclosures**

- a) *Do you think that the scope of the disclosures should be the same as the scope of the application of the PRA? Why or why not?*
- b) *If you do not think that the scope of the disclosures should be the same as the scope of the application of the PRA, what do you think would be an appropriate scope for the disclosures, and why?*

If the accounting solution was to amend the existing IAS 39/IFRS 9 hedge accounting model, new disclosures would be required as to the risks and the effects of mitigation for the ‘banking book’, as set out in response to the previous question.

If the Board continues with the PRA, with a scope focussed on risk mitigation, then we agree that extra disclosure is warranted to provide transparency as to the risks not hedged. However, consistent with our response to the previous question, we believe this would mean disclosing the interest rate sensitivity for the dynamic risk management activity, which is not the same as disclosing the gain or loss in the period on the intentionally unhedged position. This is in part due to its irrelevance: the goal of dynamic risk management is not to manage the present value but to mitigate future net interest income. In any event, the fair values of banking book assets and liabilities recorded at amortised cost are already disclosed, as required by IFRS 7. It would be inappropriate in terms of costs and benefits to require the introduction of the full PRA model, just for disclosure purposes.

**22) Date of inclusion of exposures in a managed portfolio**

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

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

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

If the accounting solution for dynamic risk management were to be amendments to the hedge accounting models then this question is not relevant. If the scope of a PRA were focussed on risk mitigation, then we believe that the date of inclusion of exposures within the PRA should not be restricted to the date the entity first becomes a party to a contract. A risk mitigation scope would not be operational if such a restriction existed, and would be inconsistent with actual risk mitigation. We recognise that this will introduce additional amortisation and tracking requirements, but as noted in our response to questions 15 and 23, we believe that this is necessary in order to represent risk mitigation.

If the PRA were to be introduced with a focus on risk mitigation, then we have a preference for amortisation of revaluation adjustments that will not naturally unwind, rather than a day one profit or write off on maturity (DP, 7.1). This would increase operational complexity, but achieving appropriate representation of dynamic risk management in the financial statement is a higher priority than operational simplicity. It also reduces the opportunity for making accounting choices which would arbitrarily create volatility in recorded profit or loss.

**23) Removal of exposures from a managed portfolio**

- a) *Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?*
- b) *Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from a managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?*
- c) *If exposures are removed from a managed portfolio prior to maturity, how would you propose to account for the recognised revaluation adjustment, and why? Please explain your reasons, including commenting on the usefulness of information provided to users of financial statements.*

Within a scope focused on risk mitigation it is essential that only those gross exposures making up the net residual position for which risks have been mitigated are included within the revalued portfolio. Consistent with the dynamic nature of the portfolio, the gross exposures for which risk has been mitigated are likely to change over time. Accordingly, we would support the ability to remove exposures from the revalued portfolio, in line with risk mitigation activity. We recognise that this will result in the need for amortisation and tracking of revaluation adjustments, but we believe this is preferable to being prevented from representing risk mitigation activity faithfully in the financial statements.

**24) Dynamic risk management of foreign currency instruments**

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

As noted in paragraph 7.3.2 of the DP, there are various ways in which banks manage foreign exchange risk. Where foreign exchange risk impacts dynamic risk management a PRA should be able to accommodate it. There is not a one size fits all for the management of FX risk, even within a single bank.

For Scenario A in 7.3.3, we believe it is essential that approach (a) as described in 7.3.6 is permitted. Volatility from cross currency basis swaps remains a significant issue for many banks, as was noted by the IASB in the discussions on IFRS 9 hedge accounting. Therefore there is an expectation that the ‘cost of hedging’ concept would be available under any accounting solution for dynamic risk management suggested in 7.3.6 (a).

**25) Application of the PRA to other risks**

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

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

Not applicable

**26) PRA through OCI**

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

There is no support amongst our members for a PRA through other comprehensive income (OCI).

**Appendix 2: *Alternative approach***

We do not believe that an accounting solution based on revaluing managed risk positions through the profit or loss is fully consistent with a dynamic risk management focus on mitigating future net interest income volatility. Nevertheless, our members have already identified the vital aspects that would be required in any accounting solution for dynamic risk management in order to deliver an improvement on the existing solutions available. In addition, some of our members have explored alternative accounting approaches that would more closely align with how risks are actually managed

One version is that where derivatives can be shown to lower the sensitivity of future net interest income, then the exposures whose risks are being mitigated, are adjusted (as a single line of the balance sheet, as described in paragraph 6.1.4(c) of the DP) with the other side of the double entry in the revaluation profit or loss for the lower of:

- i) their change in value due to changes in interest rates and
- ii) the change in fair value of the hedging derivatives.

This approach utilises the cash flow hedge mechanics from IFRS 9 general hedge accounting, but applied to a revaluation model. So, similar to the PRA, there would be a need to identify and revalue the exposures within the managed portfolio. Ineffectiveness would be recorded if the change in fair value of the derivatives was higher than the change in value of the exposures, and this would include the change in fair value that relates to features of the derivatives that are not representative of the managed risk, such as credit risk and methods of discounting.

The test to ensure that the derivatives are effectively mitigating risk would be carried out regularly. To the extent that the bank has too many derivatives, so that risk is not reduced, the excess change in fair value would be reported in profit or loss.

If this approach were applied, then further consideration would be required as to the treatment of internal derivatives.

There are two further versions:

- a) If it can be shown that derivatives identified as being for dynamic risk management purposes actually mitigate risk within the managed portfolio, again using sensitivity analysis, then the risk in the managed portfolio to be revalued could be represented by cash flows based on the those derivatives. Hence the change in value of the exposures are calculated using the cash flows from dynamic risk management derivatives, but, it will not equal the derivative fair value due to elements of the change in the fair value of the derivatives that cannot be represented in the exposures, such as credit risk. The accounting for the managed portfolio under this approach would be as follows:

DR/CR single BS line representing valuation changes in the managed portfolio

CR/DR revaluation P&L

- b) Subject to a similar sensitivity test, but using accounting mechanics more similar to a cash flow hedge. The change in value of the risk reducing derivatives (except for elements of this change that are specific to the derivatives such as the effect of credit risk) are recorded in OCI



rather than in the profit and loss account. This is not the same as the PRA through OCI proposal, which posts to OCI the revaluation that is not effectively mitigated. This approach has the advantage that it might help address some of the conceptual issues raised in the DP (e.g. inclusion of the EMB), as it will not require any revaluation of the managed exposures. However, it has the considerable disadvantage that it can only be taken forward if banking regulators would be prepared to filter the effect on OCI for regulatory capital purposes (as currently done for the cash flow hedge reserve). The accounting for the derivatives under this approach would be as follows (ignoring differences due to credit risk etc):

DR/CR OCI

CR/DR derivatives at fair value

In all three variations, additional disclosures would be given, to provide users with sufficient information to distinguish between banks with different risk appetites. Information on sensitivities of future net interest income and the effect of mitigation may meet that need.