

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
United Kingdom
EC4M 6XH

17 October 2014

Dear Mr Hoogervorst

Discussion Paper DP 2014/1 – Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's ('the IASB's') Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* ('the discussion paper').

We support the IASB's development of an approach to account for dynamic risk management activities. We acknowledge that dynamic risk management activities are complex and commend the work done by the IASB to understand and clearly present in its discussion paper how banks dynamically manage interest rate risk and also to consider more broadly how the accounting for such activities in a variety of industries could be improved. We are supportive of an accounting approach that better reflects in the financial statements an entity's economic activity including its execution of its risk management activity as we believe this would provide useful information to users of financial statements.

However, we do not support the Portfolio Revaluation Approach (PRA) detailed in the discussion paper. The PRA endeavours to be an all-encompassing measurement approach for items subject to dynamic risk management. While we commend the IASB for developing an approach that starts in understanding the risk management activities, we do not believe the solution is an alternative measurement approach for risk management activities that should be pursued. We are concerned that such an approach has conflicts with accounting principles in the conceptual framework, will require risk management activities to be defined in order to determine what is in or out of the revaluation model, and the approach fails to build on the classification, measurement and general hedge accounting concepts already established in IFRS 9 *Financial Instruments*.

The discussion paper requests views on whether the project should extend to entities other than banks hedging interest rate risk. As noted in our responses to the IASB on phase two of Insurance Contracts in 2010 and 2013 we believe a portfolio hedging solution should be explored for insurers as it is common for insurers to use derivatives to hedge interest rate risk on their duration mismatch between their non-derivative financial assets and insurance liabilities. Given the measurement of insurance contracts is due

to be finalised next year we recommend that the Board consider whether such hedging strategies will lead to accounting mismatches that can be minimised with a portfolio hedge accounting solution that includes insurance contracts as hedged items. Further, as the development of the PRA is a solution to a structural interest rate hedge in banks, we would favour outreach to non-financial entities on whether their portfolio hedging strategies share similar characteristics to financial entities.

Our preference is to develop an approach like IFRS 9 that aims to mitigate the accounting mismatches that can arise from an entity executing its risk management objective due to the mixed measurement and recognition approach in IFRSs. Such an approach is voluntary, builds on the thinking used in IFRS 9, does not seek to define risk management nor to remeasure all assets, liabilities and future transactions that are subject to risk management.

We acknowledge that the IASB already has a hedge accounting based solution to portfolio hedges of interest rate risk in IAS 39 but note that this approach has not been universally applied because of the prohibitions in hedging certain items and applying the model to an open and dynamic portfolio. This has led to complexity in application without providing information that is necessarily easily understandable. Our preference therefore would be for the IASB to focus on specific issues, as already identified in the discussion paper, which, if overcome, could be built on top of approaches already contained in IFRSs, so as to give preparers a hedge accounting approach that is more compelling than the current one in IFRSs.

Areas the IASB should explore in developing our preferred approach are:

- the eligibility of core deposits as hedged items;
- valuing assets, liabilities and firm commitments hedged for interest rate risk on a basis of behaviouralised, rather than contractual, cash flows;
- hedging the 'bottom layer' of a portfolio of prepayable loans; and
- the designation of LIBOR when the yield on the instrument is sub-LIBOR.

Firstly, core deposits are a significant part of banks' exposures hedged for interest rate risk and therefore for a macro hedge model to be accepted and applied it will need to accommodate such exposures. We acknowledge there will be challenges in objectively identifying and measuring core demand deposits. However, we think it would be worthwhile for the Board to explore how such challenges could be overcome. We note that the value ascribed to purchases of core deposits in practice is not equal to the demand amount given the 'stickiness' of these deposits. Permitting such liabilities to be remeasured for changes in interest rates in a macro hedge model would be a significant step towards developing a portfolio hedge accounting model that would be operational, reflective of banks' risk management activities and consistent with accounting principles and the conceptual framework.

Secondly, we believe that valuing assets, liabilities and firm commitments hedged for interest rate risk based on behaviouralised, rather than contractual, cash flows (for example, after considering prepayment expectations) is another essential feature of a portfolio hedge accounting model if it is to be accepted and applied. We note that for phase two of Insurance Contracts the IASB has adopted an approach based on probability weighted values of deposit components in insurance contracts and the use of behavioural assumptions in projecting cash flows rather than relying solely on contractual cash flows. Without such a behaviouralised approach, a portfolio hedge accounting model would not take account of the portfolio effects and enhanced predictability of grouping assets, liabilities and firm commitments together and hedging them as a single portfolio or unit for risk management purposes.

We consider that valuing groups of assets, liabilities and firm commitments, taking into account any offsetting effects and portfolio behaviours, can be consistent with established accounting principles. For

example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* includes requirements to measure large populations of items by weighting all possible outcomes by their associated probabilities (i.e. based on expected values). Also IFRS 13 *Fair Value Measurement* includes an exception for valuing portfolios of items with certain offsetting risk positions as a single unit for valuation purposes provided specific conditions are met.

Given these precedents, we believe the Board should consider how a portfolio valuation approach that includes core deposits as well as consideration of behaviour can be accepted within the confines of the conceptual framework.

Thirdly, when hedging a portfolio, we believe that the Board should consider further how it may be appropriate to identify the hedged item as the bottom layer of a portfolio. We note that identifying a bottom layer of a single item is already permitted in the IFRS 9 general hedge accounting model, and if it were possible to view a portfolio as a unit for hedge accounting purposes, this would permit the bottom layer for a portfolio of prepayable items to be designated as a hedged item.

Fourthly, reconsideration should be given as to how an instrument that has a yield that is sub-LIBOR can be hedged for LIBOR for accounting purposes. Given the historically low central bank interest rate environment and the nature of savings products offered it is common that financial liabilities have a yield less than sub-LIBOR, yet for risk management purposes they form part of a portfolio that is hedged for LIBOR (or another suitable benchmark interest rate risk).

Overall, an approach that combines existing thinking in IFRS 9 with the ability to behaviouralise cash flows on a portfolio basis (including core deposits) and allowing bottom layers to be designated has the potential to be more relevant than the existing portfolio fair value hedge accounting model in IAS 39. This would be less complex than a more wide ranging measurement alternative for risk management activities as envisioned by the PRA and have the potential for applicability to other industries, such as for insurers.

Our detailed responses to the questions in the invitation to comment are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole at +44 (0) 20 7007 0884 or Andrew Spooner at +44 (0) 20 7007 0204.

Yours sincerely



Veronica Poole
Global IFRS Leader

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

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

We believe that where an entity uses financial instruments for risk management purposes, and the application of the classification and measurement requirements of IFRS 9 gives rise to accounting mismatches, hedge accounting should be available (subject to meeting certain eligibility criteria) to address this mismatch and provide useful information for users. We appreciate that hedge accounting becomes more complex to apply when risks are hedged on an open, dynamic, portfolio basis and agree that a portfolio hedging model is required to address this. However, we do not believe that the portfolio hedging model should aim to represent dynamic risk management in entities' financial statements by revaluing all financial assets and liabilities for interest rate risk.

We believe a more appropriate approach would be to develop a portfolio hedging model that builds on concepts already established in the general hedge accounting approach in IFRS 9. The model should take into account the characteristics of portfolio hedging from an economic perspective to ensure a more meaningful presentation of risk management activities. Such an approach should aim to minimise conflicts with the Conceptual Framework. In our response to the remaining questions we outline those aspects of the PRA that we believe are, or could be developed to be, consistent with the Conceptual Framework and appropriately used in a portfolio hedging model that aims to minimise accounting mismatches rather than one that focussing exclusively on accounting for risk management.

Question 2—Current difficulties in representing dynamic risk management in entities' financial statements

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

We agree the IASB has identified the key issues faced by financial institutions in applying hedge accounting for dynamic risk management activities.

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

The PRA represents a significant change to the accounting of certain financial instruments that are part of dynamic risk management activities. Although we believe that such a model may address some of the issues entities currently face when applying the current hedge accounting requirements, it would raise other more fundamental issues which we discuss further in our response to the questions below. One particular issue we have with the PRA is the disconnection of risk management and accounting volatility through hedging. In our view, simply focusing on risk management could effectively override the general classification and measurement requirements in IFRS 9. This could result in misleading performance reporting since portfolios of assets held to collect contractual cash flows would be revalued for interest rate risk. Therefore, focusing on risk management alone appears insufficient without taking into account the effects from dynamic risk management on accounting, more precisely on accounting volatility. As most hedging instruments are measured at fair value through profit or

loss, whereas the hedged items are usually not, this creates accounting volatility where positions are economically hedged. To align accounting volatility with economic volatility from hedged positions when dynamic risk management takes place should be a key objective in developing the new requirements. This would provide users of financial statements better information on the economic position of an entity without having the conceptual shortcomings of the PRA or its features, as discussed below.

Another observation is that application of the PRA would conflict with the Conceptual Framework in many instances as noted in our responses below. The Board will need to consider carefully for each case in turn whether such exceptions are appropriate.

Hence, overall, we do not consider the PRA a viable solution to the issues that entities currently face when applying the current hedge accounting requirements.

Question 3—Dynamic risk management

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

We believe the description in paragraphs 2.1.1 – 2.1.2 captures some of the key characteristics of dynamic risk management but note that dynamic risk management across different entities and industries can be diverse. We believe this would be sufficient as a high-level description of dynamic risk management rather than as a qualifying criterion for portfolio hedge accounting which should be avoided given the difficulties in defining it for all entities and industries.

Question 4—Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

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

We agree that pipeline transactions are often part of entities' dynamic risk management of interest rate risk and hence will be considered in their gap analysis of net interest rate risk position. Furthermore, we recognise that there may be potential to consider some limited pipeline transactions to have value that could be recognised in the statement of financial position whilst complying with the Conceptual Framework (where for example they represent a constructive obligation which under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* can give rise to the recognition of a provision).

However, in many cases pipeline transactions will represent forecast transactions with a higher degree of uncertainty where recognising any assets or liabilities in respect of them in the statement of financial position would be inconsistent with basic accounting principles such as the definition of assets and liabilities in the Conceptual Framework. To resolve this, as an alternative to the PRA, we believe a portfolio hedging model should allow all exposures managed for interest rate risk (including any pipeline transactions) to be included in the

determination of the net risk position, but only permit the recognition of revaluation adjustments on items where the recognition of the adjustment is consistent with the Conceptual Framework (i.e. only recognising adjustments that meet the definition of an asset or liability, for example in respect of pipeline transactions that represent constructive obligations in accordance with IAS 37, or in respect of core demand deposits, see response to Question 9). Under this alternative, the revaluation adjustment would only apply in respect of the hedged net position. Therefore, as noted in our response to Question 9 we believe that the IASB should prioritise developing a model where core demand deposits can be included as this would, in many cases, ensure there are sufficient eligible exposures to revalue in respect of the net position hedged. This would in turn reduce the need to recognise valuation adjustments in respect of pipeline transactions.

Exposures that make up the determination of the net position for which hedge accounting is applied to, including pipeline transactions, should be subject to disclosure that helps explain the objective of risk management, how it was executed, and how the execution of the risk management objective is presented in the financial statements.

EMB

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

If the objective of the model is to represent entities' dynamic risk management in the financial statements then it is difficult to see why the equity model book that forms part of that risk management should not be included and remeasured for changes in interest rates. However, we are concerned that if the EMB is included as part of a revaluation model, leading to revaluation adjustments recognised in profit or loss with cumulative changes recognised as assets or liabilities, this would be inconsistent with the Conceptual Framework. This is another reason why we do not support the objective of representing entities' dynamic risk management in the financial statements.

As noted in our response to Question 3(a), we would support a portfolio hedging model that allows the equity model book to be included in determining the net risk position, provided revaluation adjustments are only recognised in respect of exposures where adjustments meet the definition of an asset or liability (thus excluding the equity model book from this). To supplement this approach, disclosures could be used to communicate the effect of the entity's risk management in respect of the equity model book.

In developing a portfolio hedge accounting model that permits revaluation of core demand deposits the need to allow the equity model book to be revalued would be diminished since there would be a significant increase in the availability of financial liabilities to revalue for interest rate risk to match the net hedged position. Therefore, although both EMB and core demand deposits can be a source of funding, an accounting mismatch resulting from hedging the EMB could be reduced by designating a proxy hedge of core demand deposits which would not violate the fundamental principle in IFRS that equity is not subject to remeasurement. Hence we are not supportive of the IASB recognising revaluation adjustments in respect of the equity model book.

Behaviouralisation

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

We believe a portfolio hedge accounting approach should take account of portfolio characteristics and are supportive of a model based on behaviouralised contractual cash flows (and constructive obligations in respect of pipeline transactions) where this is consistent with existing IFRSs as discussed below. Valuing assets, liabilities and firm commitments hedged for interest rate risk based on behaviouralised, rather than contractual, cash flows (for example, after considering prepayment expectations) is an essential feature of any portfolio hedge accounting model. Without such an approach, a portfolio hedge accounting model would not take account of the portfolio effects, economics and enhanced predictability of grouping assets, liabilities and firm commitments together and hedging them as a single unit on a portfolio basis.

We believe that valuing groups of assets, liabilities and firm commitments, taking into account any offsetting effects and portfolio behaviours is consistent with established accounting principles. For example:

- IFRS 9 allows the effective interest rate method to be applied on a portfolio basis as it is presumed that the cash flows of a group of similar financial instruments can be estimated reliably.
- IAS 37 includes requirements to measure large populations of items by weighting all possible outcomes by their associated probabilities (i.e. based on expected values).
- IFRS 13 includes an exception for valuing portfolios of items with certain offsetting risk positions as a single unit of valuation provided specific conditions are met.

Hence we believe that a behaviouralised approach can be developed that is acceptable and consistent with existing accounting principles.

Question 5—Prepayment risk

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

Within a hedge accounting model, where entities use financial instruments with optionality for hedging purposes, we believe they should be treated like any other hedging instrument under the IFRS 9 hedge accounting model. Whether the valuation of such options could be used as a proxy measure of the hedged exposure for changes in interest rate risk would depend on the specific terms of the options relative to the risk they were hedging.

Question 6—Recognition of changes in customer behaviour

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

In the context of a hedge accounting approach we understand that changes in behavioural assumptions may affect the valuation of certain hedged exposures that are revalued for interest rate risk. Where this is the case we believe such changes should be recognised in profit or loss in the hedged period when the changes in assumptions occur. Where the effect of changes in assumptions is material, disclosures should give further information about the reason and impact of the change in assumptions. Not to recognise the effect of changes in assumptions in profit or loss in such cases will give rise to additional complexity in the application of any portfolio hedge accounting model.

It should be noted that not all changes in behavioural assumptions will have an effect on the hedged exposure, for example where only the bottom layer of a portfolio is revalued and the changes in behavioural assumptions of the overall portfolio do not change the cash flows of the bottom layer.

Question 7—Bottom layers and proportions of managed exposures

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

As noted in our response to Question 4, we believe it is appropriate to model the hedged portfolio based on expected, behaviouralised cash flows which takes account of the portfolio effect of grouping together similar items. As an extension of this principle, we believe that it is appropriate to develop a model that can identify the hedged item as the bottom layer of a portfolio. We note that identifying a bottom layer of a single item, or certain groups of items, is already permitted in the IFRS 9 general hedge accounting model, and if we are to view a portfolio as a unit for hedge accounting purposes, we believe a bottom layer should also be permitted for a portfolio of prepayable items. We understand that designating a bottom layer of a portfolio of prepayable items could lead to no hedge ineffectiveness from lower/higher than expected prepayments, provided the designated bottom layer cash flows are still forecast to occur. However, we believe this is consistent with the risk management approach for such items and is consistent with the valuation of a bottom layer of a portfolio which behaves differently to a proportional amount.

We recognise that there will be further factors to consider in developing a bottom layer approach. For example, consideration of whether to only permit a bottom layer of a static

portfolio (which could be advantageous in terms of tracking but would break with the basic idea of dynamic risk management to some extent) or a dynamic portfolio and whether to define the portfolio based solely on notional amounts or whether to also consider the quantum of the interest rate paid/received on the underlying items.

Question 8—Risk limits

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

As noted in our response to Question 1, we believe that the IASB should pursue a portfolio hedge accounting model rather than a broader portfolio valuation approach for all risk management activities. This would have the additional benefit of accommodating risk limits, since an entity could only apply hedge accounting to the extent that it has hedged the risk. However, an important difference to the concept of risk limits as presented in paragraph 3.8.3 of the DP is that there would be volatility to the extent that the hedge is ineffective, whereas under the risk limits concept in the DP, there would be none, even if the hedge does not perfectly offset.

Question 9—Core demand deposits

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

Core demand deposits are a significant part of banks' exposures hedged for interest rate risk and not recognising the change in value of such deposits due to changes in interest rates can give rise to an accounting mismatch which we believe should be addressed through hedge accounting.

In particular, risk management of core demand deposits is usually based on expected behaviour and using bottom layer approaches. This is in contrast to the general accounting requirements that restrict the unit of account and the measurement of demand deposits to their contractual features rather than their expected behaviour. A way to better align accounting with risk management and also reducing accounting mismatches could be focusing on a portfolio of core demand deposits as a unit of account. This could apply in circumstances where risk management is also based on the portfolio (similar to the requirements already in place under IFRS 13.49), which then overcomes the restriction in IFRS 13.47 given the different unit of account.

We acknowledge there can be challenges in objectively identifying and measuring core demand deposits, however, we do not think these would be too difficult to overcome given the difference between the value of core demand deposits and the demandable amount is already reflected in the accounting in certain circumstances, for example in business combination accounting where core deposit intangibles are recognised on acquisition. Furthermore, the cash flow profile of core demand deposits is also recognised by regulators in

the assessment of interest rate and liquidity risk at banks.

Allowing such liabilities to be remeasured for changes in interest rates would be a significant step towards developing a portfolio hedge accounting model that would be more operational and reflective of banks' risk management activities than the portfolio fair value hedge accounting approach currently in IAS 39.

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

To promote consistency we believe it will be essential for guiding principles to be provided on the factors that should be taken into account when behaviouralising core demand deposits.

Given the significance and subjectivity of the behavioural assumptions for valuing core demand deposits, we believe sufficient disclosures should accompany the model to explain the assumptions used and explain any changes in assumptions applied.

Question 10—Sub-benchmark rate managed risk instruments

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

We believe that sub-benchmark instruments should be eligible hedged items in a portfolio hedge accounting model if they are hedged for changes in the benchmark interest rates. In particular we note that this is necessary in order for demand deposits to be eligible hedged items since in many cases such deposits have very low or nil interest rates which are often lower than the benchmark rate.

Where fixed rate sub-benchmark instruments are designated as the hedged item, we believe the discount rate used to value the hedged item for changes in interest rates should be the benchmark rate and the numerator should be the hedged expected cash flows identified and designated from the overall portfolio.

(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?*

Variable rate exposures with an embedded floor would be included as part of a portfolio cash flow hedge and hence give rise to hedge ineffectiveness to the extent that an embedded floor impacts the variability of the designated hedged cash flows and the same (but offsetting) effect is not present in the hedging instrument (i.e. the hedging instrument is a vanilla swap with no equivalent embedded floor). In such a cash flow hedge, we do not believe the

embedded floor should be fair valued for interest rate risk unless it is hedged as part of a fair value hedge.

Question 11—Revaluation of the managed exposures

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

In developing a portfolio hedge accounting model, we believe the IASB should retain the principle that the designated hedged risk must be ‘separately identifiable and reliably measurable’ and subject to risk management in order to be eligible for hedge accounting. Hence, we believe in practice the identified hedged cash flows and the hedged risk will typically be based on a funding benchmark interest (i.e. 3-month LIBOR in the analysis presented in section 4.1 of the DP).

- (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?*

As noted in response to Question 11(a), we believe the hedged risk should be “separately identifiable and reliably measurable” and subject to risk management in order to be eligible.

Question 12—Transfer pricing transactions

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

As noted in response to Question 11(a), we believe the managed risk should only be eligible as the designated hedged risk if it is ‘separately identifiable and reliably measurable’. Hence, transfer pricing transactions will not necessarily be relevant in determining the hedged risk for hedge accounting purposes. Where the rate used in transfer pricing transactions is equivalent to the designated hedged risk (which must be ‘separately identifiable and reliably measurable’ and subject to risk management), such transactions (as a proxy to external hedged transaction) may represent a useful way to identify and measure the hedged item.

- (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.*

As noted in our response to Question 11(a), we believe the designated cash flows and the discount rate applied should be based on the hedged risk which must be 'separately identifiable and reliably measurable'. Based on this, we would accept the 'market funding index' approach (assuming that market funding index is separately identifiable and reliably measurable and subject to risk management).

- (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?*

Yes, as noted in our response to Question 11(a) we believe the hedged risk should be 'separately identifiable and reliably measurable' in order for it to be an eligible hedged risk.

- (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?*

As noted in our response to Question 12(a), we believe the use of transfer pricing would be limited to certain situations, which in turn would avoid the issues identified in paragraphs 4.3.1 – 4.3.4 of the DP.

Question 13—Selection of funding index

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

As noted in response to Questions 11 and 12, we believe the hedged risk can be any rate provided it is 'separately identifiable and reliably measurable' and is subject to risk management. This could result in the hedged risk being a single rate for all hedged items even where actual funding is based on more than one index.

- (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?*

As noted in response to Questions 11 and 12, we believe the hedged risk can be any rate provided it is 'separately identifiable and reliably measurable'.

Question 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?*

We have not fully considered examples of different pricing indexes that may be dynamically

managed since we believe those entities that dynamically manage interest rate risk based on a pricing index will be best placed to comment here. However, as noted in response to Question 11(a), we believe the hedged risk should be “separately identifiable and reliably measurable” and subject to risk management in order to be eligible. Therefore, dynamically managing interest rate risk with respect to a pricing index alone would not be sufficient to permit revaluation of the hedged exposure using the pricing index as the discount rate.

Question 15—Scope

- (a) *Do you think that the PRA should be applied to all managed portfolios included in an entity’s dynamic risk management (i.e. a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (i.e. 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?*

As noted in our response to Question 1, we do not support the PRA as described in the DP and instead prefer the development of a hedge accounting model that caters for accounting mismatches arising from risk management activities. A hedge accounting approach that includes the ability to behaviouralise cash flows on a portfolio basis and allowing bottom layers to be designated would reduce the operational complexities experienced under the existing portfolio fair value hedge accounting model in IAS 39 that are exacerbated through the ineligibility of demand deposits and restrictions from applying a bottom layer approach. We acknowledge that operational challenges will remain but consider these are commensurate with a portfolio hedge accounting approach that portrays complex portfolio risk management activities in the financial statements.

- (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?*

As noted in our response to Question 1, we do not believe that the objective should be to represent dynamic risk management in the financial statements. The PRA as described in the DP can result in items (or open exposures) that are purposely not risk reduced through risk management activities that under the classification requirements of IFRS would by default be measured at amortised cost be revalued through profit or loss leading to income volatility. We question the usefulness of this and therefore our preference is to develop a portfolio hedge accounting model that respond to accounting mismatches arising the execution of risk management activities. We believe that developing a portfolio hedge accounting model where (portfolios of) core demand deposits are eligible, bottom layers of portfolios may be designated and the hedged cash flows of portfolios can be based on expected (or ‘behaviouralised’) cash flows would represent a significant improvement on the current hedge accounting requirements and provide more useful information about an entity’s performance. As noted above, where exposures are not eligible to be revalued for accounting purposes (e.g. EMB), they may still be included by an entity to determine the net risk position of which some or all is hedge accounted.

- (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?*

Since we do not support the PRA, for the reasons highlighted in our response to the questions above, we have not commented on the operational feasibility of applying the PRA for the various scope alternatives presented in the DP.

- (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?*

For consideration of application to other risks, please see response to Question 25 below.

Question 16—Mandatory or optional application of the PRA

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

We do not support the PRA and would not support mandatory application.

- (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?*

Consistent with application of hedge accounting under the general hedge accounting model, we do not believe that a portfolio hedge accounting model should be mandatory because (1) it represents an exception to the default accounting requirements in IFRS 9 and (2) it would not be operationally feasible to enforce hedge accounting through defining what risk management is.

Question 17—Other eligibility criteria

- (a) *Do you think that if the scope of the application of the PRA were focused on dynamic risk management, then no additional criterion would be required to qualify for applying the PRA? Why or why not?*
- (i) *Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.*
- (ii) *If the application of the PRA were optional, but with a focus on dynamic risk management, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.*

Since we do not support the PRA focused on dynamic risk management we have not considered further any qualifying criteria that would be necessary.

- (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.

Under a portfolio risk mitigation hedge accounting model we would expect eligibility criteria consistent with that required under the IFRS 9 general hedge accounting model except for tailored concessions relating specifically to portfolio hedge accounting. For example, we would expect hedge accounting to be permitted only if the hedge is formally designated and if an economic relationship exists (rather than the 80 – 125% effectiveness threshold). Specific for portfolio hedging for interest rate risk, and as noted in our responses to the other questions, we would expect the model to include (portfolios of) core demand deposits, sub-LIBOR exposures and behaviouralised cash flows.

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

We do not support a mandatory model and have therefore not considered how the eligibility criteria might be different under a mandatory model.

(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 believe that any accounting alternative to address the accounting mismatches arising from executing risk management activities, like hedge accounting, should be an exception to the IFRS 9 classification and measurement model and voluntary to apply. Consistent with our comments on ED/2010/13 IFRS 9 Hedge Accounting we believe that ceasing to apply hedge accounting should also be a free choice. This will be particularly important for a portfolio hedging model given the dynamic nature of the hedging activity where the hedged items and hedging instruments will change frequently.

Question 18—Presentation alternatives

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

In the context of a portfolio hedge accounting approach, we would prefer the presentation in the statement of financial position to be consistent with the current requirements for portfolio fair value hedge accounting in IAS 39. That is separate lines for aggregate adjustments to assets and liabilities. We believe that this alternative is operationally simpler than adjusting on a line by line basis and consistent with existing accounting principles since the IAS 32 *Financial Instruments: Presentation* criteria for offsetting the aggregate asset and aggregate liability would not be met.

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

In the context of a hedge accounting approach we believe that the actual net interest income

presentation would be the most relevant presentation in the statement of comprehensive income. However, where the hedged item is not a net position (for example where the hedged item is solely a portfolio of demand deposits), we believe the interest from the hedging instruments should be presented in the same line as the interest from the hedged item rather than in a separate line as presented in paragraph 6.1.17 of the DP. We believe the separate line presentation of interest from the hedging instruments is only appropriate if the hedged item is a net position. This presentation is consistent with the presentation of amounts reclassified from the cash flow hedge reserve for cash flow hedges under IFRS 9. That is, the reclassified amounts are presented in the same line as the hedged item unless it is designated as a hedge of a net position in which case the reclassified amounts are presented in a separate line.

- (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.*

We have not considered any other alternatives.

Question 19—Presentation of internal derivatives

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

As stated above, we do not support the PRA as described in the DP and so we have responded to the question from the perspective of developing a hedge accounting model that caters for accounting mismatches arising from risk management activities.

We do not believe that internal derivatives should represent eligible hedged items or eligible hedging instruments in a portfolio hedge accounting model as we do not believe that the resulting gross presentation in the statement of comprehensive income, arising solely from internal transactions, is appropriate.

Furthermore, in practice, the formalities and controls around internal derivatives can vary significantly which could introduce significant challenges in practice and could hinder comparability amongst reporters.

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

Since we do not support the risk management PRA approach, we have not considered whether the treatment of internal derivatives would enhance its operational feasibility.

We do not believe that a portfolio hedge accounting model needs to accommodate internal derivatives in order to be operable.

- (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?*

We do not support the recognition and measurement of internal derivatives in the consolidated financial statements.

Question 20—Disclosures

- (a) *Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views.*
- (b) *If you think that an identified theme would not provide useful information, please identify that theme and explain why.*
- (c) *What additional disclosures, if any, do you think would result in useful information about an entity's dynamic risk management? Please explain why you think these disclosures would be useful.*

Given that we do not support the PRA as proposed in the DP and the early stage of its development we have not considered the disclosure requirements in detail. However, if the IASB were to develop a portfolio hedge accounting model that builds on the concepts already in IFRS that includes core demand deposits, behaviouralised cash flows and bottom layers, we would support disclosures that help users understand the significant judgements and assumptions applied and an analysis of the impact of hedge accounting on the financial statements.

Furthermore, to make the financial reporting more useful for users, disclosures will play a key role for bridging the gap between risk management activities and recognition and measurement in the primary financial statements. However, in developing appropriate disclosures, we recommend a full evaluation of current disclosure requirements and other disclosure related initiatives by the IASB and others (e.g. FASB, EDTF, etc.).

Question 21—Scope of disclosures

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

Please see our response to Question 20 for our initial views on disclosures.

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

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

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

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

We believe the approach to inclusion of exposures in a portfolio hedge accounting model should be consistent with the current requirements in IAS 39. That is, items can generally be included at any time typically from the point they become contractual (or, in respect of pipeline transactions, become constructive obligations).

Question 23—Removal of exposures from a managed portfolio

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

Consistent with our response to Question 17 and 22, we believe that under a portfolio hedge accounting model, hedged items can be removed (i.e. de-designated) voluntarily with the resulting adjustment accounted for in the same way as under the current portfolio fair value hedge accounting model in IAS 39.

Question 24—Dynamic risk management of foreign currency instruments

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

Since we do not support the PRA we have not considered its extension to dynamic risk management of foreign currency instruments. However, in the context of portfolio hedge accounting, we do not see why such a model should not permit the inclusion of foreign currency risk if both interest rate and foreign currency risk are hedged together (for example with cross-currency interest rate swaps). In this context, we believe the Board should reconsider the requirements from IFRS 9.6.5.16. This is because basis spreads, without a similar or identical special accounting treatment, would give rise to ineffectiveness.

Question 25—Application of the PRA to other risks

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

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

For the reasons outlined in response to Question 1 (and responses to other questions), we do not support the PRA approach and hence do not support it for other non-bank dynamic risk management.

We believe the Board should consider more broadly a portfolio hedge accounting approach to interest rate risk, not just for banks. As noted in our responses on phase two of Insurance Contracts in 2010 and 2013 we believe a portfolio hedging solution should be explored for insurers as it is common for insurers to use derivatives to hedge interest rate risk on their duration mismatch between their non-derivative financial assets and insurance liabilities. Given the measurement of insurance contracts is due to be finalised next year we recommend that the Board consider whether such hedging strategies will lead to accounting mismatches that can be minimised with a portfolio hedge accounting solution that includes insurance contracts as hedged items. Further, as the development of the PRA is a solution to a structural interest rate hedge in banks, we would favour outreach to non-financial entities on whether their portfolio hedging strategies share similar characteristics to financial entities.

Question 26—PRA through OCI

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

We do not support the PRA through OCI approach and therefore do not think this should be pursued.