German Banking Industry Committee

Die Deutsche Kreditwirtschaft

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Comments by the German Banking Industry Committee (GBIC) on DP 2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

17-10-2014

Dear Mr Hoogervorst,

The German Banking Industry Committee (GBIC) would like to thank you for the opportunity to comment on the IASB Discussion Paper 2014/1 "Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging".

General Comments

On a more general note, we welcome the International Accounting Standards Board's (IASB) plans for the development of a new accounting approach for dynamic portfolios. In our view, the IASB's proposed Portfolio Revaluation Approach (PRA) touches upon key aspects which we would like to address in greater detail in the comments below.

Due to the existing restrictions under IFRS 9 General Hedge Accounting or, moreover, IAS 39, the current accounting framework fails to provide an accounting solution for dynamic risk management. In light of this, we support the preparation of a new accounting approach that accommodates key risk management aspects. The GBIC explicitly welcomes the fact that, in its Discussion Paper, the IASB *inter alia* focuses on the treatment of the following eligible hedged items:

- Core demand deposits
- Prepayable mortgages
- Sub-benchmark exposures
- Equity Model book

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As far as the GBIC is concerned, it is of decisive importance that a future accounting approach addresses the accounting mismatch between the amortised cost measurement of hedged items and the Fair Value of the hedging instruments / derivatives. For this reason, we would like to advocate in favour of a macro hedge accounting approach with a focus on risk mitigation and we whould like to object to a compulsory coverage of the entire risk management (focus on dynamic risk management).

Furthermore, we would like to point out that in practice, banks feature very heterogeneous business models and risk management approaches. The forthcoming development of a macro hedge accounting approach needs to accommodate this aspect. The PRA approach presented in the Discussion Paper is specifically predicated on an interest rate risk management approach which, in turn, is based on a transfer pricing model and which uses internal transactions for the purposes of pooling and managing exposures in a portfolio. These approaches allow banks to transfer risks between books that follow different business strategies. This way, banks do not need to draw upon the external market. This allows a high precision replication of risk and earning profiles due to the fact that internal transactions are indeed transacted at market terms (like external transactions) but are not subject to other restrictions, risks and costs of external transactions.

Thus, compared to a lack of recognition of these transactions, an accounting measurement through P&L of these internal transactions can better reflect the actual risk and earnings position resulting from the risk management activities. Provided the management process is designed accordingly, this can ensure an appropriate allocation to the net interest income and valuation result without incurring the need to implement a complex amortisation logic.

Other banks refrain from use of internal transactions for risk management purposes for various reasons. Rather, risks are reduced on the basis of aggregated sensitivity profiles through external transactions. Whilst this may successfully reduce the impact of interest rate changes on net profit or loss it does not "automatically" translate into an adequate picture of the hedged margin in the net interest income. An adequate allocation of valuation components to the interest income or moreover valuation result requires an amortisation logic.

Hence, a new approach for the representation of dynamic risk management needs to accommodate different management approaches. In this respect, the following constellations should be covered:

1. Stable interest income:
- Role of the business model: The meaning of the breakdown in the net profit or loss posted may vary depending on the business model. For instance, the reporting of stable interest income is of major importance for an investor with a long-term focus.
- Internal vs. external transactions: the open risk positions may be hedged by means of internal and / or external transactions. In order to facilitate the objective of a stable interest income, hedging by means of external transactions should allow an amortisation logic.

2. Granularity of the information in risk management:
   Information on exposures may exist on the basis of individual transactions or in the form of an aggregated risk profile. Along with a valuation approach that is based on individual transactions, it needs to be legitimate to use a method which is based on an aggregated cash flow. Otherwise, it will be impossible to achieve the underlying rationale i.e. the reflection of dynamic risk management.

3. Gross / net management
   Depending on the business model, the structure of the asset and liability side may be highly different. As a result, some banks use a gross management approach (e.g. micro hedging on the liability side and macro hedging on the asset side). In these scenarios, also the inclusion of gross portfolios under the macro hedge approach needs to be a legitimate option.

In light of this, the requirements for the identification and measurement of the hedged exposure need to allow methods for all management approaches that can be operationalised. However, under the current proposals concerning risk management by means of external transactions and on the basis of aggregated risk profiles, the PRA yet fails to deliver this objective.

For this reason, as part of a risk mitigation approach, we suggest an alternative method for the accounting treatment of hedging transactions on a macro level. Whilst the hedging instruments always feature a solo transaction view, more often than not, in the hedged item this is not the case. Hence, the identification and measurement of the mitigated risk should be permissible on the basis of the hedging instruments: It should be allowed to use certain components of the (internal or external) hedging instruments as a basis for determining the mitigated risk and the risk mitigating effect. Other components of the hedging instruments such as Credit Valuation Adjustments (CVA) or Debit Valuation Adjustments (DVA) are not offset and thus are measured through profit or loss (P&L). Proof of the derivatives' risk mitigating effect is an eligibility criterion for this approach. To this end, it is possible to draw upon risk management methods.

<u>Question 1 - Need for an accounting approach for dynamic risk management</u>

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?

On a more general note, we welcome the IASB's efforts for the development of a new accounting approach for dynamic portfolios. The GBIC holds the view that this is clearly called for given the existing restrictions under IFRS 9 General Hedge Accounting or, moreover, IAS 39 as it is currently not possible to provide an adequate picture of dynamic risk management in the financial statements. Open portfolios are furthermore characterised by frequent inclusions and removals of underlying transactions thus testing the limits of existing accounting principles. This has a particular effect especially on banks., becauserisks such as interest rate risks are managed dynamically on a portfolio level. In our view, the need for specific rules for dynamic portfolios results from the existing accounting mismatch between hedged items and hedging instruments (amortised cost vs. fair value). Based on the foregoing, the GBIC advocates in favour of a solution that features a risk mitigation approach. We object to a representation of the total risk management (focus on dynamic risk management). Our caveat is owed to the fact that the latter approach is not limited to the removal of an accounting mismatch (please cf. also our comments under question 15 for a more detailed discussion of this issue).

<u>Question 2 - Current difficulties in representing dynamic risk management in entities' financial statements</u>

(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?

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

Yes, we do think that the DP has correctly identified many elements of a typical interest rate risk management approach. Whilst not limited to, this particularly includes the issues core demand deposits, prepayment option, internal derivatives and equity model book. However, we doubt the applicability of the PRA proposed in the Discussion Paper when it comes to banks that manage their interest rate risk by means of derivatives contracted externally on the market as well as on the basis of an aggregated risk profile. This requires a solution for such a dynamic risk management approach for identifying and measuring the mitigated risk - i.e. an approach that can be operationalised. Such an approach needs to be capable of eliminating the accounting mismatch between underlying and hedginginstruments. Apart from this, an appropriate allocation of changes in net present value to net interest income or valuation result requires a differentiation between amortisation effects (net interest income) and purely interest rate driven effects (valuation result).

<u>Question 3—Dynamic risk management</u>

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?

As far as the GBIC can see, the Discussion Paper addresses key aspects of a dynamic risk management approach that is based on a transfer pricing model and that transfers risks through internal derivatives to a book featuring fair value accounting.

Yet, the DP's description of other risk management approaches is not accurate and complete. We have particular concerns over the lacking consideration of an interest rate risk management by means of externally contracted hedging instruments, the failure to consider a risk measurement which is based on an aggregated sensitivity profile as well as the lacking coverage of a gross management of interest rate risks.

<u>Question 4—Pipeline transactions, EMB and behaviouralisation</u>

(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).

(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.

(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 welcome the IASB's plans to align the accounting approach for open portfolios more closely on the day-to-day realities of actual risk management on the ground. From our point of view, any future macro hedge accounting model that is based on a risk mitigation approach should therefore consider replication portfolios for modelling target ROEs (equity model book) as well as behaviouralised approaches for determining cash flows (provided the latter are subject to an entity's actual risk management approach). We hold the view that this would enhance the communication of decision-useful information, i.e. the underlying rationale of IFRS accounting. Whilst we acknowledge the theoretical possibility of considering expected lending transactions at a predefined interest rate (pipeline transactions), we still hold the view that the recognition of these transactions present a major challenge. Our reservations are owed to the fact that the respective risk positions involved constitute merely behaviouralised risk positions that are based on assumptions.

<u>Question 5—Prepayment risk</u>

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.

We advocate in favour of considering such transactions as part of a risk mitigation approach if and when the latter are used for the purposes of managing prepayment risk under the actual risk management approach adopted. However, in order to consider prepayment risks, in line with the risk management approach, also behaviouralised modelling of cash flows should be an option.

<u>Question 6—Recognition of changes in customer behavior</u>

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?

The GBIC is of the opinion that changes in customer behaviour should at any given point in time also be reflected in the internal assumptions regarding customer behaviour. Thus, it must be possible to adjust own assumptions to actual circumstances.

The recognition of the impact of changes in customer behaviour in the financial statements should depend on the actions that risk management undertakes to transform the re-modelling.

<u>Question 7—Bottom layers and proportions of managed exposures</u>

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.

Provided this approach reflects the activities of the actual risk management for risk mitigation purposes, we are in favour of the consideration of a bottom layer approach as part of a PRA.

<u>Question 8—Risk limits</u>

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

Due to the fact that this would translate into both conceptual and operational obstacles, we have reservations over reflecting internal risk limits as part of the PRA. Doubtlessly, limiting risks plays a key role as part of the capital and risk allocation; more often than not, it is an element of banks' internal risk management. However, we also agree with the Discussion Paper's statement that risk limits need to be laid down individually as part of the internal risk management. Provided the concept were to be rolled out to accounting, it could potentially result in wrong incentives (the higher the risk limit, the higher the accepted risk and the lower the volatility in P+L). As a result, this would undermine the actual rationale of a limit system i.e. it would be incompatible with the limitation of risks. Furthermore, from an operational point of view, reflecting risk limits for accounting purposes would raise an important question, i.e. how to deal with situations in which risk limits are exceeded within a year.

Notwithstanding the foregoing, we would also like to point out that whilst a definition of limits may allow certain discretion, the fixing of limits cannot be an arbitrarily exercise. This is because a bank's capital and risk allocation is restricted by the available risk capital. Furthermore it is subject to comprehensive regulatory requirements as well as the audit of the financial statement.

<u>Question 9—Core demand deposits</u>

(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?

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

(a) Usually, classical deposits such as demand deposits are callable at short notice. However, due to the fact that these deposits do not respond in a highly sensitive manner to market interest rate movements it is a common market practice to define core deposits on the basis of behaviouralised assumptions. From the perspective of a bank these core deposits are deemed to be available over a certain period of time with a sufficient degree of certainty. Risk management usually treats these so-called "core demand deposits" by way of analogy to an economically fixed interest position. For this reason we advocate in favour of including core demand deposits for accounting purposes as part of the PRA if and when these core demand deposits form part of the actual risk management for the purposes of risk mitigation.

(b) The determination of core demand deposits is subject to a certain degree of discretion on the part of the accounting entity. However, we are not of the opinion that this discretion should be restricted by guidelines. In practice, depending on the risk management approach determining core demand deposits takes place on the basis of bank-specific data and experience. Hence, we are concerned that guidelines imposed for accounting purposes will - at best - limit individual risk management. In light of the above, we object to the development of any such guidelines. Instead, the GBIC holds the view that the required degree of transparency may be achieved as part of the disclosure.

<u>Question 10—Sub-benchmark rate managed risk instruments</u>

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

an appropriate reflection of the risk attached to sub-benchmark instruments? Why or why not?

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

(a) Sub-benchmark instruments feature an interest rate that is below the market rate (benchmark). By way of a funding transaction example, in economic terms, the interest rate could be interpreted as a payable benchmark rate (swap rate) plus a premium received - this could indeed be an integral part of a business model. However, as part of risk management, hedging the benchmark rate is a common practice. Under IFRS 9, it is merely allowed to designate the cash flows that are actually hedged which means that the exceeding part would have to be recognised in P+L. This would result in volatility which is at odds with the risk management that is actually being conducted. Hence, we feel that there is a need to allow a designation of the benchmark interest rate if and when the latter represents the managed risk. As a consequence, we advocate in favour of approach 3 ("Risk included in ALM”) presented in Chapter 3.10.

(b) We would like to reiterate that a sub-benchmark rate funding transaction may potentially be an integral part of a business model. In this case, the assumption of an embedded floor is not correct. Hence, the definition of the benchmark rate as a hedged risk should always be an option without any restrictions(c.f. also (a)).

<u>Question 11—Revaluation of the managed exposures</u>

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

(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?

In terms of the risk mitigation approach, the calculation of the revaluation adjustments concerning managed risks is an approach that is fit for purpose. Provided the calculation method and the presentation are designed appropriately, this overcomes the accounting mismatch between hedged net positions from underlying transactions that are not measured at fair value through profit loss and hedging derivatives which are measured at fair value through profit and loss (FVPTL).

Concerning the interest rate risk, the GBIC is of the opinion that a benchmark index which provides the basis for the internal interest rate risk management may represent the managed risk for the purposes of calculating the revaluation adjustment (provided certain preconditions are met and depending on the bank-specific risk management). The benchmark index will then be the (uniform) index on the basis of which liquidity is obtained from the ALM and passed on[1] and which is used as the basis for interest rate risk management in the hedging derivatives (variable leg). Any interest components (e.g. margins) beyond the benchmark index should not be considered during the calculation or, moreover, the calculation should be adjusted accordingly (cf. also our presentations on the valuation approaches in response to question 12).
However, it is worth noting that - depending on the entity-specific risk management - it is also possible that there will be several deviating indexes in the liquidity and interest rate risk transfer for assets and liabilities (cf. comments under questions 13 and 14 as well as, for instance, example 1).

[1] The condition at which liquidity is obtained or, moreover, passed on, is defined by the ALM as index + spread.

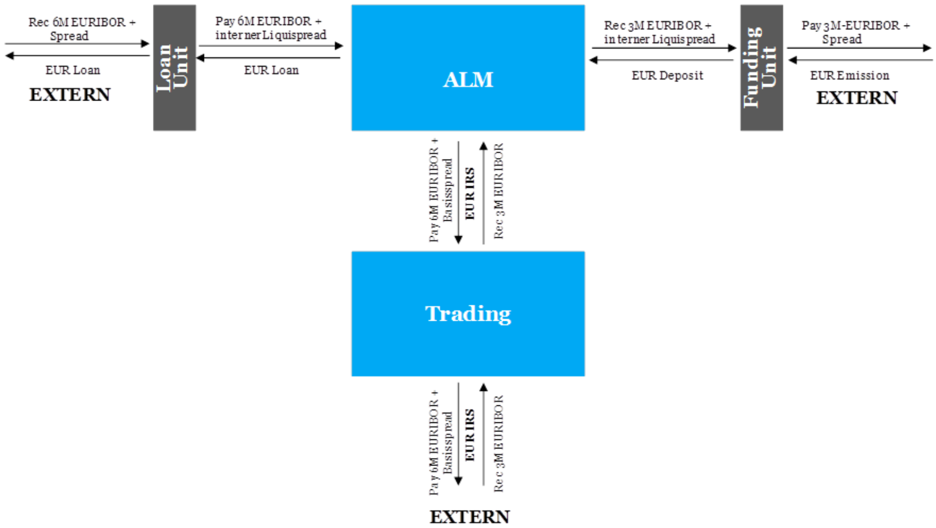
At this juncture, we would like to point out that Section 4.1.7 is not entirely unambiguous. The meaning of "counterparty credit spread" remains unclear. This term is used in the example provided concerning the management of the funding index to the amount of 3%; also, it remains intransparent whether this spread shall be equivalent to the "customer specific margin" of 3 % in the example provided concerning the "role of transfer pricing‟ under Section 4.2.12. Furthermore, it is doubtful whether the bank will enter into a transaction which it would actually have to conclude at 7.5% (funding + credit spread) and not at 7.1%.

In line with our comments under question 15 we advocate in favour of limiting the scope of the current proposals to the field of risk mitigation. As an alternative choice other than the ones presented in the Discussion Paper it might be worth considering an approach where a revaluation adjustment shall be calculated on the basis of the internal and external hedginginstruments. This approach would require proof that the hedging derivatives mitigate the managed risk resulting from the net positions of underlying transactions. In our view this approach would be an appropriate solution: After all, the hedging derivatives represent the risks which are actually being hedged. This is particularly essential in those cases where no funds transfer pricing transactions are being used for risk management purposes resulting in the absence of a benchmark index from the funds transfer deals. In light of this, the GBIC is of the opinion that it should also be permissible to calculate the revaluation adjustment on the basis of the hedging derivatives. The valuation results of the derivatives which are used for the underlying transactions for the purposes of derivation would potentially have to be adjusted for value changes relating to risks which are not present in the managed net risk positions (margins, CVA).

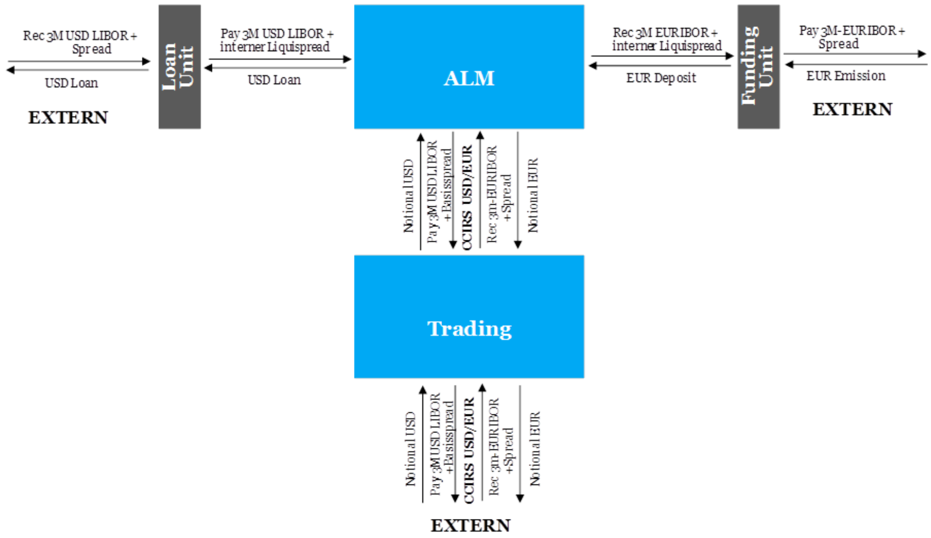
Along with the hedging of interest rate risks in relation to a benchmark index, banks' dynamic interest rate risk management may also include the hedging of basis risks between deviating indexes for lending and funding transactions. In this regard, the basis risks resulting from interest tenor deltas or, moreover, interest currency basis risks are calculated by juxtaposing the asset and liability positions. These positions are subject to changes due to newly included and / or removed transactions; furthermore new hedging instruments can be transacted. Any surplus can then be hedged by basis swaps or, moreover, interest currency basic swaps. The following figures use two examples to illustrate the management of basis risks within an exemplary Funds Transfer Pricing Mechanism.

In example 1, the loan unit extends EUR denominated loans on the basis of the 6-M-EURIBOR. The requisite liquidity is provided internally by ALM through loans denominated in EUR. These are based on the 6-M-EURIBOR. Through issues, the funding unit obtains liquidity denominated in EUR on the basis of 3-M-EURIBOR. It transfers this liquidity internally to ALM by means of deposits. This transfer takes place on the same basis plus a liquidity spread which is defined by ALM. The tenor basis risks resulting from the deviating indices for EUR lending and funding are analysed in ALM on a net basis. If needs be, the ALM hedges open net risk positions by means of internal basis swaps with the trading unit. The latter, on the other hand, conducts a net risk analysis of its total positions. Within its risk limits, it then decides on an external hedging by means of basis swaps.

In example 2, the loan unit extends USD denominated loans on the basis of the 3-M-USD-LIBOR. The requisite liquidity is provided internally by ALM by means of USD denominated loans. These are based on the 3-M-USD-LIBOR. Due to the fact that the bank only has limited access to direct USD funding, it acquires liquidity in EUR on the basis of the 3-M-EURIBOR and transfers this liquidity internally to the ALM by means of deposits; said transfer to the ALM takes place on the same basis plus a liquidity spread defined by the ALM. The interest rate basis risks from the different currencies and indexes for lending and funding are analysed on a net basis in ALM. If necessary, ALM hedges open net risk positions by means of internal interest rate swaps with the trading unit. These interest rate swaps contain a notional exchange of EUR into USD meaning that a USD funding transaction is generated when viewed in combination with the EUR issues. As part of a net risk analysis of its total positions and within its risk limits, the trading unit in turn decides on an external hedging by means of an interest rate currency swap.



Example 1: Management Tenor Basis Risks EUR



Example 2: Management Cross Currency Basis Risks EUR/USD

In the event of dynamic hedging of basis risks, the measurement approach for determining revaluation adjustments would have to be conceived of in a way that ensures an appropriate offsetting of fair value changes of the hedging derivatives (basis swaps, cross currency basis swaps). See also our comments under question 14.

<u>Question 12—Transfer pricing transactions</u>

(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?

The use of internal transactions is reasonable for the purposes of determining the managed risk. However, we would propose that the mitigated risk or, moreover, the revaluation adjustment may also be determined on the basis of the hedging derivatives (cf. also our corresponding comments under question 11 for a more detailed discussion of this matter).

The calculation of the revaluation adjustments on the basis of the valuation of the derivatives needs to factor in an adjustment for value changes regarding risks that are not integral part of the managed net risk positions (margins, CVA). In order to facilitate a pragmatic implementation under due cost-benefit considerations, we advocate against imposing any specific methodology for calculating or, moreover, adjusting the revaluation adjustments for unmanaged risks. The specific approach should be chosen at the level of the individual bank in line with its respective risk management and after due consideration of the respective operational feasibility. Any presentations on the choice of methods could then be included as part of the disclosure exercise.

Under the heading "Role of transfer pricing‟ the DP discusses a potential inconsistency between a bank's dynamic risk management and the requirements under IFRS 13 (Section 4.2.16, footnote 28). We believe this inconsistency is a surmountable obstacle to providing a faithful representation of dynamic risk management in financial accounting

<u>Question 13—Selection of funding index</u>

(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?

Based on our above presentations, we are of the opinion that (depending on the exact nature of the entity-specific risk management) a representation of the managed risks on the basis of one or several indexes may be an option, indeed. Hence, in the same vein, in order to ensure a consistent presentation of the managed risks in risk management, it should also be possible at the level of the individual entity to define the index or moreover of the indexes which shall be used for the purposes of determining the revaluation adjustments. The GBIC would like to caution against imposing any mandatory selection criteria. Our reservations are owed to the fact that in order to achieve an accounting measurement that reflects a faithful view, the risk management could have to be adjusted to accounting rules. Any description of the indexes used as the basis for revaluation purposes can be included during the disclosure exercise.

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?

One possible approach to the Funds Transfer Pricing Mechanism is that ALM obtains liquidity on the basis of an index that differs from the one used for providing liquidity to the lending units. For a more detailed discussion see also example 1 presented under question 11 where internal liquidity is obtained on the basis of 3M EURIBOR, whilst 6M EURIBOR is used as a basis for the liquidity provided as part of lending. Provided 3M Euribor is defined as a uniform benchmark index, the pricing index for the loan used in this example would not be the benchmark index (3M Euribor) but, instead, it would be the 6M EURIBOR. The resulting basis risk between lending and funding will be measured by ALM and, if necessary, will be hedged by means of basis swaps.

Depending on which index is used for the cash flow forecasts (forward curve) as well as for the net present value calculation of the cash flows (discount curve), the valuation approach used for the calculation of the revaluation adjustments features the following alternatives:

- If the 6M EURIBOR pricing index is used for the purposes of projecting the cash flows for loan A and if the 3M EURIBOR funding index is used for the funding, the result would be fit for purpose. After all, a uniform net present value calculation on the basis of the 3M EURIBOR index would offset the distortions resulting from the revaluation adjustments through the value changes from the basis swaps concluded.
- If the 3M EURIBOR benchmark index was used on a uniform basis for the purposes of cash flow forecasts as well as for the calculation of the net present value, the basis risk (in its capacity as a managed risk of the net position) would have to be reflected by means of an additional revaluation adjustment.

At this point it is worth noting that - particularly in the context of the risk mitigation approach which we advocate - the choice of the valuation approach or, moreover, the indexes used thereunder, should be flexible and in line with the individual risk management. The valuation approach needs to be geared towards the hedged risk. Further to our comments under question 15 we would like to propose one more alternative the IASB might wish to consider in addition to the approaches presented in the Discussion Paper where the hedged risk or, moreover, the revaluation adjustment may also be calculated on the basis of the derivatives.

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 (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?

(a) We are of the opinion that a PRA shall and may merely be applied to portfolios where the risk is hedged by means of risk management instruments ("focus on risk mitigation"). This would be in line with the initial rationale of hedge accounting, i.e. removing accounting mismatches that result under different valuation approaches applied to different categories of financial instruments (mixed model).

The overarching objective should be a convergence of the risk management generally in those areas where differences in measurement arise that do not feature an economic justification. This also applies *mutatis mutandis* to natural hedging relations (without use of derivative risk management instruments). For a more detailed discussion of this matter, c.f. also our response to question 17.

In practice, among banks, a PRA with a focus on dynamic risk management would lead to a revaluation of large parts of the banking book with resprect to the underlying interest rate risk (and potentially to other managed risks). *De facto* this would lead to fair value measurement for those assets and liabilities which have to be accounted for at amortised cost under the provisions of IAS 39 or, moreover, under IFRS 9 - yet, the sole reason for this fair value measurement would consist in the fact that the risks resulting from these assets and liabilities are subject to regular monitoring. Whilst not limited to, such a presentation would prove particularly counterproductive for business models with a long term focus (hold-to-collect) and would furthermore contradict the mixed measurement model according to IFRS 9 and IAS 39.

(b) We are convinced that the combination of a PRA with a risk mitigation focus and the rules on General Hedge Accounting under the provisions of IFRS 9 complemented by additional disclosures in the notes can generally provide a faithful representation of dynamic risk management which would accommodate the underlying hedge accounting rationale. On the other hand, a nearly complete revaluation of the banking book transactions in the financial statement would not reflect the nature of these transactions; what is more it would fail to enhance the decision-usefulness of the information contained in the financial statement.

(c) We advocate in favour of using a sub-portfolio approach in the PRA with a focus on risk mitigation and we should like to argue against a proportional approach. In our understanding, a sub-portfolio approach provides a more concise presentation of the approach adopted in risk management. However, as far as the definition of sub-portfolios for the purposes of the PRA is concerned, we would like to point out that there are also banks where the interest rate risk is managed and hedged on the basis of one single (total) portfolio (e.g. total banking book). In these cases a sub-portfolio approach shall and may not lead to a situation where this (total) portfolio that is being assessed will have to be broken down artificially into sub-portfolios. This would potentially be at odds with business management. Concerning a sub-portfolio approach that is conceived of with a view to operational feasibility, we agree that there may result changes to the risk management approach adopted with regard to individual (sub) portfolios. However, the individual (sub) portfolios do not feature such changes on a regular basis; consequently, such changes can be rather deemed an exception.

As an alternative to the sub-portfolio approach, we also advocate in favour of the option to determine the revaluation adjustment of the underlying transactions by means of the hedging instruments / derivatives (cf. also our presentations under question 11 for a more detailed discussion of this matter). This would constitute a simplified approach. From our point of view, it would strongly enhance the PRA's operational feasibility. One eligibility criterion for such an approach is proof of the risk mitigating effect of the hedging instruments (e.g. through a sensitivity reduction concerning the hedged risk for the respective portfolio). In our opinion, this approach would be fit for purpose due to the fact that all elements of the mitigated risk of the underlying will also be included in the hedging instrument. The GBIC holds the view that any other valuation components included in the hedging instruments which cannot be attributed to risk mitigation could also be valued separately and recognised as ineffectiveness.

(d) In our view, the deliberations under (a) to (c) also apply to FX and commodity price risks.

<u>Question 16—Mandatory or optional application of the PRA</u>

(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?

(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?

(a) We object to the application of the PRA with a focus on dynamic risk management.

(b) The application of the PRA focused on risk mitigation should be optional. In the event of a mandatory application, the implementation costs would frequently bear no relation to the benefit derived from the PRA application (hence, they would be in breach of the principle of proportionality). Furthermore, also in the event of a mandatory application within individual entities, the diverging approaches adopted by risk management means that the objective of enhanced comparability between the statements could only be achieved to a limited extent.

<u>Question 17—Other eligibility criteria</u>

(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.

(a) We object to the application of the PRA with a focus on dynamic risk management. However, our comments under (b) also apply to this approach.

(b) From our point of view, portfolios that are subject to hedge accounting under the provisions of IFRS 9 should be excluded from the PRA's scope of application. Furthermore, the absence of a an accounting mismatch shall warrant the option of excluding portfolios or, moreover, positions. Whilst not limited to, this particularly applies to natural hedges which do not use hedging derivatives.

Above and beyond this, we would also like to highlight one further peculiarity which may result from a decentralised risk management approach in a group. Whilst not limited to, this particularly concerns situations where risk management as well as hedge accounting are not conducted across group level but primarily at the level of the individual group companies (solo level). In these cases, the interest rate risk management of every individual group company includes both group internal and also group external risk exposures and derivatives. There is no cross-group portfolio creation nor is there cross-group portfolio management. Also, hedge accounting for the consolidated financial statements will be conducted at the level of group companies. At present (in line with IAS 39 rules) there is respectively only the designation of group external risk exposures and derivatives meaning that there is no need for any adjustments on group level as part of the consolidation. This begs the question whether, in light of the above, the application of the PRA proposed in the Discussion Paper leads to an appropriate reflection of the risk management. Section 2.1 of the Discussion Paper sets out that the PRA may only be applied to risks arising from external exposures. If and when the group external lending transactions of a group entity were to be funded by group internal transactions, the group entity's risk management takes into account both the lending transactions and also the funding transactions; the same applies to the (group) internal or, moreover, (group) external derivatives transactions concluded for the purposes of risk management. Any unilateral inclusion of lending and derivatives transactions into macro hedge accounting without the possibility for the PRA to equally take into account the risk exposures from the group internal funding would trigger inconsistencies in the measurement (accounting mismatches). In the absence of a fundamental change to the risk management as well as to the group's management processes, it would be impossible to remove these inconsistencies at group level. The GBIC is of the opinion that it is of paramount importance that the new rules on the accounting treatment of dynamic risk management shall and may not trigger any changes to the operational risk management. In this context there should also be further analysis of the possible inclusion of (group) internal risk exposures in the PRA.

Question 18—Presentation alternatives

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

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

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

(a) We are of the opinion that the only appropriate presentation of a net risk management consists in a single net line item. In our view, a gross representation through separate line items for assets and liabilities let alone an even more granular breakdown of the adjustment amount generates no useful information. After all, any allocation of the result from a net position to individual gross positions would be artificial.

(b) The GBIC is of the opinion that the actual net interest income approach is a more useful presentation of the interest rate risk hedging effects. At this point, it is our understanding that the net interest income includes both the accruals from underlying exposures and hedging instruments as well as any amortisation effects arising from hedging transactions (i.e. the stabilisation effect on net interest income arising from hedging transactions). The amortisation effects offset the changed market interest rates which means that they are an element of the hedged margin. Hence, from our point of view, there is invariably a need for allowing an amortisation logic. In the presentation of net interest income this is required in order to present the stabilisation effect of the net interest income which was the underlying rationale of the hedging transactions[2]. In our expectation, the revaluation effect will demonstrate very low volatilities. Our reservations are owed to the fact that we object to the focus on DRM; instead we suggest limiting the scope to the risk mitigation approach. Consequently, this can merely reflect valuation components of the hedging derivatives which are not included in the underlying transaction (e.g. CVA/DVA).

We object to the stable net interest income approach described in the Discussion Paper. Under the current proposals, budget figures would be adopted for accounting purposes which potentially fail to take account of changed market conditions. On the other hand, as a residuum , the item "Revaluation effect from DRM" would include both realised as well as unrealised net income components. Through its hybrid nature, this item would become comparable to a compound item which is devoid of any meaningfulness. Consequently, whilst in our view it would fail to deliver any useful information, its explanation would become highly complex.

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

[2] Avoiding an amortisation logic is only possible if removals of hedged transactions are reflected by an internal offsetting transaction at prevailing market rates (c.f. presentation under Chapter 4.3.2 (b) of the DP and cf. also our comments under question 11). However, in banks in which exposures are not transferred by means of internal transactions this is not in line with the usual control activities.

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?

As far as banks are concerned in which interest rate management takes place by means of internal derivatives (i.e. derivatives which serve to transfer risks from the ALM into the trading book) we hold the view that the gross presentation of the profit or loss from internal derivatives is necessary for an appropriate allocation of profit or loss from derivatives to the net income from hedge relationships or, moreover, to the profit or loss from trading. Due to the fact that the net effect from the internal derivatives is zero, this is merely a methodology for the allocation of risks and profit or loss in line with its economic objective.

If there is a risk transfer by means of internal transactions from the ALM to the trading book, an approach would be conceivable where portfolio changes arising from external transactions will invariably be reflected by an offsetting internal transaction at prevailing market rates. In this case posting of the accrual from the internal transactions should dispense with the need for an amortisation logic thus reducing the operational complexity of the PRA. However, not all banks adopt this approach for recognising portfolio changes in the risk management. There are banks where the interest rate risk is managed on the basis of external derivatives (c.f. also our introductory comments for a more detailed discussion of this matter). The conclusion of external derivatives transactions incurs costs; hence, a representation of portfolio changes by means of external offsetting transactions would not be economically viable. Instead, if the corresponding hedging instrument is derecognised, this hedging instrument would be closed out or, if needed, it will be used for the purposes of hedging a corresponding new business transaction. This results in the need for tracking and amortisation. The reduction of the operational complexity resulting from the recognition of the internal derivatives transaction is consequently limited to a group of banks which use internal derivatives for risk management purposes. In all other cases we perceive a need for an amortisation logic; hence, we do not perceive any reduction in operational complexity. In our understanding, the use of macro hedge accounting shall and may neither depend on a bank's business model nor on the specific nature of its business management.

<u>Question 20—Disclosures</u>

(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.

In our opinion, qualitative disclosures concerning the risk management approach are useful if they provide users of the financial statements with an idea of the risk management quality. This includes the following disclosures:

- Types of managed risks / portfolios
- Risk strategy
- Organisational risk management workflow
- Risk measurement methods

In order to enhance comparability, further qualitative disclosures could also be useful concerning the accounting approach adopted with regard to the risk mitigation effect. These qualitative disclosures could refer to the valuation methodology / the model's underlying assumptions.

We object to quantitative disclosures concerning the open risk position if and when such disclosures exceed the regulatory risk capacity calculation. More specifically, we object to any disclosures concerning the level and distribution of the risk positions.

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 cf. also our comments under question 20 for a more detailed discussion of this issue.

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.

(a) Dynamic portfolios are subject to ongoing changes. For instance in practice, more often than not, also migrations between individual dynamic portfolios can be observed. In our view there is a compelling need to allow inclusion of exposures in the managed portfolios after an entity first becomes a party to a contract (in line with the Discussion Paper's proposal). Otherwise, at this point we perceive the potential risk that the dynamic portfolios created for accounting purposes will be inconsistent with the portfolio allocation for business management purposes.

(b) In our view, valuation models should be allowed which ensure that there will be no day 1 valuation effect. This can be ensured, for instance, by the so-called Par Bond method.[3] However, we would like to point out that further work is necessary on this issue and that this question can finally be decided after the definition of the risk mitigation approach.

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,

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[3] The Par Bond method constitutes a valuation approach in which the valuation cash flow is fixed and determined on the basis of the benchmark rate on day one. The discounting takes place by means of the current day benchmark rate. As a result, the day one value equals par (no day 1 valuation effect) the subsequent valuation represents the value change which can be attributed to the hedged risk.

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.

(a) Due to the fact that dynamic portfolios are subject to constant change (cf. also response to question 22a) we doubt that the creation of a rule which prohibits the removal of exposures from a dynamic portfolio would be fit for purpose. More often than not, the removal from a portfolio will take place upon a derecognition. However, portfolio changes / portfolio shifts (for instance in the course of restructuring) may also arise from constellations which do not lead to a removal of the exposure from the accounts. Hence, we hold the view that there is a need for an explicit permission to remove exposures.

(b) The list below is not complete but contains examples illustrating the need to remove exposures:

- Changes to the risk strategy
- Changes to the organisational allocation
- Restructuring activities
- Portfolio migrations for instance due to credit risk changes

(c) In our view this question can only be decided after the definition of a final risk mitigation approach taken into account the circumstances we have mentioned under (b).

<u>Question 24—Dynamic risk management of foreign currency instruments</u>

(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.

On principle, the GBIC is of the opinion that the application of the PRA to the combined dynamic management of interest rate risks and FX risks is operationally feasible. However, if and when interest and foreign currency risks are managed separately (usually within units operating separately from each other) we would welcome it if pure FX portfolios were allowed as part of the PRA or, moreover, if the PRA was opened up to further exposure types (including but not limited to liquidity risks).

<u>Question 25—Application of the PRA to other risks</u>

(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.

It is worth noting that the PRA cannot be transferred to all non-bank specific business models. This particularly applies to insurance companies whose investment strategies are generally geared towards liabilities. The proposed approach is incapable of adequately reflecting an insurance company's risk management.

<u>Question 26—PRA through OCI</u>

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 think that the PRA's revaluation effects should be reflected in other comprehensive income.

Yours sincerely,
on behalf of the German Banking Industry Committee
National Association of German Cooperative Banks

Gerhard Hofmann   Dirk Peters