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12 September 2014 By email: commentletters@hkicpa.org.hk and by post

Mr. Simon Riley
Acting Director
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Dear Mr. Riley

Invitation to comment on IASB Discussion Paper DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

Thank you for your letter dated 28 May 2014 inviting the Association's comments on the IASB Discussion Paper DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging. Our comments on the specific questions raised in the discussion paper are set out in the enclosed annex.

We hope you would find our comments useful. Should you have any questions, please do not hesitate to contact Ms. Caris Wan of the Secretariat at 2521 1855.

Yours sincerely

Eva Wong
Secretary

Enc.

Draft comments on DP-Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

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 strongly agree that there is a need for a new accounting approach for dynamic risk management to address limitations of the current hedge accounting. For example, risk management at financial institutions is often done on a portfolio basis and managed dynamically, with frequent adjustments. The dynamic nature of such strategies makes it difficult to fit into the current hedging rules as the frequency of re-designation and amount of tracking and amortization make such effort unmanageable. Besides, the current fair value hedge accounting for a portfolio hedge of interest rate risk can only be applied for hedge of interest rate risk and not available for net position hedge or other risk types such as commodity and FX. In order for the accounting presentation to better reflect the results (i.e. success or failure) of risk management strategies, there is a need for accounting standards to have built-in flexibility to account for dynamic hedges.

However, there is potential for significant overlap in scope between what is covered by the general hedging rules as currently included in IFRS 9 and what this DP covers. For example, if an entity's risk management strategy is to have cash flow hedges covering 50% of its forecasted floating rate loans originated during a particular period of time, is that considered as a cash flow hedge of forecasted transactions – captured under the current IFRS 9? Or is that considered as part of a dynamic risk management strategy since the entity may adjust the hedging instruments in reaction to adjustments in the forecasted volume, and as materialized transactions are dropped off the pool of hedged items? There is a need to clearly define what is included in the scope of macro hedge.

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 acknowledge that the DP had identified and discussed many of the main issues such as the core deposits, the use of the equity model book, and the use of bottom layers in risk management. However, the DP's focus was limited only to the interest rate risk. We would like to have the scope expanded on other risk types and differing ways to manage risks.

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

The PRA approach seems to only address issues associated with fair value portfolio hedges. It is unclear as to how the dynamic cash flow hedges may apply the PRA approach. For example, in the case of the application of cash flow hedge of using an interest rate swap to fix the interest coupon receipt from a portfolio of floating rate loans, the purpose is to lock in interest receipts to fix the spread between assets and liabilities, the PRA approach would fair value the interest rate swap and revalue the portfolio of hedged loans. However, since the strategy aims to hedge cash flows, the change in fair value of the hedged loans caused by interest rate risk will not offset the change in fair value of the interest rate swap. The macro hedging standard will need to address a wider spectrum of hedging strategies other than fair value hedges.

We also note that some of the issues and principles behind those issues have implications not only on macro / portfolio hedges, but also on micro / individually identified hedges. For example, the issue of whether entities should be allowed to hedge behaviouralised cash flow, rather than purely contractual cash flow, affects not only the incorporation of prepayment pattern and the "stickiness" of core demand deposits in the context of hedging a portfolio of non-specific items, it is also applicable to hedges of specifically identified callable bonds. In addition, issues like hedging sub-LIBOR instruments are equally applicable to both types of hedges. It would be preferable if the standard can lay down common principles that would be applicable to both macro and micro hedges. In the event that it is not possible to do so and different rules are laid out on macro hedges, it would be important for the final standard to clearly define what would constitute a macro hedge.

<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?

The description is accurate in describing strategies that aim at locking in fair value of instruments and immunizing them from future interest rate movements. However, other types of strategies can also be run on a dynamic basis. For example, strategies to hedge reinvestment risks are sometimes employed when a portfolio of fixed income assets with shorter duration are used to back certain liabilities with longer duration. We would like to have much broader description of dynamic risk management to reflect various industries' practices or hedge by non-derivatives. The final standard should consider expanding the range of strategies that can be considered to be dynamically managed.

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

<u>Pipeline transactions</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).

We agree that the exposure from pipeline transactions should be eligible for hedge accounting. As described in the DP, we envision that the pipeline transactions could typically include forecast volumes of drawdown of fixed rate products at advertised rates. In order to secure a net interest margin, we may use our best estimate when we procure a forward starting swap. This is operationally feasible. However, we believe the Board should also address the following issues:

1. estimation on volumes of drawdown could differ significantly depending on each entity's risk management policy or geographic location, or market condition. We feel that to keep comparability and avoid diversity in practice, substantial amount of disclosures would be required. Further, such burden of disclosure may be too heavy or impractical, as it would force an entity to disclose its future outlook on interest rate or even its risk appetite.

2. following the PRA approach to account for this fair value macro hedge would result in recognizing gain or loss on items that do not otherwise meet the definition of asset or liability. Moreover, they may not even be probable of occurring. It is this aspect that we find inconsistent with the Conceptual Framework. The Board may consider an alternative approach to account for this type of hedge.

Further, "pipeline transactions", as explained in the DP, does not seem to include cases where a financial institution has made a commitment to lend at floating rates, but the customer has the option not to draw on the limit. As a result, it seems to make allowance only for fair value hedges of interest rate risk. Although hedging fixed rate forecasted loan origination is more commonly done and has a long history of discussion, the ability to perform cash flow hedge accounting of forecasted transactions on a portfolio basis will be useful as well.

<u>EMB</u>

(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.

We believe the EMB should not be included in the PRA. The reasons are as follows:

1. although an entity can include the EMB as a part of its interest rate exposure for risk management purposes, there is no real economic exposure. Rather, we view the EMB as the management target to be achieved.

2. revaluing carrying value of equity balances for interest rate movement would produce balances that would be inconsistent with the Conceptual Framework and would be difficult for readers to understand.

<u>Behaviouralisation</u>

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

We would support allowing cash flows to be based on a behaviouralised basis under the conditions that the behavioural assumptions:

1. represent the entity's best estimates,

2. are continuously updated as new information can reasonably be collected, and

3. are the same as those included for risk management purposes.

Our support behaviouralised basis is based on the following views:

1. in order to dynamically manage interest rate risks, we would use behaviouralised based cash flow estimate rather than contractual cash flow, therefore, behaviouralised based should be applied in PRA to better reflect dynamic risk management. We also consider this behaviouralised based cash flow estimate to be an accounting estimate. Similar to other accounting estimate, disclosures of the assumptions used should be provided to ensure comparability.

2. it is consistent with IFRS 9 rationale "when calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options)". Since the behavioural information represents the best information the entity has and forms the basis for its risk management activities,

including such information in defining the features of hedged items would increase the relevance and usefulness of the resulting financial statements.

However, similar to the situation of estimation on volumes of drawdown as above mentioned in part a, the consideration of behavioural factors affecting the managed risk is subjective and may vary among entities of same industry (e.g. core demand deposits are considered as a source of stable fixed interest rate funding), it will lead to different recognition patterns of revaluation adjustment among entities. Therefore, more guidelines and illustrations are required to reduce the subjective judgement made by entities so as to enhance comparability of financial statements.

Further, since the current hedge accounting rules only allow the contractual features to be designated as the hedged items, if behaviourized cash flows are allowed to be designated as the hedged items for macro hedges, the existing guidance under IFRS 9 should be revisited as the same principles should apply to both.

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.

We understand that different financial institutions have adopted different approaches in managing prepayment risk. Moreover, risk management strategies evolve over time as circumstances change and hedging instruments evolve. We think it would be better to leave it open to the reporting entity to define risk management objectives and what instruments to use. Using options would usually mean that the entity is hedging one-sided risk for certain time segments. The possibility of multiple options with multiple strike prices being used does pose a challenge to the application of the PRA approach. Possibly, such scenarios might be accommodated if there were an alternative approach (other than the PRA approach) for cash flow hedge strategies.

No matter the PRA approach or an alternative approach is applied, when an entity choose to use risk management instruments with optionality to protect its loan portfolio for potential prepayment arises in a declining interest rate situation, the PRA or an alternative approach should be restricted to the dynamic risk management of downward interest rate change only. In an upward interest rate change situation, there is no risk. Therefore, any gain or loss from the valuation changes of the risk management instruments with optionality should be taken into as an adjustment of interest income.

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 described in the answer to question 15, we support an approach that revalues the portfolio only when the entity has chosen to mitigate risks through hedging ("risk mitigation through hedging approach"). In this context, we support an approach that after the entity has included the expected customer behavior as part of the hedging strategy, and it is proved that past assumption are no longer valid, changes in expected customer behavior would be included in the revaluation adjustment.

As mentioned before, since expectation is a subjective measure, it is more susceptible to potential manipulation. Entities should be required to have an appropriate basis to support such expectations and assumptions, and the assumptions should represent the reporting entity's best estimates.

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.

We support the bottom layer approach and use of which should be permitted rather than required. Although the bottom layer approach would require a certain amount of tracking, and software will need to be developed to keep track of the designation, the actual experience, and the revalued items, we believe it would be much more operationally feasible than the proportionate approach. We recommend that the bottom layer will subjected to the PRA and any erosion of the bottom layer should be reflected in profit or loss.

Question 8—Risk limits

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

We do not support that the risk limits to be a part of the PRA, the reasons are as follows:

1. the logic behind setting risk limits is that the entity believes that it can tolerate and absorb volatility in profit or loss caused by fluctuations within those risk limits. Presentation of such volatility in profit or loss is important to the provision of relevant information and faithful representation of the entity's economic reality.

2. as the risk limits are used for internal management purposes by various institutions, and therefore, we consider them as entity specific metrics. The risk limits should be a part of qualitative disclosure.

<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?

We support allowing these core demand deposits (together with the assumptions around their behavioural pattern) to be included in the PRA if that is consistent with the risk management strategy the entity employs. However, since the behavioural assumptions can be highly subjective, the standard should require these assumptions to be supported by historical or other behavioural data and represent the entity's best estimates. In addition, users of financial statements may find the disclosures on related key assumptions to be useful in understanding the entity's exposures and its risk management approach.

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

We believe enhance comparability of financial statements would provide more useful information to users of financial statements. As determining the behaviouralised profile is an area that can be subject to manipulation if the estimates are not supported by robust methodology. We think additional principle-based guidance on how to determine the behavioural term of a portfolio of core demand deposits would be helpful as current practices in determining behavioural term (for risk management purposes) diverge.

<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?

We support the approach 3 which allows the hedging of sub-benchmark interest rate. It is in line with the transfer pricing practice where ALM's objective to secure net interest margin by entering into hedges with external counterparties and ALM generally charges business units at a benchmark rate plus a spread to replicate its funding cost regardless of actual risk which could be sub-benchmark.

(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?

In line with (a) above, ALM manages risks at the benchmark rate regardless whether the actual risk is at sub-benchmark or with a floor. Accordingly, if the floor is not included in the dynamic risk management, it is appropriate not to reflect the floor in the managed portfolio.

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?

We disagree for the revaluation calculations outlined which used the pricing index as the denominator. However, as the risk management is based on the funding index, revaluation should be done on the funding interest rate.

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

If an entity manages net interest margin for changes in a funding rate as part of its dynamic risk management, the discount rate should be based on the funding rate.

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)?

(b) If the managed risk is a funding rate and is represented via transfer pricing transactions, which of the approaches discussed in paragraph 4.2.21 do you think provides the most faithful representation of dynamic risk management? If you consider none of the approaches to be appropriate, what alternatives do you suggest? In your answer please consider both representational faithfulness and operational feasibility.

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

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

We believe that transfer pricing mechanisms could be used as a practical expedient. However, there are some defects in using transfer pricing. As no one typical industry standard of transfer pricing model, practices could differ significantly. Transfer pricing may contain non-market related elements for evaluation of internal performance purpose, as a result, it cannot reflect market change accurately. Further, entity may change transfer pricing policy frequently to achieve a targeted result on profit or loss, users of financial statements are unable to compare peer entities' results fairly. Besides, we feel a reasonable amount of audit trail that shows transfer of risk from the business unit to ALM should be required.

<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.***

We believe entities should be able to use multiple indices depending on the funding sources, (e.g., a multinational entity could be issuing bonds, notes, or equity instruments denominated in Euro as well as USD) and the expected remaining tenors of the managed portfolios.

(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?***

We strongly believe that the selection criteria should based on each entity's risk management aim and business purposes.

<u>Question 14—Pricing index</u>

(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 do not currently have comment on this issue.

<u>Question 15—Scope</u>

(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?

We do not believe the PRA should be applied to all managed portfolios. If all open net risk positions are required to be subjected to the PRA, it would introduce unnecessary volatility in profit or loss which goes against the aim of macro hedge. Moreover, including all managed portfolios in the PRA does not facilitate comparability of the resulting financial statements across entities in the same industry, since entities can have very different risk management strategies. Comparability would not be improved by forcing all managed portfolios to be revalued in the PRA. We support a scope focused on dynamic risk mitigation, which will also mitigate the effects of the accounting mismatch.

(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?

We believe that the risk mitigation approach would generate information that is more useful than that generated under the dynamic risk management approach. The main reason is that the volatility produced by the revaluation of the unhedged position under the dynamic risk management approach makes income statement analysis more difficult.

In addition, although the dynamic risk management approach would reflect the extent the reporting entity has closed its managed exposures, the resulting revalued figures for unhedged exposures neither reflect full blown fair value, nor provide information for predicting future net cash flow.

Some of the items proposed to be included in the PRA, like equity model book and demand core deposits, only represent notional exposures. The true nature of the revalued figures on the balance sheet is actually difficult for readers to understand.

(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?

As individual items go in and out of the PRA portfolio and those items should get revalued for the hedged risk for the period of time they are included in the PRA portfolio, the value of each item would need to be individually tracked to preserve the carrying value resulting from applying hedge accounting. Systems would need to be built that would be able to track items both by portfolio and on an individual item basis. Existing systems are unlikely to be able to accommodate such requirements.

(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?

The answers to questions (a) to (c) also apply to other risks.

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 think the application of the PRA should be mandatory if the scope is to include all portfolios dynamically managed. Financial institutions often do not hedge 100% of the managed risk (e.g. interest rate risk) in a particular portfolio. If the PRA includes everything that is managed dynamically, the unhedged portion would introduce artificial income statement volatility. If the unhedged items in the portfolio are recorded at amortized cost under IAS 39 or IFRS 9, such basis would have been justified. Modifying their value for a risk that is managed but not hedged would result in a value that is difficult for readers to understand.

(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?

We believe that the scope should be based on risk mitigation, and the application of the PRA should be optional. The mandatory application would not necessarily ensure the comparability due to the inherent subjectivity of dynamic risk management. Entities should be allowed to choose between the general hedge accounting and the macro hedge accounting on the dynamically managed portfolio.

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.***

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

- ***(i) Would your answer change depending on whether the application of the PRA was mandatory or not? Please explain your reasons.***
- ***(ii) If the application of the PRA were optional, but with a focus on risk mitigation, what criteria regarding starting and stopping the application of the PRA would you propose? Please explain your reasons.***

We support an approach based on risk mitigation. The additional eligibility criterion is that the general hedge accounting under IFRS 9 is not applied.

Question 18—Presentation alternatives

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

We prefer the presentation of revaluation adjustment in a separate single net line item in the Statement of Financial Position, because dynamic risk management addresses the net portfolios of asset and liability. Requiring the separate lines for aggregated adjustments to assets and liabilities would place burden of tracking.

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

We prefer the actual net interest income approach, as it provides the most useful information to the users, namely, by showing the net interest income accrued as well as the impact of dynamic risk management. The stable net interest income approach is not preferred as certain defects are found. It is based on an artificial assumption that all risk management activities must success; targeted net interest income can be achieved overall even though the entity's risk management strategy is not 100% hedged; the net interest income is stable over time which does not reflect the reality of changing market conditions. A misrepresentation to users of financial statements will result.

(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 do not currently have comment on this issue.

<u>Question 19—Presentation of internal derivatives</u>

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

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

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

We welcome this "shortcut" assumption that all internal derivatives are externalised. Thus, in order to afford this shortcut, we believe the gross up is warranted. We do not think this gross up will affect the quality of financial reporting, as it won't affect an entity's profit or loss. We note that the pricing of internal derivatives could differ from external derivatives, due to credit ratings or foreign currency denomination. Additional disclosures, therefore, are needed to address this potential price differential by describing risk transfer mechanism and pricing used for internal derivatives.

<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.

We agree that additional disclosures would be required in order to present how an entity applies dynamic risk management. Four possible disclosure themes have been developed for the PRA in the discussion paper, we support most of these themes except the following:

Theme 1: Qualitative information on the objectives and policies for dynamic risk management, including the identification of risks within exposures
We would recommend that the objective should be risk mitigation.

Theme 2: Qualitative and quantitative information on the net open risk position(s) and its impact on the application of the PRA
We believe this disclosure would not add much more than the existing risk disclosures contained in the management discussion as well as the regulatory reporting framework. Hence, we think it should not be required to be an additional footnote disclosure.

Theme 3: Application of the PRA
We support this theme as the disclosure of PRA would provide useful information to secure comparability among different reporting entities by providing detailed methodology of PRA adopted.

Theme 4: Quantitative and qualitative information on the impact of dynamic risk management on the current and future performance of an entity
We also support this theme with the focus on the actual net interest income approach with the sensitivity analysis to show effect of future interest rate change.

(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.

(See answer to the question 21 below.)

<u>Question 21—Scope of disclosures</u>

(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?

We believe that the scope of the disclosures should be based on the risk mitigation approach. Thus, the disclosures should be in relation to the risk mitigation approach, e.g., behavioural assumptions, any change in the behavioural assumptions, internal risk transfer, and risk limits.

<u>Question 22—Date of inclusion of exposures in a managed portfolio</u>

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?

We support having the flexibility to include items in the PRA any time after the entity first becomes a party to the contract. In a dynamically managed portfolio, there are frequent movements of items into and out of the portfolio. Sometimes it is necessary for risk management purposes to include items in the portfolio long after their origination. Not allowing such items to be included in the PRA would lead to a discrepancy between risk management practice and hedge accounting.

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

If the non-zero Day 1 value were to be recognized on the day of the transfer, the effect is similar to a retrospective designation of the item (since the date of origination of the item). That would not be consistent with the principle of prospective designation and essentially allows entities to use hindsight.

We propose a method that is similar to the concept applied currently for fair value hedges. That is the carrying amount of the hedged item is only adjusted for the change in fair value caused by movements in the hedged risk. The day 1 value is not included in the calculation of the carrying amount. As the hedged item is derecognized, the difference between the then carrying amount and disposal consideration will be included in profit and loss at that time. For example, the carrying value of a bond is $102 and the fair value of it is $105 by the time it is transferred into the PRA that hedges only the interest rate risk. The bond can be transferred at its carrying value of $102. Carrying value in subsequent periods is adjusted only to the extent of any movement in interest rate that occurs after the item is transferred. This way, the difference between carrying value and fair value on the date the item is transferred into the PRA (i.e. $3 in this example) would not be part of the carrying value going forward. The amount would only be recognized upon disposal of the item.

<u>Question 23—Removal of exposures from a managed portfolio</u>

(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?

We support having the flexibility to transfer items out of a dynamically managed portfolio. By their nature, dynamic pools require constant rebalancing. It would be difficult to manage the pool if items can only be transferred in but not transferred out.

If the accounting treatment does not allow for items to be transferred out, the resulting portfolio defined for accounting purposes may not be in line with that for risk management purposes. Accordingly, even though tracking would be required, we support the removal of exposures from a managed portfolio.

(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?

There are many situations under which items in a dynamically managed portfolio may need to be transferred out. The risk appetite of the entity may change and it may desire to hedge less of a particular risk. The external environment may change and it may desire to transfer some of the exposure back into the banking book. There are many possible reasons for removing an exposure before its maturity. Not allowing their removal from the portfolio would limit the usefulness of dynamic macro hedge accounting.

(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.

We would support an approach that amortizes the revaluation adjustments recognized up to the point of transfer. Although it would be operationally burdensome, it would be less distortive of the income statement and provides the option to transfer the exposure out. Transfers out of the portfolio are not expected to occur very often, so the administrative burden is not expected to be too onerous.

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.

We do not currently have comment on this issue.

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.

We do not currently have comment on this issue.

<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 support for PRA through OCI due to uncertainty of the regulatory capital treatment of OCI.