BUSINESSEUROPE

International Accounting Standards
Board (IASB)
30 Cannon Street
London EC4M 6XH
United Kingdom

22 October 2014

Dear Sirs,

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

BUSINESSEUROPE welcomes the opportunity to respond to the Discussion Paper "Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging" (the DP). BUSINESSEUROPE is composed of European Business Federations and Companies and cannot speak for any specific industry. Therefore we will respond only to a selection of your questions and we will not cover the financial industry.

The IASB should clarify the aim of the discussion paper and the Portfolio Revaluation Approach (PRA): is it to display risk management strategies within the financial statements or to reduce accounting mismatches that arise because of the weaknesses of the current hedge accounting rules (IAS 39/IFRS 9)? We think that the first approach would be a much more extensive project, whereas the latter could be resolved with amendments to the current standards (i.e. the macro-hedge guidance would be incorporated to IFRS 9 instead of being a separate standard). This would clarify the relationship/interaction between IFRS 9 as it is now and the macro-hedge guidance as it would be proposed by the IASB.

***What is the problem today?***

Although the objective of IFRS 9 is to reflect risk management appropriately we know that it can fail in some specific situations. We know that some issues are not properly addressed in IFRS 9 (net positions other than FX). We will also have to face practical issues regarding efficiency testing (even if the 80/125 bright line has been deleted in IFRS 9 ) and recycling cash flow hedges (CFH) from OCI.

**The key questions of the DP is how to define the Portfolio and measure its FV?**

BUSINESSEUROPE supports principle-based standards and welcomes the efforts of the Board to modify hedge accounting so that it better reflects the risk management model of the entity. Therefore we would welcome an alternative approach and we follow these developments with great interest. In the DP, dynamic risk management is defined as "non static" hedging since "static hedging" is dealt with in IAS 39/IFRS 9, and the only example given by the IASB in the DP is interest risk management within a bank.

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We consider that the question raised by the IASB about dynamic risk management strategy (as opposed to a one-to-one relationship) is also applicable to some industries that manage the risks on a global portfolio basis ( e.g. utilities manage fixed assets + own use contracts ).

However, we consider that it is key to align "Macro Hedge accounting" principles with IFRS 9 hedging principles. On one hand, pipeline transactions should be further defined and on the other hand, CFH is allowed only for highly probable transactions and FVH (for the hedged item) is allowed for unrecognised firm commitments (or a component thereof) we would suggest that consistent criteria be set up for an open portfolio / pipeline transactions accounted for at FV in the PRA . Consequently we support the risk mitigation approach.

Dynamic risk management (DRM) is not clearly defined. It seems to be a broad term. We find it unclear how to distinguish dynamic risk management from the hedging activities that will performed and accounted for under IFRS 9 in the future.

Should the project proceed in the direction it has taken, it must be clear how the principles affect hedge accounting under IFRS 9. Otherwise we will risk a two-model-approach on different conceptual grounds. In summary, we would suggest setting up the same principles for micro and macro hedging.

PRA must be limited to the hedged part of the portfolio, so that the derivatives' fair value changes are (partly or fully) offset by re-measurement of the hedged items. This approach, which is an extension of the Fair Value Hedge principles (IAS39/IFRS 9), could largely simplify the recycling of OCI, rebalancing and the measurement of the efficiency of hedging.

PRA must be optional, not mandatory. We can see no justification for this to be different from the current IFRS 9 hedge accounting approach.

Finally, qualitative descriptions about risk management activities are crucial for the understanding of the extent to which the PRA is being applied.

We would be pleased to be of assistance if any further clarification of our comments were to be needed.

Yours sincerely,

Jérôme P. Chauvin
Deputy Director General

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ANNEX

# APPENDIX TO BUSINESSEUROPE'S RESPONSE TO THE DISCUSSION PAPER "ACCOUNTING FOR DYNAMIC RISK MANAGEMENT: A PORTFOLIO REVALUATION APPROACH TO MACRO HEDGING"

## RESPONSES TO SELECTED QUESTIONS

### 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?**

The DP is very focused on interest risks in the banking sector. We represent mainly companies in the industrial and service sectors and we think it would be helpful if the IASB could elaborate further on how the approach could be applied outside the banking sector, for dealing with risks such as currency (FX), interest and commodity risks. As presented now, it is not easy to picture how the model could be translated for other types of risks.

We consider that questions raised by the IASB about risk dynamic management strategy (opposite to a one to one relationship) could also be applicable to some industries that manage the risks on a global portfolio basis ( e.g. utilities manage fixed assets + own use contracts ).

However we consider that it is key to align "Dynamic Risk Management accounting " principles with IFRS 9 hedging principles. In IFRS 9, CFH is allowed only for highly probable transactions and FVH (for the hedged item) is allowed for unrecognised firm commitments ( or a component thereof ). We would therefore suggest setting up consistent criteria for an open portfolio / pipeline transactions to be accounted for at FV in the PRA.

In general, for most of our hedging activities, we can achieve hedge accounting under the current regulations. However, we do agree with the DP that the current hedge accounting requirements sometimes involve a significant operational effort, are very administrative and that there is a risk that the focus is mainly on reducing profit and loss volatility in a manner that does not fully portray the economics of risk management.

Therefore we would welcome an alternative approach and we follow the development with great interest. Applying hedge accounting on dynamically managed portfolios according to today's static requirements is sometimes difficult, and we welcome another alternative for dynamical risks. The open portfolios approach seems like a good solution as long as it is optional. It is however not clear to us how dynamic risk management is defined. There seem to be no limits in how broad the definition can be and what activities can be included. In this sense it becomes difficult to assess how it is supposed to relate to the hedge accounting requirements of IFRS 9. Will IFRS 9 need to be revised and included or will it remain parallel guidance?

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To sum up, we see a need to find an accounting model for the hedging of open portfolios. We believe that the Board should prioritize finding a sustainable accounting solution in this area and we are not convinced that the project need to be as broad as it currently is being portrayed.

Most of us share the view that IFRS 9 will remove to some extent some of the operational constraints that we face under the current standard. An alternative to starting afresh with a new model like the PRA could potentially be to build on what we already have in IAS 39/IFRS 9 for cash flow hedges, relax some of the requirements and allow re-measurement of the hedged position through P/L.

**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?**

The DP is very focused on solving the accounting issues that banks have in relation to their management of interest risk. Based on our experience and knowledge regarding the risk management processes mainly in the industrial sector which we represent, we have difficulty in seeing how this could be applied to other risks in practice and consequently we cannot fully evaluate whether all issues have been covered by the DP.

From our perspective, what is lacking in the DP is a discussion of the problems around FX risk and commodity price risk in more or less open portfolios being more or less dynamically managed. Some examples or discussions in the DP around these risks would have been helpful and would have made it easier to evaluate whether all issues are covered.

It is to be noted that industrial/commercial activities, and the resulting "native[1] positions" have a physical nature and are subject to external risk factors:

(i) External risk factors include, amongst others: regulations (licence to operate), intrinsic risks of the facilities (construction defects, IT failure, blackout/imbalance, etc.), risks related to the natural environment (seismic, meteorological and climatic phenomena that can impact client consumption as well as production levels, etc.) and human risks (social conflict, terrorism, etc.)
(ii) Physical characteristics of native positions can differ significantly from hedge products available on the market, e.g. : power production peak/off peak, hourly profile of consumption and production forecasts, etc. versus base-load products for calendar years available on the market.

[1] i.e. the exposures that arise naturally from the business

As forecasts can evolve significantly, not only as a function of market prices, but also due to external elements, some entities enter into Dynamic Risk Management of their assets.

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

See our response to 2(a).

We also believe there are major difficulties inherent in the model, including question marks on how the model can be applied in practice.

For example, the discussion describes two different approaches to the PRA model in section 1.5 and 1.6. The advantages and disadvantages with these two approaches are illustratively described in chapter 5 and the approaches are fundamentally different in respect of the aims of what will be achieved. Should the aim be to reflect the total risk mitigated or should the aim be to reduce volatility in the accounting?

The accounting focus can be on dynamic risk management reflecting the total risk in the portfolio (for that particular risk) even though only part of the risk is mitigated. This can lead to volatility in the income statement, whereas companies that do not manage the risk dynamically do not book any impact ! Alternatively, only the risk that is mitigated is revalued, causing inconsistencies with all other risks that are not mitigated. (Our preferred approach is stated in our response to Question 15).

**Question 4 (a) and (c) – Pipeline transactions and Behaviouralisation**

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

The definition of pipeline transactions should be refined and reconciled with the hedged items in a CFH relationship.

In the non-financial industry, hedged items arise from exposures that are derived from:

- ✓ Off balance sheet items: forecasts, contracts, etc.
- ✓ On balance sheets items as fixed assets, inventories, financial assets,etc.

Where risks could be FX risk, commodity risk etc.

From our perspective we tend to translate these exposures into exposures from forecasted transactions as an effect of more or less firm offers/commitments. We

manage these exposures through a cash flow hedge model (from both an accounting and economic point of view) and recognize our situation in what the DP describes in the A3 section. However, as mentioned in question 1, we would regard the proposed model, adapted to dynamic risk management, as a useful alternative to cash flow hedging.

**(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.**

Today Cash Flow Hedge ( IAS 39/IFRS 9 ) is applicable to highly probable transactions whereas Fair Value Hedge is applicable to firm commitments. This difference does not make sense as Exposure and Risk management are based on forecasts/ future cash flows and not only on contractual cash flows. Therefore, the CFH principles should apply to the PRA , consequently behaviouralised basis should be used.

**Question 8 – Risk limits**

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

What it may be useful to consider in the PRA, is that the risks that are brought into the macro portfolio for hedging indeed require hedging (i.e. bringing these risks to the market is a risk-reducing action for the total existing risk position). For this purpose, risk strategies and the documentation of their risk-reducing character (and risk limits and their monitoring contribute to this documentation) are essential. This could be compared to the rules set in EMIR – coherence in this respect between IFRS and EMIR would make sense.

**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?**

We believe that the PRA should be restricted to circumstances in which an entity has undertaken risk mitigation through hedging. This is because hedge accounting usually is used in order to manage the effects on/volatility in the income statement. A focus on dynamic risk management is closer to a full fair value approach. Requiring entities to recognize FV through P&L related to exposures that are not hedged could even create incentives for entities not to hedge their exposures. Another strange effect of applying the PRA to all managed portfolios could be that entities not hedging would present a more steady income statement than entities that have actually partly reduced their risk exposure through the hedging of parts of its portfolio.

**(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?**

What is the purpose of the PRA: is it to give more information on risk management or is it a way of facilitating hedge accounting? Current hedge accounting (IFRS 9) in combination with a PRA limited to risk mitigation would seem to give more useful information if the purpose of PRA is to facilitate hedge accounting and manage volatility in the income statement.

**(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?**

We imagine that the scope focused on dynamic risk management would be somewhat easier to apply, as it relates to all managed portfolios and could probably be based on information from existing risk management activities. However, existing risk management activities are also the basis for the PRA limited to risk mitigation, and the method for identifying the portion that is hedged ought to be based on these activities in each respective entity. The proposed alternatives (sub-portfolios and proportional) might be the right way under certain circumstances, but to prescribe one method might limit the usefulness of PRA.

However, to be clear, we support the PRA focused on risk mitigation.

**(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?**

As the examples focus on interest rate risk it is hard to understand how other risks could be affected. However, if other risks were in focus we suppose the answers relating to scope would be similar.

**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?**

No, it should not be mandatory. Please see our answer to question 15(a).

**(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?**

No, just like hedge accounting in accordance with IAS 39/IFRS 9, PRA should be optional. Hedge accounting is a way to limit volatility in the income statement. We believe this choice should still be there with PRA.

**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.

If the risk mitigation approach is adopted, it should be clear that the transactions performed should be made on the basis that they are reducing the risks of the portfolio. Applying those principles to the business model explained above would result in the following questions which could be used as a basis for criteria:

- does the transaction performed with the central netting factory adequately reflect the risks embedded in the native positions ?
- have the risks been decreased following actions taken by the central netting factory ?

We note that similar requirements are to be provided in the framework of the EMIR regulation and any resulting documentation made should/could also serve for accounting purposes. In our view, once documentation of such quality is available, IFRS should allow for it to be used for accounting purposes (see our answer to Q8).

**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.

As mentioned earlier, the measured exposures do not arise from financial instruments but from other “economic assets” (assets accounted for under IAS 16, IAS 17 or IFRIC 12 ; own use contracts and other off-balance-sheet risks). As a direct consequence, we believe that the first two proposals (“line-by-line gross-up” and “separate lines for aggregate adjustments to assets and liabilities”) would not depict adequately the risks being measured and would in some cases impracticable, such as, for example, where no “accounted for” asset can be identified

Instead, we believe that approach 3 would be in line with the risk management situation: the portfolio (i.e. the risks that have been transferred to the central netting factory) is hedged as a whole.

**Question 24 and 25 – Dynamic risk management of foreign currency instruments and application of the PRA to other risks**

The strong focus on interest risk alone makes it difficult to understand how the approach could work for other risks and what measurement should be based on. We find it difficult to translate the high level model discussions and detailed examples on interest risk into a working model for other risks. See our answers to questions 1 and 2.

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