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October 17, 2014

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

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

Dear Board Members,

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[1] welcomes the opportunity to respond the DP 2014/01 – Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging.

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

The Discussion Paper (DP) brings issues only applied to banks activities, in our view the DP should treat deeply accounting for dynamic risk management applied to industrial and commercial activities due the risks (ie. Commodities price, foreign exchange risks) that their operations are exposed, which is in our jurisdiction relevant. We understand that DP is trying to apply an accounting for macro hedging closer to the way that entities manage their risks when compared to IAS 39 requirements.

Additionally, we understand that adoption of hedge accounting should be still non-mandatory such as prescribed by IAS 39 and IFRS 9.

We are responding to the DP´s questions as follows.

[1] The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

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Section 1—Background and introduction to the portfolio revaluation approach (PRA).

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?

Answer:

We believe, despite the fact that dynamic risk management activities are implemented in a comprehensive way, the current model has limitations to entities reflect the outcome of their dynamic risk management activities in their financial statements. Therefore, we believe that there is a need for a solution that could be an accounting approach for dynamic risk management or IASB should still focusing on finding a solution for hedge accounting for open portfolios.

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?

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

Answer:

(a) We believe that this DP has identified and discussed the main issues that banks currently face when applying the current hedge accounting requirements to dynamic risk management of interest rate only. If the Board has intention to allow the adoption of this approach to other risks and industries we believe that other potential main issues of those industries also should be considered in this DP.

(b) We believe that PRA brings a simplification when compared to current model and address many of accounting issues found with current model. However, we believe that applying the revaluation model to the whole portfolio could result in more profit or loss volatility than hedge general accounting even if the entity intentionally has not hedged the whole portfolio.

Section 2—Overview.

Question 3—Dynamic risk management
Do you think that the description of dynamic risk management in paragraphs 2.1.1–2.1.2 is accurate and complete? Why or why not? If not, what changes do you suggest, and why?

Answer:

We agree with description of dynamic risk management in paragraphs 2.1.1 and 2.1.2.

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Section 3—The managed portfolio.

Question 4—Pipeline transactions, EMB and behaviouralisation

Pipeline transactions

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

Answer:

We believe that pipeline transactions should not be included in the PRA even though they are part of its dynamic risk management. Pipeline transactions are not yet firm commitments as the advertised rates could be withdrawn or refused then the PRA would result in the recognition of an asset or liability without a firm commitment and in our view would conflict with the Conceptual Framework.

EMB

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

Answer:

We disagree, the base fixed return to the equity holders is not contractual, it is hedged based on the expectation that will be paid. Therefore, there is no accounting costs recognized in the financial statements and needs to reduce any accounting mismatches. In our view it would allow remeasuring items that do not meet the definitions of an asset or a liability under the Conceptual Framework.

Behaviouralisation

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

Answer:

We agree with the introduction of concept of behaviouralisation. In our view it increases operational feasibility, and the concept can be consistent with the way exposures are managed for risk management purposes. In our view behavioural estimates are estimations when and to what extent cash flows will occur, hence we believe that such cash flows measures are consistent with Conceptual Framework.

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.

Answer:

When risk management instruments with optionality are used to manage prepayment risk as part of dynamic risk management we believe that if the time value of option is excluded from the hedging relationship it could be considered cost of hedge and accounted separately.

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?

Answer:

We believe that changes in customer behaviour should not be recognized in profit and loss. We also believe that bottom layers approach, commented on question 7, could be a solution for these changes.

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.

Answer:

We believe that if a bottom layer or a proportion approach is taken for dynamic risk management purposes it should be permitted within PRA. In our view this approach reflect the way that many banks undertake dynamic risk management. We understand that amortization and tracking requirements should be simplified in this case.

Question 8—Risk limits

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

Answer:

In our view risk limits should not be reflected in the application of the PRA. As described in the DP its incorporation would represent a significant conceptual challenge while information generated could not be useful and the particular risk tolerance of each entity could lead to counterintuitive results.

Question 9—Core demand deposits

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

Answer:

We 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 because it contribute to a better representation of dynamic risk management. As commented in the DP, it would be a challenge identify if changes in core demand deposits are the result of changes in customers´ behavior, the reflection of a bank´s action or the effect of other factors and it would raise some significant issues concerning the recognition of revaluation gain or losses in the financial statements arising from application of the PRA.

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

Answer:

Due to concerning described above we believe that guidance would be necessary for entities to determine the behaviouralised profile of core demand deposits.

Question 10—Sub-benchmark rate managed risk instruments

(a) Do you think that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if it is consistent with an entity's dynamic risk management approach (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?

Answer:

We think that sub-benchmark instruments should be included within the managed portfolio as benchmark instrument if it is consistent with an entity´s dynamic risk management approach. In our view approach 3 is consistent with the dynamic risk management approach.

(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?

Answer:

We think is appropriate not to reflect the floor within the managed portfolio if embedded floor is not included in dynamic risk management. In our view, it could represent a change to both operational and dynamic risk practices, as described in the DP.

Section 4—Revaluing 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?

Answer:

We think that the revaluation calculations outlined in this Section provide a faithful representation of dynamic risk management because reflects the way that an entity manages a specific risk (ie. Funding index).

(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?

Answer:

We think that is appropriate for the managed risk to be the funding rate If the dynamic risk management objective is to manage the risk of 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?

Answer:

We 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. However, it would be only permitted as proxies for the risk from managed exposures if those transactions provide a close enough representation of the actual risk, which could increase operational complexity.

Question 13—Selection of funding index

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

(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?

Answer:

We believe that is acceptable to identify a single funding considering that it is not always possibly to identify a "known" funding source for particular exposures that will then provide a basis for determining the transfer price or funding rate as commented in the ED. We think that criteria for selecting funding index or indexes are not necessary.

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?

Answer:

In our jurisdiction is not common examples of dynamic risk management undertaken for portfolios with respect to a pricing index.

Section 5—Scope.

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?

Answer:

We think that PRA should be applied to all managed portfolios included in an entity's dynamic risk management once the PRA provides information about the managed risks and all risk management activities. Once this information should be useful for investors in their decision-making process as it is useful for an entity when managing its risks. We also believe that information that would result from application of PRA under each other scope alternatives would not be useful once it might not be representative of how banks manage interest rate.

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?
(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?

Answer:

We believe that the application of the PRA should be optional if the scope of application of the PRA were focused on dynamic risk management either, it is focused on risk mitigation. This optionality would be consistent with current hedge accounting requirements in accordance IFRS 9.

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.

Answer:

We think that additional criterion would not be required if the risk is being dynamically managed and the general hedge accounting model under IFRS 9 is not applied to the hedge relationship.

We believe, if the application of the PRA were optional:

a) **if the scope of PRA were a focus on dynamic risk management, we believe that some sort of documentation would be required to make clear when the PRA would be applied and when not.**
b) **if the scope of PRA were a focus on risk mitigation, we believe that some interaction with current accounting model would need to be considered as well some sort of documentation would be required.**

Section 6—Presentation and disclosures.

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.

Answer

We prefer the aggregate adjustment or single net line item presentation alternatives in the Statement of Financial Position because they are apparently more consistent with the dynamic risk management. We also prefer the actual net interest income approach in the Statement of Comprehensive Income because it provides the best information for users and it would be easier to implement in practice.

Question 19—Presentation of internal derivatives

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

(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?

Answer

We believe that presenting internal derivatives in the Statement of Comprehensive Income on a gross basis would be consistent with the way the exposures are managed by some entities. We also believe that requirement to prove internal derivatives are externalized should be considered in the DP in order to apply the PRA.

Question 20—Disclosures

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

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

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

Answer

We think that each of the four identified themes would provide useful information on dynamic risk management. The objective is to provide users of financial statements with information that would enable them to better understand the risks managed, how the entity manages those risks, how the exposure for the entity regarding each risk and how dynamic risk management is reflected in the financial statements.

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?

Answer

We believe that the scope of disclosures should be optional or limited to the managed risk. For example, entity A may decide to adopt the accounting choice of managed risk and thus, will provide less information than entity B that adopts dynamic risk management. In this sense, scope for entity A should be broader than for entity B in order to encompass information about the portfolio dynamic managed, but not hedged, to allow comparability with entity B, which provides more information about dynamic risk management.

<u>Section 7—Other considerations.</u>

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.

Answer

We think that the PRA should allow for the inclusion of exposures in the managed portfolios after an entity becomes a party to a contract. In our view limiting the inclusion of exposures in

managed portfolios would create a possible divergence between accounting and dynamic risk management which is not in accordance with general principle to reflect the way that the risk is managed.

Question 23—Removal of exposures from a managed portfolio

(a) Do you agree with the criterion that once exposures are included within a managed portfolio they should remain there until derecognition? Why or why not?

(b) Are there any circumstances, other than those considered in this DP, under which you think it would be appropriate to remove exposures from a managed portfolio? If yes, what would those circumstances be and why would it be appropriate to remove them from the managed portfolio?

(c) If exposures are removed from a managed portfolio prior to maturity, how would you propose to account for the recognised revaluation adjustment, and why? Please explain your reasons, including commenting on the usefulness of information provided to users of financial statements.

Answer

We agree with criterion that once exposures are included within a managed portfolio they should remain there until derecognition since the entity change has not the dynamic risk management or its business model.

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.

Answer:

We 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 because of the nature of the risk management for FX and interest rate risk, the application of the PRA for both risks would provide a faithful representation of dynamic risk management.

<u>Section 8—Application of the PRA to other risks.</u>

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.

Answer

We believe that the PRA should be available for dynamic risk management other tan banks´ dynamic interest rate risk management (ie: commodities risk prices). In our view the ED should explore better the way that such risks are managed by industry, the ED is focused only on interest rate risk management. We also believe that some business model like commodities trading companies the application of PRA would not result in significant effects in their financial statements once that inventories, derivatives and firm commitments are measured at fair value. In this case, if the entity has hedged all exposures no volatility in the profit and loss is expected, even though the PRA has not been applied.

Section 9—Alternative approach—PRA through other comprehensive income.

Question 26—PRA through OCI

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

Answer

We think that such approach should not be considered because there is many conceptual and operational concerns to deal with, as described in the DP.

If you have any questions about our comments, please contact us at operacoes@cpc.org.br.

Yours sincerely,

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Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)