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23 October 2014

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

Re: Comments on Discussion Paper "Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging"

Dear Sir or Madam,

1. The Accounting Standards Board of Japan (hereinafter referred to as the "ASBJ" or we) appreciate the IASB's efforts on the project on accounting for Dynamic Risk Management and welcome the opportunity to comment on the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (hereinafter referred to as the "DP").

Overall Comments

2. We believe that it is worthwhile to consider whether a new accounting approach to hedging activities for an open portfolio should be developed. We are of the view that, as discussed in the DP, the fair value hedge accounting requirements for hedging activities on open portfolios in IAS 39 *Financial Instruments: Recognition and Measurement* (hereinafter referred to as "IAS 39") has limitations in terms of both providing useful financial information and the practical difficulties when it is applied to hedging activities for open portfolios. Additionally we are of the view that it is difficult to faithfully represent the outcome of hedging activities in the financial statements. Accordingly, in order to address these problems, we support exploring a new approach including the consideration of the potential modification of existing hedge accounting requirements.

3. We do however disagree with applying the Portfolio Revaluation Approach (hereinafter referred to as the "PRA") discussed in the DP to all managed portfolios included in an entity's dynamic risk management (a scope focused on dynamic risk management), in the context of interest rate risk management in the banks that is mainly discussed in the DP. Our understanding of the need to initiate this project is to address problems that arise from applying existing hedge accounting requirements to open portfolios. Based on that understanding, it seems to us that applying the PRA

to all items that are managed under dynamic risk management would deviate from those needs. Furthermore, in accordance with IFRS 9 *Financial Instruments* (hereinafter referred to as “IFRS 9”), an entity is required to measure financial assets held at amortised cost or at fair value through other comprehensive income (hereinafter referred to as “FVTOCI”) depending on the entity’s business model for managing those assets subject to the criteria of the contractual cash flow characteristics. However, under the PRA financial assets and financial liabilities are revalued at the point when an entity merely identifies or analyses them in relation to interest rate risk, which is the managed risk under the dynamic risk management approach. Any resulting revaluation adjustments would then be recognised through profit or loss. Accordingly, we are concerned with applying the PRA to dynamic risk management because the amount of the revaluation effect on profit or loss under the PRA would differ significantly from that based on the recognition and measurement criteria under IFRS 9.

4. Alternatively, we are of the view that it is worthwhile to further consider the application of the PRA to circumstances in which an entity has undertaken risk mitigation through hedging (a scope focused on risk mitigation) as we believe that an approach that determines the scope of the PRA by focusing on risk mitigation is in line with the original needs of the project, whose objective is to address the problems of the existing hedge accounting requirements. We acknowledge, however, that it may not be easy to overcome the practical difficulties identified in the DP, even if the PRA would only be applied to risk mitigation. Accordingly, we think that it would be worthwhile to consider approaches other than the PRA if the IASB concludes that it is difficult for the PRA to address the practical challenges while maintaining the usefulness of the information in the financial statements.

5. We are of the view that in considering the PRA in regards to risk mitigation or considering approaches other than the PRA, the IASB should share their position on whether or not past amendments to IAS 39 or the development of general hedge accounting requirements in IFRS 9 have been insufficient to resolve difficulties in hedge accounting for open portfolio. Based on that understanding, we think that it would be worthwhile also to consider whether limited amendments to IAS 39 or IFRS 9 are possible.

6. In addition, in considering applying the PRA to risk mitigation, it is important to take into account the following specific points with regard to the application of the PRA:

(a) We think that reflecting behaviouralisation when applying the PRA would assist in a more faithful representation of risk mitigation in entities' financial statements. However, we also think that sufficient guidance should be developed in order to ensure that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation (verifiability) when reflecting the behaviouralisation. This is because the application of the behaviouralisation basis requires significant estimation uncertainties, and we believe that use of the behaviouralisation basis should be reflected only if sufficient guidance could be developed. If not, the PRA should not be applied because an entity could not confirm the extent of the effectiveness of risk mitigation.

(b) The DP presents the PRA through other comprehensive income (hereinafter referred to as "OCI") as an alternative approach, in particular when assuming that the PRA is applied to dynamic risk management. We believe however, that this alternative is inappropriate because when the PRA is applied to dynamic risk management it results in the revaluation of items that should not be revalued as mentioned in paragraph 3, and even if the revaluation difference is presented in OCI, the problem would not be solved. In addition, when the PRA is applied to risk mitigation, we believe that the revaluation adjustments arising from risk management instruments should be recognised in profit or loss in a similar manner to the existing treatment for fair value hedge accounting. Accordingly, we believe that further consideration of the PRA through OCI approach that is proposed in the DP should not be considered as an alternative approach.

(c) We are aware that there are also cases where an entity or a department of an entity dynamically manages risks, other than interest rate risk in banks, in a centralised manner in a consolidated basis, as discussed in the DP. In those cases the central unit (an entity or a department of an entity) is considered to play a role similar to that of the ALM department in a bank. We believe that in such cases, it is worthwhile to consider whether it is possible to apply the PRA as discussed in the DP. We think that it is worthwhile considering applying the PRA to risk mitigation activities in the case where an entity dynamically manages a risk such as commodity price risk or foreign currency exchange risk.

Comments on individual questions in the DP

Section 1 ***Background and introduction to the portfolio revaluation approach (PRA)*** **and Section 5** ***Scope***

(Regarding dynamic risk management)

7. We acknowledge that the application of the PRA to dynamic risk management might be helpful in enhancing the usefulness of financial reporting by reflecting on a timely basis the extent of the duration mismatch of assets and liabilities or the repricing mismatch of interest rates on the face of financial statements. However, we disagree with considering PRA that focuses on the dynamic risk management for the following reasons:

   (a) An approach focused on dynamic risk management is significantly different from the existing hedge accounting approach whose main object is to eliminate or reduce the possible accounting mismatches between derivatives and assets and liabilities that are eligible for a hedging relationship, assuming that derivatives are measured at fair value through profit or loss (hereinafter referred to as "FVTPL") at the end of each reporting period. Accordingly, the approach based on dynamic risk management might significantly deviate from the original starting point of addressing the problem of the existing hedge accounting requirements for the open portfolio.

   (b) If it is necessary to faithfully represent how an entity dynamically manages a risk on the face of its financial statements, we think that mandatory application of the PRA to dynamic risk management would be needed. However, mandatory application would cause the following problems:

      (i) Assets and liabilities recognised in the financial statements subject to dynamic risk management would be revalued for the managed risk. As a result such measurement would be inconsistent with the basic measurement requirements applied to financial assets and liabilities in general and such inconsistency would widely occur in items under risk management. Accordingly, the application of the PRA in this situation would result in inconsistencies with the outcomes based on the recognition and measurement criteria in IFRS 9.

      (ii) In this approach different measurement bases would be applied compared with the general recognition and measurement criteria for financial assets and liabilities depending on whether the assets and liabilities are subject to

dynamic risk management. This appears to be inconsistent with our comments on the IASB's Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, which commented that the measurement basis used for a particular asset should depend on how the asset would contribute to future cash flows, and that for liabilities that will be settled according to their terms, a cost-based measurement will normally provide the relevant information.

(iii) A mere difference in whether or not entities undertake dynamic risk management could give rise to a major difference in terms of how entities report items in their financial reports even if entities have the same assets or liabilities.

8. If information about duration mismatch of assets and liabilities or repricing mismatch in regards to interest rates is needed, the information could be provided through disclosures in the notes to the financial statements or other disclosures required as part of the financial reporting. Accordingly, when existing disclosure requirements relating to this information are determined not to be sufficient, it would be possible to improve the disclosures of the information.

(In relation to risk mitigation)

9. We believe that the approach applying the PRA to risk mitigation is in line with the original needs of the project whose objective is to address problems arising from the application of existing fair value hedge accounting requirements to open portfolios. We therefore believe that it is appropriate to consider the PRA based on risk mitigation if further consideration is warranted for the PRA. In addition, when users of the financial statements want additional information about the entity's dynamic risk management, we are of the view that the information could be provided through disclosures in the notes to the financial statements or other disclosures in the financial reporting as described in paragraph 8.

10. Regarding the application of the PRA to risk mitigation, there are some advantages such as eliminating difficulties relating to the assumption that a hedging relationship should have a one-to-one designation between the hedged item and the hedging instrument in accordance with IAS 39. We believe however, that the IASB should consider whether entities should be allowed to apply the PRA and where it is applied, should sufficiently consider the extent of its application and method. This is because applying the PRA to risk mitigation is considered to have many issues as follows:

(a) If the PRA is to be applied voluntarily, it would result in permitting a different accounting treatment for the same event and would possibly reduce the comparability of financial statements.
(b) If the PRA is to be introduced, it would likely be desirable to widely reflect the behaviouralisation to enhance the usefulness of financial information. However, a concern is expressed in regard to reflecting the behaviouralisation from the perspective of estimation uncertainty and the possibility of arbitrary application.
(c) If the PRA is to be applied to risk mitigation, operational complexity may arise as pointed out in the DP, because depending on the items to which the PRA is applied the scope of risk mitigation may frequently change reflecting the continuous update of the way an entity dynamically manages its risk.

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?

11. The need for a specific accounting approach to represent dynamic risk management would vary, depending on which factors of dynamic risk management described in paragraph 1.1 of the DP the IASB chooses to focus on.

12. Specifically, we are of the view that, while the DP presents the two alternative scopes, it is worthwhile to consider further development of an accounting approach to representing actual risk mitigation in the financial statements, similar to the existing hedge accounting. On the other hand, we believe that it is unnecessary to consider further the PRA in regards to dynamic risk management as described in paragraph 7 and paragraph 8.

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?

Question (a):

13. We are of the view that, in general, the DP identifies the main issues that entities currently face when applying the existing hedge accounting requirements to dynamic risk management.

14. However, the IASB introduced fair value hedge accounting for a portfolio hedge of interest rate risk into IAS 39 in 2004 and set up new requirements in IFRS 9 in 2013 for eligibility of group hedge accounting to accommodate risk management practices on a net basis by relaxing hedge accounting requirements in IAS 39. We do not think that the IASB sufficiently explained the reason for the needs for the significant improvements suggested in the ED in spite of the abovementioned amendments. Accordingly, we believe that when the IASB decides not to consider applying the PRA to dynamic risk management in the future, it should share its view on whether or not the past amendments to IAS 39 or the past developments of general hedge accounting requirements to IFRS 9 have been insufficient before it proceeds with the application of the PRA. We also think that it is worthwhile to consider the possibility of eliminating the difficulties of hedge accounting requirements for open portfolio by making limited amendments to the existing requirements in IAS 39 or IFRS 9.

Question (b):

15. We are of the view that the PRA might address the issues identified such as a one-to-one designation between the hedged item and the hedging instrument and reflect risk management on a net basis.

16. We are of the view that in regards to interest rate risk management in a bank, most of the recognised assets and liabilities are subject to dynamic risk management for interest rate risk and classification and measurement that do not reflect the classification and measurement criteria in IFRS 9 would be extensively applied. Although financial assets subject to contractual cash flows characteristic criteria that are held under a business model whose objective is to hold assets in order to collect contractual cash flows are measured at amortised cost based on the basic criteria in IFRS 9, the effect of a revaluation on profit or loss under PRA would differ significantly from that based on the recognition and measurement criteria under IFRS9. This is because the interest rate risk of these financial assets, which are subject to the application of the PRA, are revalued for the managed risk and the revaluation adjustments would be recognised through profit or loss.

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?

Question (a):

17. We agree with the scope focused on risk mitigation. We disagree with considering the scope focused on dynamic risk management.

18. This is because, as described in paragraph 9, this project started from the need to address the operational difficulties of applying existing fair value hedge accounting requirements to open portfolios and the scope focused on risk mitigation that is similar to existing hedge accounting would be appropriate considering the needs for improvement of existing hedge accounting.

Question (b):

19. If the PRA can address the difficulties faced by general hedge accounting for open portfolios through a scope focused on risk mitigation, the PRA could provide information relating to the effects of hedging activities. We think that an entity could apply appropriate hedge accounting based on the nature of the hedged items by applying the PRA.

20. As described in the response to Question (a), we believe that the IASB should consider

applying the PRA to risk mitigation. Based on this view, we provide our comments on two alternatives that are considered in the DP as follows:

(Sub-portfolio approach)

21. In our view, it is appropriate for the IASB to continue to consider the sub-portfolio approach assuming the scope focused on risk mitigation.

22. We understand that the sub-portfolio approach is that an entity would designate a specific sub-portfolio to which the PRA is applied. Based on this understanding, we are of the view that the sub-portfolio approach could address the difficulties in defining an entity's risk mitigation. Furthermore, in our view, the application of the PRA seems to be consistent with the hedge accounting in IAS 39 or IFRS 9, because hedge accounting in IAS 39 or IFRS 9 is applied on an individual or portfolio basis and on a voluntary basis.

(Proportional approach)

23. We are of the view that it is difficult to apply the proportional approach itself described in the DP.

24. This is because, although the approach might be possible in theory, there are not necessarily many cases where an entity establishes a policy to mitigate risks of a specific proportion of the entire portfolio that are dynamically managed, if the size of the portfolio is relatively large. Accordingly, we think that it would normally be difficult to faithfully represent hedging activities for an open portfolio by applying the proportional approach.

Question (c):

25. For a sub-portfolio in which an entity intends to mitigate a risk, we suggest that:

    (a) an entity should designate an entire sub-portfolio on transition or when a change in an entity's risk management objectives or risk management strategies, including a method of identification of a sub-portfolio subject to hedging activities, has occurred, and;

    (b) an entity should be required to continue applying the PRA to the sub-portfolio and should not voluntarily discontinue the PRA unless the risk management objectives or the risk management strategies have significantly changed.

    This is because if an entity is allowed to adjust the scope of the PRA corresponding to the timely change in hedge ratio, this may result in providing an entity with an

arbitrary discretion to adjust revaluation gains or losses, which may result in impairing comparability of financial information.

26. In addition, in the case of the proportional approach, similar to the discussion in the previous paragraph, we suggest that an entity should designate an item when that item is included in the portfolio or when risk management objectives or strategies have been changed and that an entity should not be allowed to have the proportion of the portfolio reflect flexible changes in the hedge ratio, unless the risk management objectives or the risk management strategies have significantly changed.

Question (d):

27. Our response would not change even if the risks considered are risks other than interest rate risk, for example commodity price risk or foreign currency exchange risk.

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?

Questions (a) and (b):

28. We believe that the IASB should consider applying the PRA to risk mitigation in terms of addressing issues on existing hedge accounting requirements. From this perspective, we think that the application of the PRA should be voluntary, which will be in line with the treatment of hedge accounting in IAS 39 and IFRS 9. This is because an entity is allowed a choice to apply hedge accounting in the existing accounting requirements when certain criteria are met, and significant concerns about this voluntary application have not been expressed. This is also because, regarding the scope focused on risk mitigation, it would be extremely difficult from an operational standpoint to mandate the PRA unless sophisticated risk management processes are established within the entity.

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.

Question (b):

29. Although we are concerned with estimation uncertainties, we believe that when the PRA is applied to risk mitigation, additional criteria would be necessary to identify sub-portfolios in which an entity mitigates a risk through hedging activities.

30. This is because when assets and liabilities that should be measured at amortised cost or FVTOCI would be revalued to reflect changes in interest rates through profit or loss by the PRA. This revaluation is considered to be an exception to the recognition and measurement criteria in IFRS 9. Accordingly, we believe that it should be necessary to meet certain criteria in accessing such an exception.

31. Such criteria may include:

    (a) Prior to applying the PRA, formal documentation is prepared detailing the method of risk mitigation, including identification of items and risk management objectives of items included in the sub-portfolio and the specific risk management strategies employed to achieve the risk management objectives.

    (b) There is a clear definition of the sub-portfolio that is consistent with the risk

management objectives and risk management strategies, and based on that definition items in the sub-portfolio are clearly determined.

(c) An entity is expected to implement its risk management strategies so that it can manage the risk arising from the changes in the exposures within a certain range in an effective and timely manner.

Question (b)(i):

32. We are of the view that eligibility criteria would be the same irrespective of whether there was voluntary or mandatory application. However, we do not support mandatory application of the PRA because we support the application of the PRA to risk mitigation as a possible improvement for the existing hedge accounting requirements (see paragraph 28 of this comment letter).

Question (b)(ii):

33. A possible criterion may be that an entity should designate a certain portfolio that can be clearly defined and continuously exist, and that items in the sub-portfolio should automatically be included within the scope of the PRA. The application of the PRA to a specific item starts when the item is included in the sub-portfolio and ceases when it is excluded from it.

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?

34. As described in paragraph 17 of this comment letter, we propose that the IASB consider the PRA based on the scope focused on risk mitigation. Accordingly, we do not necessarily believe that the description of dynamic risk management needs to be accurate and complete. In this context, we think that the description in paragraphs 2.1.1–2.1.2 in the DP would depict appropriately the general characteristics of dynamic risk management compared to static risk management.

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*). **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.* **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*.

Question (a):

35. Because pipeline transactions can lead a third party to form a certain reasonable expectation that an entity will accept his or her application depending on the way the offer is advertised, entities sometimes use hedge transactions to mitigate the risk arising from pipeline transactions. Therefore, if an entity includes the pipeline transactions in its dynamic risk management as part of dynamically managed items, we agree that as an exceptional treatment the entity could include the pipeline transactions in the scope of the PRA so that the entity can more faithfully reflect how the risk is mitigated through its hedging activities.

36. However, it could be practically difficult to identify which pipeline transactions should be included in the scope of the PRA because an entity has not yet entered into the

contract with the third party for pipeline transactions. Accordingly, when the IASB seeks to include pipeline transactions in the PRA, we believe that it is particularly important to clarify the scope of the application in the standard. As an example of clarification, the IASB may be able to establish criteria such that the relationship between the pipeline transactions and risk mitigation is clear in light of risk management objectives.

Question (b):

37. We believe that the IASB should not include equity model book (EMB) in the PRA. Including EMB as part of dynamic risk management would result in revaluing equity in a similar manner to liabilities from the view point of revaluation of managed risk, and a change in the value of equity would result in profit or loss. It could cause serious conceptual difficulties from the perspective of distinction between liability and equity transactions. Accordingly, we do not believe that we have sufficient reasons to override these conceptual difficulties to include EMB in the PRA.

Question (c):

38. We think that, if a risk is managed based on behaviouralisation, considering behaviouralisation in estimating cash flows in the application of the PRA would result in more faithfully representing risk mitigation in the financial statements. Furthermore, there are some requirements in existing accounting standards that consider behaviouralisation such as prepayment features. Thus, we understand that considering behaviouralisation has some advantages of enhancing the usefulness of financial information and of ensuring consistency with existing accounting requirements.

39. However, consideration of behaviouralisation would entail significant estimations, which causes concern about estimation uncertainty. Accordingly, reflecting behaviouralisation in the financial statements should be limited to the case where sufficient guidance can be provided in order to ensure verifiability. Alternatively, when sufficient guidance cannot be provided, the PRA should not be applied because an entity could not confirm the extent of the effectiveness of risk mitigation.

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.

40. When risk management instruments with optionality are used for risk mitigation, revaluation of managed risk should adjust both up and down.

41. We understand that in existing hedge accounting requirements, when hedging instruments with optionality are used in a fair value hedge, revaluation differences of one-sided risks secured by hedging instruments would only be reflected in the financial statements with reference to implementation guidance F1.10 of IAS 39, which has already been removed. Similarly, it follows that if the PRA is applied to the scope focused on risk mitigation, only revaluation differences of one-sided risks should originally be reflected in the financial statements.

42. However, assuming an open portfolio, it would be extremely rare to undertake risk management using only hedging instruments with the optionality as described in the DP. Additionally, it would be practically difficult to identify a portion in which only one-sided risks are hedged in a managed portfolio. Furthermore it is inconsistent with the intention of using the PRA. Therefore, we think that it is appropriate to consider both increasing and decreasing revaluation adjustments, though it could be inconsistent with the intention of uses hedging instruments with optionality.

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?

43. We believe that developing sufficient guidance to reflect behaviouralisation is necessary because we are concerned about the estimation uncertainty required in reflecting behaviouralisation. However, the impact of changes in past assumptions about behaviouralisation should be recognised in profit or loss through the application of the PRA when, and to the extent that the changes occur in a manner consistent with the treatment described in paragraph 36 of IAS 8 *Accounting Policies, Change in Accounting Estimations and Errors*.

44. This is because when the measurement difference attributable to changes in estimations of cash flows arises, the change would have effect only in the reporting period in which the change arises, and accordingly the impact of the difference should be recognised in profit or loss.

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.

45. We think that it is difficult to apply the bottom layer approach within the PRA. Our reasons are as follows:

    (a) We understand that the bottom layer approach is the approach where an entity estimates and identifies a bottom layer from a portfolio that consists of financial instruments which have prepayment risk and that an entity considers a part of the bottom layer to be an exposure that does not have prepayment risk, recognising that there is a margin for error in the behaviouralisation estimate.

    (b) On the other hand, we believe that, as described in paragraph 38 of this comment letter, by considering behaviouralisation, an entity would be able to reflect risk mitigation more appropriately when the PRA is applied. We think that reflecting behaviouralisation may assist in identifying a part of a portfolio that is not expected to be prepaid in the same way as the bottom layer approach.

    (c) However, as pointed out in the DP, the bottom layer approach assumes that the risk sensitivities of all exposures making up the portfolio are homogenous and it ignores prepayment risks in the bottom layer. Taking these into account, the PRA is incompatible with the bottom layer approach in terms of reflecting behaviourlisation and the estimation of prepayment risks of assets and liabilities. Accordingly, we believe that it is difficult to apply the bottom layer approach when an entity applies the PRA.

46. We note, however, that there are many cases where borrowers are entitled to a prepayment option for fixed rate mortgage loans in Japan. For this reason banks often manage the interest rate risks of such products that have exposures to prepayment risks by using the bottom layer approach. Therefore, we additionally

note that banks in Japan have great need to use the bottom layer approach to reflect the economics in the financial statements independent of the application of the PRA.

Question 8—Risk limits
Do you think that risk limits should be reflected in the application of the PRA? Why or why not?

47. We do not believe that risk limits should be reflected in the application of the PRA. This is because we believe that the accounting should not rely too much on how a risk is managed and because the concept of risk limits is unnecessary in applying the PRA to risk mitigation.

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

Questions (a) and (b):

48. We are of the view that, similarly to the response to Question 4(c) on behaviouralisation (paragraph 38 of this comment letter), reflecting behaviouralisation on demand deposits would result in more faithfully representing risk mitigation in the financial statements and we understand that there are certain advantages to considering the behaviouralisation of customers of demand deposit (depositors). This is because banks often undertake risk management activities for customers' deposits not on a contractual basis but on a behaviouralised basis (considering the expectation of the amount and timing of withdrawal by customers). In particular for demand deposits, this would result in enabling an entity to more faithfully represent risk management activities. Furthermore, it seems to be important to consider behaviouralisation of core demand deposits, because demand deposits would account for a large portion of hedged items in a bank's risk mitigation, and as a part of financial strategies, banks often recognise core demand deposits as long-term financing method.

49. However, for demand deposits, a bank is contractually required to accept customers' demands to withdraw its deposits from the bank and a customers' behaviour depends

on external factors including economic outlook. Therefore, we are concerned with reflecting behaviouralisation from the perspective of estimation uncertainty including amounts and time periods. For this reason, we believe that reflecting behaviouralisation in the financial statements should be limited to the case where sufficient guidance could be developed in order to ensure verifiability. Alternatively, where sufficient guidance cannot be developed, we believe that the PRA should not be applied because an entity cannot confirm the extent of the effectiveness of their risk mitigation.

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?
(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?

Question (a):

50. We 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.

51. This is because treating sub-benchmark instruments as benchmark instruments could be consistent with the risk management activities of the ALM department and, using the transfer price in the PRA as commented later in the response to Question 12, if the risks transferred to the ALM department via transfer pricing transactions for sub-benchmark instruments do not include the negative margin and the associated embedded floor.

Question (b):

52. If sub-benchmark variable interest rate financial instruments have an embedded floor

that is not included in the dynamic risk management because it remains in the business unit, we think that it is appropriate not to reflect the floor within the managed portfolio.

53. This is because the risks within the associated embedded floor remain in the business unit and do not need to be considered as the managed risks, being consistent with the response to Question (a) above, if the risks transferred to the ALM department via transfer pricing transactions for sub-benchmark instruments do not include the negative margin and the associated embedded floor.

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? (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?

Question (a):

54. Although we are concerned with the application of the PRA to the scope focused on dynamic risk management as described in paragraph 3 of this comment letter, if an entity were to apply the PRA to that scope we think that the method of revaluation calculation outlined in this section would also be useful for faithful representation of dynamic risk management in the ALM department as the calculation method for the application of the PRA. Additionally, if an entity were to apply the PRA to risk mitigation, we think that the revaluation calculations outlined in this section would assist in a faithful representation of dynamic risk management in the ALM department.

55. This is because the cash flows and the interest rate of the managed risks only affect the numerator and denominator in the revaluation calculation formula illustrated in paragraph 4.1.2 of the DP, the revaluation gains or losses only represent changes in the risks managed by the ALM department. Consequently, the part of risks managed by the business units would, as a result, be excluded from the revaluation gains or losses.

Question (b):

56. When the dynamic risk management objective is to manage net interest income with respect to the funding curve of a bank, we are of the view that it is appropriate for the managed risk to be the funding rate. This is because, when the risks are managed using the internal transfer price based on the funding curve of the bank, we think that it is acceptable to use the funding curve of the bank as long as the economics of assets and liabilities are reflected, consistent with the response to Question 12 in which we agree with using the transfer price.

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?

57. The following comments are based on the premise that the internal transfer transactions are internally offset with each other.

Question (a):

58. We agree with using the transfer pricing transactions for the purposes of applying the PRA. However, we think that specific restrictions should apply to their use.

59. In many cases, banks centralise interest rate risks on assets and liabilities in the ALM department using a transfer pricing mechanism and then centrally manage the interest

risks on a portfolio basis. The items included in that portfolio come from various funding sources and are invested in various operation forms. We therefore think that the banks should primarily revalue managed exposures using the funding benchmarks applicable to each asset and liability (such as, LIBOR or TIBOR) in applying the PRA to the scope focused on risk mitigation. However, it would be practically difficult to use the funding benchmarks applicable to each asset and liability because the portfolio managed by the banks includes large numbers of assets and liabilities. Accordingly, we think that as a result, an entity would have to use the transfer pricing transaction as a practical expedient in order to ensure operationality of the application of the PRA.

60. However, the transfer price is determined for the purpose of assessing profitability and performance of the departments and is not necessarily determined for the purpose of financial reporting. If political or intentional considerations were taken into account when determining transfer price, the economics of assets and liabilities would not be reflected in the PRA and it could cause concern for the arbitrary revaluation. Accordingly, if transfer pricing were to be used in the application of the PRA, it would be necessary to impose restrictions on its use and establish requirements to provide related disclosures.

Question (b):

61. We prefer the third approach described in paragraph 4.2.20 of the DP, that would be to use the full transfer prices to identify the cash flows that are used for the purpose of determining the revaluation adjustment, but to fix all spreads other than the market funding index within the transfer price for the purposes of the discount rate at the original spread that was used in the pricing of the transfer pricing transaction. This is because this approach would use the transfer price that includes the spread and would not recognise Day 1 profit or loss.

Question (c):

62. We think that specific restrictions are needed. If spreads due to political or intentional considerations were included in the transfer price, it would be less likely to reflect economics of assets and liabilities. Therefore, we think that the transfer price should reflect an arms' length price that can be confirmed by the external interest rate. For example, we think that it may be appropriate to test the spread to see whether it is determined to reflect the entity's credit risk.

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.

Question (a):

63. We would prefer a line-by-line gross up presentation of the revaluation adjustment for presentation in the statement of financial position. This is because we think that, when the scope of the application of the PRA is focussed on risk mitigation, a line-by-line gross up presentation is more consistent with the treatments of existing hedge accounting requirements and adjusting carrying amounts on a line-by-line basis would result in more faithfully representing economics of the assets or liabilities recognised in each line item. If the revaluation adjustments arising from the PRA were not presented on a line-by-line gross up basis, we think that the financial positions of each asset and liability would not be presented appropriately.

Question (b):

64. We would prefer actual net interest income presentation in the statement of comprehensive income. The actual net interest income presentation is the method to present actual income and expense as interest income and interest expense in a similar manner to the existing accounting presentation. The presentation also shows the process related to how the risks of actual income and expense are mitigated by the risk management instruments through separating effects relating to the current period from those relating to future periods. We think that there are benefits to this presentation alternative because it could show how an entity's interest income changes through risk mitigation.

65. The stable net interest income presentation is the method whereby an entity presents interest income on the assumption that an entity's dynamic risk management objective is to stabilise net interest income. We think that it has a benefit of presenting the

difference between the entity's risk management objectives and the outcome of the risk management. However, it would be difficult to apply this approach considering that an entity has usually a part of the exposures that are not subject to dynamic risk management.

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?

Question (a):

66. We disagree with a gross presentation of internal derivatives. This is because we believe that internal derivatives are internal transactions in regards to the consolidated group and their effects should not be presented on the face of financial statements. In addition, when it is necessary to provide information about the risk mitigation in the ALM department, we think that it is possible to provide related information by disclosing it in the notes to the financial statements.

Question 20—Disclosures
(a) Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views. (b) If you think that an identified theme would not provide useful information, please identify that theme and explain why. (c) What additional disclosures, if any, do you think would result in useful information about an entity's dynamic risk management? Please explain why you think these disclosures would be useful.

Question (a):

67. We have no comment at this stage on the four themes that are identified in the DP. We believe that the IASB should consider specific disclosure requirements corresponding to the specific accounting requirements to be discussed in the future. However, in our view, the IASB should consider avoiding potential overlaps with the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* related to risk arising from financial instruments (specifically, sensitivity analysis).

Question (c):

68. As described in the response to Question 19 above, we recommend that the information of the risk mitigation in the ALM department relating to internal derivatives be disclosed in the notes to 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?

Question (a):

69. We think that the scope of the disclosures should be the same as the scope of the application of the PRA. This is because, by aligning the scope of the disclosures with that of the application of the PRA, an entity could ensure consistency between the information disclosed in the notes and the accounting on the face of financial statements. In addition, if the scope of the disclosures relates to the portfolio in which the dynamic risk management is undertaken, whereas the scope of the application of the PRA is focussed on risk mitigation, it would be necessary to define precisely what dynamic risk management is. However, it seems to us that the DP has not provided such a concise definition as would be required in this case.

70. However, there is a view that it would be useful to users of financial statements to provide the information related to the whole picture of the dynamic risk management at one time. That is, it would be worthwhile to consider requiring an entity to provide overview of the dynamic risk management of an entire portfolio the part to which the PRA is applied, so that the users could better understand the outcome of the

PRA, in a similar manner to IFRS 7 that requires an entity to disclose general information about its risk management strategy and how it is applied to manage risk in the context of general hedge accounting.

Section 7 Other considerations

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.

71. Basically, we think that the PRA should include exposures in the managed portfolios when an entity first becomes a party to a contract. However, we think that there might be rare cases where the application of the PRA should be allowed after an entity becomes a party to a contract. Those cases might occur when an entity is required to establish a new sub-portfolio in order to reflect significant changes in the risk management objectives or the risk management strategies. In addition, those cases might also occur based on the way a sub-portfolio is determined. Based on this we think that sufficient guidance on how to determine sub-portfolio should be provided.

Question (a):

72. It might be appropriate in cases where an entity is required to establish a new sub-portfolio in order to reflect significant changes in the risk management objectives or strategies. In addition, it might be appropriate in the case where a sub-portfolio only includes items with similar remaining periods, to aggregate items with similar risk sensitivity for the change in interest rates.

Question (b):

73. We think that an entity should recognise revaluation adjustments that arise after the inclusion of exposures in the portfolios and not recognise Day 1 revaluation gains or losses.

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.

Question (a):

74. In principle, we think that the exposures should be included within the managed portfolio when an entity first becomes a party to a contract, and that the exposures should remain in the portfolio until derecognition. However, we think that in rare cases the exposures may be removed from the sub-portfolio before derecognition depending on how the sub-portfolio is determined.

Question (b):

75. There may be circumstances where an entity should remove exposures from the managed portfolio as follows:

    (a) This may depend on the way a sub-portfolio is determined (for example, an entity may establish a sub-portfolio based on the remaining periods of items).

    (b) This may be when the managed portfolio becomes ineligible for application of the PRA in its entirety. For example, where risk mitigation on managed portfolios is judged to be less effective or it would be no longer necessary to apply the PRA to sub-portfolios because of the significant changes in the risk management objectives or strategies.

Question (c):

76. We think that the revaluation amount determined at the time when the exposures are removed should be carried forward as the new carrying amount of those exposures and they should continue to be measured based on the business model. This is because we think that it is appropriate to account for the items in line with the treatments for

changing business models in classification and measurement requirements of IFRS 9.

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.

77. We do not believe that, in principle, the application of the PRA to foreign currency exposures that are recognised as assets or liabilities is necessary. This is because the accounting for foreign currency exchange risks has substantially similar effects to that of the PRA, and for that reason we think that it is not necessary to apply the PRA even if foreign currency exchange risks are dynamically managed.

78. However, if foreign currency exposures which are not recognised as assets or liabilities (for example, foreign currency firm commitments and forecast transactions that are highly probable to occur) are included in the scope of the risk mitigation, we think that it should be considered if the PRA could be applied to such transactions because these items would not be translated.

Section 8 Application of the PRA to other risks

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.

Question (a):

79. With respect to dynamic risk management, other than dynamic interest rate risk management in banks, there are cases where some business lines or companies may manage risks, including risks of commodity price changes and foreign currency exchange risks (foreign currency assets or liabilities, foreign currency translation adjustment), in an integrated manner in the consolidated group. In those cases, the

business lines or companies managing risks may play a similar role to that of the ALM department in banks. We think that applying the PRA in the DP could faithfully represent the economics of risk mitigation in those cases.

80. However, if the IASB further considers how to apply the PRA, in terms of efficient use of resources, we think that the bank's risk management for interest rate risk should be prioritized to deal with the most prominent needs from constituents, and then other risks should be considered.

Question (b):

81. Certain business lines or certain companies in the consolidated group manage risks of commodity price changes in an integrated manner on a net basis. We are aware that some entities indicate the needs to apply the PRA to sale and purchase contracts that are not treated as financial instruments according to the net settlement criteria based on paragraph 2.4 of IFRS 9 or paragraph 5 of IAS 39. We are of the view that the entity could reflect their risk management on the face of their financial statements more appropriately by offsetting revaluation adjustments arising from the PRA with the changes in fair value of derivatives including commodity futures which are treated as risk management instruments.

82. Certain business lines in some entities manage foreign currency exchange risks in an integrated manner on a net basis. These entities may include foreign currency exchange risks not only relating to recognised assets or liabilities but also to unrecognised firm commitments in their risk management. In this case, we think that it is appropriate to include these unrecognised firm commitments in the scope of the application of the PRA to faithfully represent the risk mitigation. If an entity manages foreign currency exchange risks in recognised assets and liabilities as well as those in unrecognised firm commitments on a net basis, and these risks are offset against the hedging instruments, such as foreign exchange forward contracts, we think that these offsetting relationships could be presented faithfully in the financial statements by applying the PRA.

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?

83. The DP proposes the PRA through OCI as an alternative approach especially when assuming that the PRA is applied to dynamic risk management. We recognise that there might be cases when the PRA applied to dynamic risk management would revalue items which are not necessarily appropriate for revaluation. We do not think that this problem is resolved even if the revaluation adjustments of the PRA are recognised through OCI based on this alternative approach. Accordingly, we are of the view that it is not worthwhile considering the PRA through OCI.

84. The use of OCI could theoretically be considered as an alternative to the application of the PRA through profit or loss to risk mitigation. In this case, both the revaluation adjustments arising from a part of the managed portfolio and the changes in the fair value of the risk management instruments are to be recognised in OCI simultaneously. But we think that it is unnecessary to develop this alternative approach. We think that the objective of applying the PRA to risk mitigation is to reduce difficulties in applying existing fair value hedge accounting to hedging activities on open portfolios. Accordingly, the use of OCI is inconsistent with this objective because the use of OCI would produce an entirely different accounting model from the existing fair value hedge accounting. We also think that it is difficult to apply this approach in practice because of the following problems described in the DP:
    (a) ineffectiveness would not be recognised in profit or loss,
    (b) risk management instruments including derivatives would not be accounted for as at FVTPL (Revaluation adjustments for derivatives would not be recognised in profit or loss in this case, which we think is difficult to justify given the history of the development of the standards for derivatives.),
    (c) this would entail reconsideration of the treatment of internal derivatives as proposed in the DP and,
    (d) recycling from OCI into profit or loss may not occur even when assets or liabilities under entity’s risk management are sold or the risk management instruments are terminated.

Other comments

85. We think that it is helpful to consider that the IASB should develop educational material for cash flow hedge accounting when interest rate risk is managed on a net basis (hereinafter referred to as "macro cash flow hedge accounting") in this project in addition to further considering how to apply the PRA to risk mitigation.

86. Paragraphs F6.2 and F6.3 of Guidance on Implementing IAS 39 (before they were amended in 2013) provided considerations and illustrative examples of implementation of macro cash flow hedge accounting. Although this guidance has been removed from IAS 39 and has not been carried forward in IFRS 9, the IASB Staff unofficially indicated that macro hedge cash flow accounting based on this guidance could also be applicable in the context of IFRS 9.

87. However, the abovementioned understanding that this guidance is still applicable could not be shared widely among constituents because the guidance has not been carried forward in IFRS 9. Accordingly, we think that it might be helpful to develop and disseminate educational material for macro cash flow hedge accounting based on the illustrated examples within the guidance so that constituents can have a shared understanding that macro cash flow hedge accounting for open portfolios based on the guidance could be applied consistently in the context of IFRS 9 and how to apply the guidance.

* * * * *

We hope our comments will contribute to the forthcoming deliberations on the project.

Yours sincerely,

Yukio Ono
Chairman of the Accounting Standards Board of Japan
Chairman of the Financial Instruments Technical Committee