Dynamic Risk Management

Background and Proposed Approach

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Agenda Paper 4

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Disclaimer

Meeting Objectives

This objectives of this meeting are:

- Review project history and background;
- Discuss our approach and initial project plan; and
- Discuss next steps

History and Background

History and Background

The hedge accounting requirements of IAS 39 *Financial Instruments: Recognition and Measurement* have guided how entities account for their risk management activities since 2004.

Entities that manage risk dynamically (i.e., where the risk position being hedged experiences frequent changes) have found the requirements of IAS 39 challenging, making it difficult to reflect dynamic risk management in their financial statements.

Both preparers and users provided feedback during outreach about the lack of connection between actual risk management and the hedge accounting requirements.

History and Background

In September of 2010, the International Accounting Standards Board (the Board) began deliberations on the Accounting for Macro Hedging project after receiving feedback that entities experience difficulties applying the existing portfolio fair value interest rate hedging model in IAS 39.

Specifically, the difficulties focused on:

- Application of guidance focused on static assets and liabilities to a portfolio of changing assets and liabilities;
- Eligibility of hedged items — certain key items were ineligible for designation under the existing model;
- Assessment of effectiveness; and
- Amortisation of hedge adjustments.

In May 2012, the Board decided to develop a discussion paper as an initial due process step in developing an accounting model for dynamic risk management (DRM).

Given the scope of work to develop a DRM accounting model and to avoid delaying IFRS 9, the decision was made to separate the projects.

History and Background

The Board published the Discussion Paper Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging in April of 2014.

Primary objective:

Obtain feedback if the Portfolio Revaluation Approach (PRA) would result in enhanced usefulness of financial statement information.

Key components:

In the PRA, the net open risk position is identified and revalued for changes in the managed risk (i.e., interest rate risk) with any gains or losses recognised in profit or loss.

The net open portfolio(s) would reflect core demand deposits and equity on a behaviouralised basis consistent with risk management.

Two choices were provided on scope of application:

- Focus on Dynamic Risk Management: Applied to all managed portfolios; and
- Focus on Risk Mitigation: Applied only when an entity has mitigated risk through hedging

History and Background

Overall, respondents were impressed by research done to date. However, objected to proposed solutions.

Summary of the Discussion Paper feedback

Positive statements:

- the Discussion Paper captured the critical elements of DRM;
- challenges of the existing model were well understood; and
- necessity of the project was re-inforced

Negative statements:

- revaluing residual risk does not necessarily reflect DRM and will lead to profit and loss volatility
- proposals for certain transactions may not reconcile with *The Conceptual Framework for Financial Reporting*; and
- few alternatives were suggested

EFRAG

In January 2017, the European Financial Reporting Advisory Group (EFRAG), published the results from its 2016 outreach on DRM to assist with the Board's DRM project.

Main Findings

- a comprehensive solution for reporting DRM activities does not yet exist;
- DRM is generally undertaken for the full banking book and includes modelled positions from demand deposits and equity; and
- general purpose of interest rate risk management is to "stabilise net interest income" (i.e., reduce volatility of the interest margin)
  - Banks also take action to optimise Net interest income

Information consistent with IASB understanding

Project Need, History, Approach and Stages

Need for the Project

There are a number of factors that dictate the necessity of the project and the imperative of success:

- Current accounting model does not always reflect high quality information in the financial statements. Entities currently:
  - Rely on “best effort” attempts to force their dynamic risk management practices into the IFRS accounting model (i.e., proxy hedging); or
  - Use of alternative reporting methods that vary in scope from the use of:
    - Non GAAP metrics; or
    - Application of amended accounting standards
- Support from users and industry to develop a new accounting model:
  - EFRAG Outreach
  - Agenda Consultations
  - Discussion Paper
- Comparability across institutions
  - Varied business practices; and
  - Numerous accounting models

Project History

The project team is very familiar with the IASB’s previous work efforts, specifically:

- 2014: Discussion Paper; and
- 2006: Net Interest Margin Hedging

The project will build upon the previous work efforts.

While the ultimate solution could be similar to those explored previously, the team will actively explore new solutions when developing the model.

Project Approach

Key Question:

What should be the information content of Financial Statements regarding Dynamic Risk Management Activities?

Guiding Principles:

1. Is the information content **improved** considering the objective of financial statements?
2. Can **users understand** the risk management objective? Are they able to **evaluate management** on it's ability to **deliver against the stated goal**?
3. Does it allow risk managers to **faithfully** and **transparently** represent their activities in the financial statements?
4. Does the solution fit within the *Conceptual Framework*?

Focused on solutions involving measurement and disclosure

Project Stages

Stage 1 – What is DRM?

Without a common understanding of DRM activities, it is likely impossible to answer the key question. As such, the initial stage will focus on developing foundational knowledge on which to build.

Areas of Focus

- What is Dynamic Risk Management?
  - What are the objectives?
  - What are the challenges?
  - Why do risk managers take the actions they take?
- How are DRM activities currently reflected in Financial Statements
  - What information is provided to users?
  - What information is not provided to users?

Project Stages

Stage 2 – How would a new accounting model be evaluated?

With a common understanding of DRM and how it is currently reflected in the financial statements, accounting models can be considered against the guiding principles. Developing and agreeing upon those guiding principles will be key in evaluating the success of any model.

Areas of Focus

- What are the user needs?
  - Do they understand the risk management objective?
  - Can they evaluate management's actions and strategy?
- Develop guiding principles
  - Does it effectively address the identified challenges?
  - Improved information content of Financial Statements?
- Implementation
  - Does the model faithfully reflect risk management?
  - What are the costs of implementation?

Project Stages

Stage 3 – Evaluate Proposals and Select Preferred Approach

After the principles have been decided, the merits and shortcomings of accounting model prototypes will be discussed and debated.

A preferred approach will be selected for further development and discussion.

Project Stages

Winter / Spring 2017		Summer 2017	Fall 2017	Post Fall
What is DRM? • What are the objectives? • What are the challenges? • Why do they take the actions they do?	**How is DRM currently reflected in the Financial Statements?**	**How do we evaluate a proposed accounting model?** • User needs • Establish Criteria • Implementation	**Evaluate potential solutions against agreed upon criteria.** **Select Preferred Approach**	**Develop and finalise preferred approach**

Model(s) Prototyping

Next Steps

Define DRM

Elaborate on the stated goal of DRM to stabilise net interest margin

- why is net interest margin important?
- what does *stable* mean?
- why are time horizons relevant?
- what does *optimise* mean?

Discuss demand deposit modelling / core balance management

- what is DRM trying to accomplish with the modelling of demand deposits?
- what would occur if DRM didn't model deposits?
- how does DRM evaluate the 'substance' of a demand deposit?

Road map of next steps