

## STAFF PAPER

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## REG IASB Meeting

<b>Project</b>	<b>Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging</b>		
<b>Paper topic</b>	Feedback summary: users of financial statements		
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**Purpose of the paper**

1. This paper is a summary of the feedback received by the IASB from users of financial statements such as investors and analysts (hereafter ‘users’) on the Discussion Paper DP/2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (‘the DP’).
2. This summary includes feedback received from users through comment letters, face-to-face meetings, telephone and video conference calls.
3. This paper does not provide a quantitative analysis of the feedback received or capture a complete record of all issues and recommendations raised by users. The paper is provided for information only, and no decisions are required from the IASB. The staff will present a more detailed analysis of each issue when it asks the IASB for decisions

**Demographic analysis**

4. The IASB has received 4 comment letters from users. In addition, certain Board members and staff attended 14 meetings with users between April and November 2014, including 4 meetings with user groups. In total we had interactions with approximately 35 users. None of the user meetings were public. Meetings covered a wide variety of users from those specialising in banking to others covering the

markets more generally. Users who participated in outreach meetings included both buy-side and sell-side institutions and credit rating agencies.

5. Outreach meetings were undertaken in the UK, Japan and Canada. Users from other jurisdictions also participated in these meetings through conference calls.

## Overview

6. The users of financial statements generally supported the project and the *concept* of the portfolio revaluation approach (hereafter ‘the PRA’). Users generally felt that it was a step forward in terms of better alignment between financial reporting and dynamic risk management (hereafter ‘DRM’), thereby ultimately providing more useful information.
7. Their support is based on the fact that existing accounting requirements (ie IAS 39 or IFRS 9 hedge accounting) do not always adequately represent risk management when it is dynamic, because hedge accounting requires one-to-one designations between the hedged item and the hedging instrument. Consequently, the application of hedge accounting in a ‘patchwork’ manner or through proxy designations to account for DRM has resulted in a lack of transparency of financial information. As DRM is an important function for financial institutions, a better representation of DRM activities would provide useful information for decision-making.
8. One of their key requirements was to be able to analyse a banks’ net interest income (hereafter ‘NII’) by the profit source (or driver) and derivatives by their use. For instance, the bifurcation of NII by decomposing the NII between pre and post hedging was considered to be useful information by users.
9. However, there was no common view among users as to whether the information being provided under the PRA needed to be recognised in profit or loss or OCI or whether disclosures would be adequate without recognition and measurement for the purpose of representing DRM.
10. The other main concerns raised by users were;
  - (a) the lack of comparability if the application of the PRA is optional;

- (b) the possibility of earnings management and departure from the *Conceptual Framework for Financial Reporting*; and
- (c) the accuracy of the revaluation for only interest rate risk given that it is correlated with other risks such as credit and/or liquidity.

## The scope of the PRA

11. As previously mentioned, user views were mixed on whether the revaluation of unhedged exposures, which would work as a leading indicator of *all future* NII, should be presented on the face of primary financial statements (ie the statement of comprehensive income and the statement of financial position). A scope focused on DRM shows the effects of both hedging and not hedging on future NII in the primary financial statements, based on present value techniques. In contrast, under the alternative scope, namely a focus on risk mitigation, the PRA is less effective as a leading indicator of future NII, because only hedged exposures are incorporated in the PRA.

### *Views in support of a focus on DRM*

12. Some users support a focus on DRM. These constituents noted that they are interested in both what is hedged and what is unhedged, and that a holistic perspective is important for them to understand how successful or otherwise DRM has been. This is based on the view that both hedging and keeping open positions unhedged are important drivers of NII, which is the dominant revenue source for commercial banks. They are of the view that the management decision *not* to hedge is just as important as the decision to hedge from a user perspective.
13. Those who supported a scope focused on DRM considered the scope alternative with a focus on risk mitigation to be similar to the general hedge accounting model based on the *static* one-to-one designation, and is thus inconsistent with *dynamic* risk management. One of user groups raised the concern that a focus on risk mitigation could allow arbitrary selection of hedged exposures to achieve favourable results in profit or loss.

14. Some users mentioned that, as long as the PRA is applied to financial institutions, the PRA with a scope focused on DRM better captures how they generate profits and the related risks.
15. However, there was no common view on *where* (profit or loss, OCI or note disclosures) and *how* the information should be shown among users who supported the scope focused on DRM. Some mentioned that it should be presented in profit or loss because it is very important information, while some others mentioned that OCI would be better placed to capture the revaluation effect from DRM. Others mentioned that disclosures alone would be adequate given that the revaluation of future cash flows including behaviouralisation is dependent on entity specific judgements.

*Views in support of a focus on risk mitigation*

16. Other users thought that a scope of application with a focus on risk mitigation would better help them understand the effects of DRM, as they consider that understanding the performance of the *hedged* position to be the more useful and relevant information.
17. It was also thought that this approach would mitigate the problem of accounting mismatches that arise between assets and liabilities accounted for at amortised cost and derivatives accounted for at fair value through profit or loss.
18. Those who supported this approach tended to show a concern that increased profit or loss volatility would be noisy, even if it reflected economic reality. There was also the view that a scope focused on DRM would result in balance sheet information being stated neither at amortised cost nor at fair value, and would thus obscure the economics.

## **Presentation and disclosure**

19. Users stated that clear presentation and adequate disclosures were both critical for their ability to understand an entity's DRM practices.
20. As for presentation in the statement of comprehensive income, almost all users expressed a preference for actual net NII presentation over stable NII presentation. This is because they are of the view that the proposed new line item titled 'net

interest from DRM' correctly captures how derivatives (eg interest rate swaps) used for DRM purposes have affected the current NII, by clearly differentiating it from the profits earned from derivatives used for trading purposes.

21. Stable net interest income presentation was further considered to involve too much use of judgement and to be unreliable. However, one user felt that disclosing stable net interest income in the notes to the financial statements could be useful for understanding the difference between actual results and a preparer's targets for stabilising NII.
22. Fewer users commented on balance sheet presentation. However, those that did expressed preference for separate lines for aggregate adjustments in respect of assets and liabilities because it would provide a clear presentation and enable users to calculate the net amount, or a single net line item because net presentation is more consistent with how DRM works, ie on net risk positions. A smaller number thought a line-by-line gross-up would provide more detailed information.
23. Users were split on the use of OCI, assuming that the scope of the PRA is a focus on DRM. A few preferred the OCI alternative, mainly out of concern about volatility in profit or loss. This in their view would address the issue of volatility in profit or loss whilst still showing a holistic picture of DRM in the primary financial statements. Others however considered the information to be of such importance that it warranted recognition in profit or loss.
24. Constituents noted that NII is a critical metric for banks and consequently were interested in understanding its composition, drivers and associated risks. Key to this analysis is the disaggregation of NII into customer margin, change in volume, and the effect of ALM activities including open positions. This is based on the view that the quality and sustainability of earnings is very different between those arising from customer margin within business units and those that result from net open risk positions within ALM. It was noted that the information about the effect of ALM activities is of critical importance, because it could overshadow other components such as customer margin, and thus distort the view on NII, if not presented appropriately.
25. Adequate disclosure was raised as a topic of importance in various other contexts. Specific disclosure themes mentioned include:

- (a) assumptions in relation to behaviouralisation;
- (b) information that distinguishes derivatives by purpose of use; and
- (c) the impact of DRM on NII, including forward-looking information on future NII (eg sensitivity analysis).

## Behaviouralisation and deemed exposures

- 26. The DP considered whether the PRA should allow exposures to be included in the PRA on a behaviouralised basis for cases in which DRM is based on behaviouralised cash flows rather than on the contractual life of the exposures.
- 27. Users generally supported cash flows being based on a behavioural basis, because this was considered to better reflect the economics and to be more aligned with the intention of the PRA ie to reflect DRM. They also said that, in principle, a *direct* representation of DRM based on behaviouralisation is better than an *indirect* representation through ‘proxy’ hedge accounting.
- 28. However, most users also expressed concern about the subjectivity involved in behaviouralisation, as it could lead to earnings management and comparability issues because of different methodologies used for behaviouralising exposures. Such subjectivity could also affect auditability as well, and make it more difficult for users to accept the resulting accounting information. It was suggested that disclosures (eg of behavioural assumptions used) would be critically important if behaviouralisation was indeed to be accepted.
- 29. Users generally supported allowing behaviouralisation of prepayable instruments and demand deposits. Users noted that core demand deposits were a type of portfolio that would benefit from being accounted for on a behavioural basis. However, one user group expressed concern about the IASB’s ability to develop rigorous guidance that would provide banks with the proper methodology for defining its outstanding balance of core demand deposits. It was also suggested that it would be difficult (eg because of the behavioural maturity of core demand deposits varies by jurisdiction) and perhaps inappropriate for the IASB to lay out guidance for core demand deposits, and that such a task is more suited to a prudential regulator. Again, disclosures were mentioned as an important factor

when applying behaviouralisation to core demand deposits—suggestions included disclosing the estimated duration and the amount outstanding of core demand deposits.

30. The users were more concerned about allowing pipeline transactions and the equity model book, mentioning the inconsistency with the *Conceptual Framework for Financial Reporting*. Some users thought that pipeline transactions should not be included in the scope of behaviouralisation, because they are not yet assets or liabilities, and that EMB should not be included because it is not a liability.

### **Other risks and industries**

31. Several users commented on the application of the PRA to non-financial institutions. These users considered that the PRA could potentially be useful for different types of risk exposures such as commodity price risk, and hence supported a broad scope for the model.
32. Nevertheless, one user stated that the PRA approach appears most useful for financial institutions and that the IASB should be cautious about extending it to other risks. According to that user, the PRA should be only be applicable to a sector where the absence of the PRA would make faithful representation difficult. That user holds this view because the level of judgement involved in applying the PRA.