STAFF PAPER

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IASB Meeting

Project	**Accounting for macro hedging**		
Paper topic	Due process and permission to ballot		
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Purpose

1. This paper:

   (a) provides a brief summary of the project to date;

   (b) sets out the due process steps undertaken in developing the discussion paper (DP);

   (c) discusses the comment period for the DP;

   (d) seeks the IASB's permission to ballot the DP.

Purpose of the discussion paper

2. The DP is the IASB's first step to develop an accounting model for macro hedging. The purpose of the DP is to seek input on the issues addressed in the DP. We will consider comments received with a view to developing an exposure draft (ED).

Genesis of the project

Development of the DP

3. The Board started its deliberations on various aspects of accounting for macro hedging" in September 2010. The objective of the project is to simplify and improve the usefulness of financial statements by developing accounting requirements for hedging within the context of open portfolios that are more closely aligned with a company's risk management activities. The primary driver for initiating the project was the problems associated with applying hedge accounting, which is a fundamentally static concept (linking hedging instruments to hedged items), to dynamic risk management of open portfolios. Therefore, the Board decided to consider a new model to account for dynamic risk management of open portfolios, including *but not limited to* accounting for portfolio fair value hedges which are currently addressed in IAS 39 *Financial Instruments: Recognition and Measurement.*

4. To illustrate some of the challenges, dynamic management of interest rate risk was used as an example as it is a common situation that any model would need to address. In the course of its discussions four areas, outlined below, were identified that were considered as common features of interest rate risk management for banks in practice:

   (a) Risk management strategies are based on a net open portfolio as a unit of account;

   (b) The focus is on net interest margin as the hedged risk;

   (c) Management of cash flow optionality (eg prepayments) is based on expected cash flows and (economic) layer approaches at a portfolio level;

   (d) Multi-dimensional targets are set for the risk management activities.

5. In light of the above features, the project aims to develop an accounting model that (a) reflects how businesses manage risk dynamically, and (b) helps users understand risk management activities. Also, in line with the direction of the Board discussions, a *remeasurement approach* is considered, where for accounting purposes the hedged risk position is identified and remeasured for changes in the hedged risk and recognising the gain or loss in profit or loss. The advantages of this approach are as follows:

   (a) The remeasurement of the risk position with gains and losses recognised in profit or loss, in combination with explanatory disclosures regarding the factors and inputs for this remeasurement, enhances transparency regarding the actual business and risk management activities.

(b) Economic volatility is more accurately portrayed, rather than showing volatility that arises from applying a hedge accounting model that is inconsistent with risk management.

(c) Greater opportunity to use data already available for risk management purposes, rather than imposing system and data collection requirements solely for accounting purposes.

Consequently, as mentioned above the approach explored in the DP is a remeasurement approach rather than a hedge accounting solution.

6. To determine the conceptual direction for an accounting model for macro hedging, four broad alternatives were compared based on the extent to which the accounting would be aligned with risk management.

Alternative 1	**Alternative 2**	**Alternative 3**	**Alternative 4**
Accept risk management approach, including risk management policies	**Accept risk management approach**, but restrict the impact of entity specific risk management policies on accounting	**Do not accept risk management approach**, but provide accounting policy choices instead to bridge the gap	**Do not accept risk management approach**
Development of a new accounting model for macro hedging		Proxy-solution (like IAS 39)	No special accounting model for macro hedging

7. Among these alternatives, the Board developed the possible accounting model for macro hedging with the focus on considering the extent to which accounting standards can and should draw on risk management. Through these discussions a portfolio revaluation approach (by risk) emerged, whereby for accounting purposes the hedged risk position is identified and remeasured for changes in the hedged risk recognising the resultant gain or loss in profit or loss.

8. The Board considered the question of whether assets and liabilities that are dynamically managed should be treated as another business model for the purposes of classification and measurement. However, given that IFRS 9 is

applicable to all entities and not just banks the Board considered it more appropriate to consider a revaluation approach specifically targeted towards those assets and liabilities that are managed dynamically for risk management purposes instead of making pervasive changes to the entire measurement and classification framework to accommodate macro hedging.

9. In addition, dynamic risk management activity is not just undertaken by banks for interest rate risk. A number of non-financial entities manage other risks from non-financial instruments on a dynamic basis; hence a solution is also required for such dynamic risk management. Consequently, amending IFRS 9's classification and measurement requirements to reflect dynamic risk management activities for interest rate risk would not be sufficiently comprehensive.

10. Accordingly, the Discussion Paper focuses on possible ways of capturing the risk that various types of entities dynamically manage, by revaluing exposures for changes in those hedged risks.

11. In addition the Board did not want to develop an accounting model that is 'static' (in that it involves tracking the relationship between particular designated items over time) because it wanted to avoid operational difficulties. Therefore, the portfolio revaluation approach need not necessarily be restricted to the same constraints as hedge accounting under IFRS 9.

12. Overall in developing the DP 11 steps (outlined below) were identified and evaluated to balance the requirements of accounting and risk management.

The 11 Steps	
Step 1	- Full Fair Value Measurement (Step 1)
Step 2	- Limit valuation to interest rate risk
Step 3	- Net margin as hedged risk
Step 4	- Valuation on the basis of a (closed) portfolio
Step 5	- Open portfolios as unit of account
Step 6	- Timing difference of cash flows (bucketing)
Step 7	- Multi-dimensional risk management objectives
Step 8	- Floating leg of derivatives
Step 9	- Counterparty risk
Step10	- Internal derivatives
Step11	- Risk limits

Risk Management

13. The draft of the DP is based on the discussion of these steps.

14. The Board chose to give particular consideration to the way in which banks dynamically manage their interest rate risk as a starting point for the DP as it is a typical example of dynamic risk management that is widely prevalent. It also provided a specific fact pattern for use as the basis for the discussions. However, while the discussions for the DP have focussed only on this form of dynamic risk management the Board has acknowledged the importance of considering the application of the model to other risks and other industries, for example for commodity and foreign exchange risks. The Board considered whether further outreach should be undertaken with other industries prior to publication of the DP but decided on balance to use the DP as a basis for those discussions. Accordingly, one of the main objectives of the DP is to obtain constituent feedback on if and how the above model could be extended to other risks.

Alternatives Considered

15. The Board evaluated whether a special exception should be provided by permitting accrual measurement for derivatives used for dynamic risk management. Such an exception would however automatically imply 'perfect risk management' as any mismatches between the changes in the fair value of these derivatives and the risk being managed would not be visible in the financial statements. Consequently, the Board did not consider that accrual accounting for derivatives transacted for dynamic risk management purposes would provide transparent information about such activities. For instance, in the context of interest rate risk management in banks, information on the success or failure of macro hedging activities undertaken to stabilise future net interest margin would not be visible to users of financial statements.

16. The Board also considered whether a special exception is justified to require entities to measure all financial instruments included within dynamic risk management at fair value through profit or loss (ie reflecting the full fair value rather than only remeasuring the items being hedged for the risk being managed). This would arguably achieve the objective of reducing the

perceived inconsistency in the mixed measurement approach to accounting for financial instruments and better reflect the economics of such risk management in the financial statements.

17. However, in many cases, this approach fails to reflect an entity’s underlying business model for the risks that are not dynamically risk managed. The purpose of dynamic risk management activities is not usually to hedge the risk of changes in the full fair value of instruments under management. Rather, entities usually seek to hedge a particular risk. For example, in the case of banks, typical risk management for financial assets (eg loans) and liabilities (eg deposits), that are held for the purpose of collecting contractual cash flows, is to transact derivatives to hedge only the interest rate risk, with one possible objective of stabilising the net interest margin. The other risks within such portfolios such as liquidity and credit will normally be managed separately. Consequently, if full fair value measurement of all items within a dynamically managed portfolio were required, any changes in the liquidity or credit risk of those financial instruments could obscure the impact of the interest rate risk management and would result in core information on the entity’s business model being lost.

18. In summary, the Board considered that neither of these approaches is without significant shortcomings. Both approaches, accrual accounting and fair value accounting, fail to appropriately reflect actual risk management in the financial statements.

Why issue a Discussion Paper

19. In May 2012, the Board decided to move towards a DP as the next due process step instead of an ED. The Board took cognisance of the fact that the macro hedge accounting model being explored was not simply a modification to hedge accounting but represented a fundamental change in how the role of risk management judgment is considered for the purposes of financial reporting. The Board also realized, given the complexities involved, that it was unlikely that it would be possible to get a single answer that could be tested using the format of an ED. In contrast, using a DP would allow the

Board to seek feedback on a broader range of alternatives and ask a broader range of questions, and hence is a better medium to seek views from various parts of our audience.

20. In view of the above the Board also realized that a thorough development of a new accounting model for macro hedging through the DP and its subsequent finalisation into a Standard would take time. This however conflicted with the timeline for IFRS 9 and keeping the projects together would significantly delay the finalisation of IFRS 9. Therefore, the Board also at its May 2012 meeting decided to separate the two projects thereby allowing it to continue the development of IFRS 9 as planned while progressing the accounting for macro hedging as a separate project with a DP as the first step.

Board Meetings and External Consultations

21. Between September 2010 and July 2013, sixteen public board meetings and one educational session were held to develop an understanding of dynamic risk management and to discuss accounting models that could present the same.

22. In addition, in order to gather preliminary views from constituents, targeted outreach was undertaken.

23. Discussions were also held with the Accounting Standards Advisory Forum (ASAF) in September 2013.

Consultative Group

24. The Due Process Handbook states that the IASB normally establishes a consultative group for major projects. The purpose of a consultative group is to provide additional practical experience and expertise. The staff propose that the Board consider the need for a specific working group with relevant expertise following the comment period for the discussion paper.

25. On 26th September 2013, IASB members and staff met with ASAF and discussed the project. ASAF members provided comments on a series of papers that, taken together, comprise the core components of an early draft of the DP.

Who will be affected by the proposals in this discussion paper?

26. Preparers who dynamically risk manage open portfolios will be affected if the proposals are developed into a Standard. The combination of a remeasurement approach and the focus on operational simplicity, along with the fact that dynamic risk management is relevant to a wide range of entities mean the proposals have the potential to ultimately affect a significant number of entities. Also, for those entities the model may impact the accounting for a significant portion of their activities (depending of course on their risk management activities). This will include but not be limited to preparers using the existing portfolio fair value interest rate model in IAS 39, including those using the European carve out to account for their macro hedging activities under IAS 39.

27. In addition as mentioned in paragraph 19 of this paper, the model proposed is not just simply a modification to hedge accounting. It would represent a paradigm shift in current thinking by incorporating risk management judgement in financial reporting. In addition the aim of the Board is not restrict this to hedges of interest rate risk but rather to extend the accounting to other dynamically managed risks as well.

28. However, the extent of the impact will be determined by the ultimate scope of application of the approach. For example, whether or not it is applicable to all items that are risk managed dynamically or on a more targeted basis and whether or not its application would be mandatory or optional.

Applicability of the Discussion Paper

29. The DP is designed to help the Board to develop an ED of an accounting model that captures the impact of dynamic risk management in financial statements. In developing the DP the Board has focussed primarily on areas that have been considered troublesome and onerous in practice in accounting for dynamic risk management. Although, the Board has considered the various approaches outlined in the DP the discussion has been exploratory in nature. The Board has not made decisions on the issues discussed in this DP.

30. In some areas this DP involves more discussion than the Board would include in an ED or final Standard. The Board believes that this additional analysis is needed at this stage of the project to enable interested parties to understand, and provide comments on, the issues raised.

Comment period

31. The Due Process Handbook states that the comment period for a DP is normally at least 120 days.

32. However the staff would recommend a longer comment period of 180 days for the following reasons:

    (a) Macro hedging is a complex area, which has ramifications for the accounting as it relates to a broad range of risk management strategies, techniques and approaches. Consequently, for the purposes of evaluating the proposals it would be advisable to consider a longer comment period.

    (b) Although the focus of the DP is on interest rate risk management in banks, it is intended that the DP will result in information and insights being gathered for various other types of risks—especially for sectors other than financial services and risks other than interest rate risk (those areas are still quite unfamiliar from a standard setting perspective). Consequently, a longer comment period would enable both constituents and the IASB to reach out to a larger audience;

    (c) The accounting model outlined in the DP – a portfolio revaluation approach – is a new model. Accordingly, it is expected that constituents will take time to develop an understanding of the model and its interactions with the Conceptual Framework (including how aspects of risk management explored in the DP such as pipeline trades and the equity model book relate to the Conceptual Framework) and with other accounting standards;

    (d) The proposals could be relevant to a range of industries. Also for some industries dynamic risk management may affect a large portion of their business and hence can have a significant effect on an entity's financial position and performance including significant operational aspects (it typically requires systems to capture and model risk profiles representing large groups of items, which also has ramifications for accounting) which would need to be evaluated by constituents;

(e) The above aspects also mean that obtaining input from users of financial statements on this issue is more difficult than for well-established accounting concepts and debates. Consequently, obtaining views from users of financial statements is of particular importance. A key objective is to understand users' views so the Board can evaluate whether and how the new model would result in financial statements that provide useful information, and also to determine the appropriate position regarding how much management judgment is accommodated in the model;

(f) Last but not the least given the timing of the publication of the DP which is planned for late 2013, many constituents would be focussed on finalisation of year end accounts. Consequently, the staff believe that it would be appropriate to consider a longer comment period to give constituents adequate time to address the issues raised in the DP.

33. In our discussions with the ASAF, members also suggested that an extended consultation period should be considered by the Board and some suggested a period of 180 days would be appropriate.

Question 1
Does the IASB agree with the staff's proposal that the comment period for the DP on the accounting for macro hedging should be 180 days?

Permission to ballot

34. The appendix to the paper summarises the due process steps undertaken so far in developing this DP.

Question 2

Is the IASB satisfied that it has completed all of the steps that are necessary to ensure that the DP on the accounting for macro hedging is likely to meet its purpose?

35. If you are satisfied that you have completed all necessary steps, the staff would like permission to prepare a ballot draft.

Question 3
Do the staff have permission to begin the balloting process for the DP on the accounting for macro hedging?

Appendix – Due process steps during the development of DP on the accounting for macro hedging

Step	Required/ Optional	Metrics or evidence	Actions
Discussion or Research Paper development			
DP developed in public meetings.	Optional	Meetings held to discuss the topic.	Public board meetings held to discuss the topic.
		Project website contains a full description with up-to-date information.	Project website is up to date.
		Meeting papers have been posted in a timely fashion.	Papers for the IASB meetings were posted before each meeting.
Or			
Decision to publish an RP is made in a public meeting, with a clear statement of the extent of the IASB's involvement.		Decision was supported by a paper and reported in the *IASB Update*.	No decision has been made at the IASB on this project, except for the decision at the May 2012 IASB that this project is separated from IFRS 9 *Financial Instruments*. A summary of each meeting was included in *IASB update*.
Consultation with the IFRS Advisory Council (the 'Advisory Council') has occurred.	Optional	Discussions with the Advisory Council on the topic.	A specific presentation has not been provided on accounting for macro hedging but updates on the work plan including the financial instruments projects have been provided to the Advisory Council on a regular basis.
Project-specific updates are sent via email alerts to registered users.	Optional	Frequency of alerts provided.	Not done during development of the DP.
Consultative groups are established depending on the nature of issues and the level of interest among interested parties.	Optional	Argument provided for or against the use of the consultative group.	To be determined
		Extent of consultative group meetings that have been held.	
		Feedback to the consultative group has been provided.	
Online survey to generate evidence	Optional	Survey shown on the IASB website.	Not done during development of the DP.

Step	Required/ Optional	Metrics or evidence	Actions
in support of or against a particular approach.		Number and diversity of respondents. Analysis of the response.	
Outreach meetings to promote debate and hear views on the financial reporting issue that is being examined.	Optional	Schedule of the outreach meetings.	Preliminary outreach has been undertaken in the development of the DP.
Public discussions with representative groups.	Optional	Meetings held.	The project has been discussed with the ASAF in September 2013.
Regional discussion forums, where possible, with national standard-setters with the IASB.	Optional	Extent of meetings held and the venues where issues have been discussed.	Not done during development of the DP.
Podcasts to provide interested parties with high level updates or other useful information about the specific project.	Optional	Number of podcasts. Number of participants on podcasts.	Not done during development of the DP.
Publication			
DP or RP has appropriate comment period.	Required	The IASB has set the comment period. If outside the normal comment period, an explanation from the IASB to the DPOC has been provided, and the decision has been approved.	To be discussed at the October 2013 IASB meeting.
Press release to announce publication of the DP.	Optional	Release was announced in a timely fashion. Media coverage of the release.	Planned
Snapshot document to explain the rationale and basic concepts included in the DP.	Optional	Snapshot prepared at the time of the release.	Planned
Webcast of interactive presentations	Optional	Number of webcasts held.	To be considered

Step	***Required/ Optional***	***Metrics or evidence***	***Actions***
streamed in real time from the IASB's office.			
The IASB determines if focused investor consultation is required to supplement the comment letters.	Required if DP issued	Staff Paper.	Planned
Request for additional comment and suggestions by conducting fieldwork.	Optional	Meetings held.	To be considered
Round-table meetings between external participants and members of the IASB.	Optional	Number of participants in round-table meetings and venues for the round-table meetings confirmed.	To be considered