

STAFF PAPER

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CONTACT(S)	Jane Hurworth	jhurworth@ifrs.org	+44 (0)20 7246 6410
	Yuji Yamashita	yyamashita@ifrs.org	+44 (0)20 7246 6410

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Introduction

1. The discussions with the Board have focused on developing an accounting solution for dynamic risk management. The solution being developed is known as the ‘portfolio revaluation approach’. One of the perceived benefits of the approach is the additional information it should provide on dynamic risk management activities. This paper now considers the disclosures that should support that accounting to further enhance users’ understanding of an entity’s dynamic risk management and how the portfolio revaluation approach has been applied in the financial statements.
2. Dynamic risk management is a complex and often pervasive activity, therefore the whole information set provided in the financial statements is important. The Discussion Paper will outline alternative approaches for the presentation¹ and scope of the portfolio revaluation approach so these matters are not fixed. Therefore, this paper focuses on the sort of information on dynamic risk management and the application of the portfolio revaluation approach that users of the financial statements might find useful. The presentation and scope that is ultimately decided upon will have an impact on the appropriate disclosures.

¹ Presentation and scope were discussed at the May 2013 IASB, agenda papers 4A and 4B respectively.

3. The staff would like to include the proposed information set in the Discussion Paper, in order to obtain feedback from users of financial statements as to the usefulness of the proposed information and from preparers as to the feasibility of obtaining the proposed information including an understanding of the costs involved, and how best to balance the need for transparency about dynamic risk management practices with commercial sensitivities. If this insight is provided in conjunction with feedback on the scope and presentation for the application of the portfolio revaluation approach, it would be very informative.
4. Comprehensive information about dynamic risk management will only be reflected if the scope of the application of the portfolio revaluation approach and/or disclosures are holistic².
5. The IASB discussed in the May 2013 meeting, that if the portfolio revaluation approach is not applied holistically, then *perhaps* holistic disclosures should be required in order to supplement the information provided through the portfolio revaluation approach, to ensure the overall context of risk management is portrayed in a meaningful way. The potential scope of the disclosures is considered later in this paper³.
6. This paper has been written with a focus on a bank's dynamic risk management for interest rate risk, but, subject to decisions on the scope of disclosures (discussed below), we expect disclosures to be applicable to all risks and industries.

Potential disclosure themes

7. Irrespective of the scope of the portfolio revaluation approach and the disclosures themselves the staff think that it is useful to consider broad types of information or themes that could help users of financial statements understand dynamic risk management activity and the effect of the portfolio revaluation approach on the

² Holistic in this sense includes all exposures that are dynamically managed in contemplation of one another, as discussed by the IASB in May 2013, agenda paper 4B. For a bank, holistic may mean the whole banking book, if it is dynamic managed as a whole for interest rate risk.

³ The IFRS7 disclosures on hedge accounting are not applicable to exposures included within the portfolio revaluation approach is applied, as those disclosures only relate to the application of the IFRS 9 hedge accounting guidance.

financial statements. Accordingly, set out below are some disclosure themes which the staff believe will provide useful information on dynamic risk management and the application of the portfolio revaluation approach.

8. In each case the objective of the disclosure is discussed and then examples are given of the types of information that could fulfil that objective.
9. As was highlighted in the recent disclosure discussion forum, current disclosure requirements can lead to boiler plate descriptions. Disclosures on dynamic risk management would need to be sufficiently descriptive and specific to the entity in order for the disclosures to provide meaningful information about risk management.

Qualitative information on the objectives and policies for the performance of dynamic risk management, including the identification of risk within exposures.

10. The aim of these proposed disclosures is to provide users of financial statements with information that will provide them with a full understanding of the managed risks, the aim of risk management and how the risk management is undertaken. This will enable them to better understand the returns that are impacted by risk management and the risks involved in the business.
11. A bespoke qualitative description should be provided of the different types of exposures and risks considered within the dynamic risk management and how the entity perceives risk within the exposures. Specifically, for each type of exposure managed dynamically, information should be provided to enable users of financial statements to understand the basis upon which the risk is measured and analysed. This could include whether the managed risk is monitored based on the contractual terms of the exposure, or if risks are considered differently such as from a behavioural perspective, for example by modelling risk based on the expected profile of prepayable portfolios, deemed interest rate risk in replication portfolios for demand deposits, equity model book (EMB) and others. In addition, where the full cash flows from exposures are not included in dynamic risk management, a clear indication should be provided about which elements of the cash flows *are* dynamically managed and which remain the responsibility of the originating business unit.

12. Qualitative information should also be disclosed on the dynamic risk management policies and performance objectives. This should include a high level description of the risk management processes, including the role of risk limits and the extent to which hedging instruments are transacted with external or internal counterparties (eg the trading desk). Explanations as to the types of hedging instruments used and the measures of success for risk management would also provide useful information for users of financial statements.

Qualitative and quantitative information on the calculated risk position and its valuation on application of the portfolio revaluation approach.

13. The rationale for these proposed disclosures is to provide information that will enhance users of financial statements' understanding of how risks are calculated for both risk management and accounting purposes and the importance of judgement within those calculations. In addition, users of financial statements should gain insight into the risk positions maintained by the entity, including where the naturally occurring interest rate risk occurs and to what extent it is (or is not) hedged.
14. Qualitative disclosures should be provided on how the risk position is calculated which should be consistent with the risk management approach, eg using VaR⁴ or other sensitivity measurement techniques such as GPS⁵. This should include a description of the methods used for quantification of risk within the dynamically managed portfolio and an explanation of the valuation methodology used to calculate the revaluation adjustments on application of the portfolio revaluation approach, including any changes to such techniques during the period and an explanation of the reasons for such changes. Additionally, information on estimation techniques used for risk management and accounting purposes, in

⁴ Value at risk (VaR) is statistical technique used to measure and quantify the level of financial risk over a specific time frame. Value at risk is used by risk managers in order to measure and control the level of risk which the entity undertakes, to ensure that risks do not exceed the level at which the entity can absorb the losses of a probable worst outcome.

⁵ Grid Point Sensitivity (GPS) is a method to measure the change in value of risk exposures that would materialise in each maturity bucket if the benchmark market rate of corresponding maturity changes by XX basis points (10bps, for instance). See September 2012 IASB agenda paper 4B.

particular including any reliance on subjective or judgemental inputs will be essential, for example prepayment curves⁶ or other non market driven factors.

15. Quantitative information should be provided on the calculated risk position, and the portfolio revaluation adjustment recognised at the reporting date. The staff are aware that particular information about an entity's risk position can be highly commercially sensitive. Consequently we would welcome input from preparers through the Discussion Paper on the extent to which these disclosures should be provided, along with practical suggestions about what could be disclosed to assist users of financial statements in their understanding that is not unduly commercially sensitive. Ultimately the Board must balance the need for transparency about dynamic risk management practices with commercial sensitivities⁷.
16. Quantitative disclosure on risk positions should be required that provide sufficient information for users of financial statements to understand the extent to which the managed risk position is *not* based simply on the contractual terms of the exposures. Ideally this could include a comparison of contractual and managed risk positions for all types of exposures subject to dynamic risk management.
17. Existing sensitivity disclosures⁸ pursuant to IFRS 7 *Financial Instruments: Disclosures*, are usually fulfilled with a single risk measure. Given the pervasive nature of dynamic risk management, there is a question as to whether a single risk measure is sufficient, or whether it should be broken down into more discrete calculations of risk, consistent with the entity's risk management approach. For example, most banks dynamically manage risk by time horizon or bucket, therefore should quantitative disclosures of risk positions also be broken down by time bucket, or other risk dissection used for risk management?

⁶ As well as highlighting the use of such curves in both risk management and the calculation of the revaluation adjustment, information should also be provided on how the curve is derived.

⁷ There might be an argument that detailed disclosures would be necessary on the calculation of risk position, the actual revaluation and/or sensitivity (duration in the case of interest rate risk) when modelling techniques are used (eg mortgages, core deposits). This is because small changes in major parameters that include subjective factors (eg expected duration of mortgages) can have significant consequences on accounting results. At a minimum, an understanding of the reliance on these assumptions, when there have been changes in the assumptions that have a material impact on the calculations and the reason why the assumptions were changed would be useful information.

⁸ IFRS 7 paragraph 40.

18. Information on risk positions as at the reporting date will enable users of financial statements to gain an understating of the risk position *after* risk management on that date. However in order to fully understand the role of risk management, perhaps quantitative risk information *before* risk management could also be disclosed.
19. At the May 2013 IASB meeting, the income statement and balance sheet presentation⁹ for the portfolio revaluation approach was discussed. A key feature of the discussion on the appropriate presentation in the balance sheet was whether or not it would be useful to have a breakdown of the portfolio revaluation adjustments by class of instrument in the balance sheet, in the notes, or at all. Although no decisions were taken by the IASB at the meeting, there was notable support *not* to include a breakdown of the portfolio revaluation adjustment by class of instrument in the balance sheet. Arguments supplied to support this view focused on the fact that dynamic risk management is usually undertaken on a net basis, hence gross information by class of instrument is not considered relevant. The alternative view raised was that users of financial statements probably would be interested in knowing where the majority of the interest rate risk is coming from, in particular if there are significant risk concentrations from risk exposures that involve more subjective elements (eg modelling of customer behaviour).
20. The information considered so far in this paper would typically be based on the risk position as at the reporting date. However, if the position at the reporting date was not representative of the positions throughout the year, then additional disclosures providing an indication of the more representative position may provide relevant insight on risk management activity during the period¹⁰.
21. The application of the portfolio revaluation approach is designed to provide useful information on the *actual* risk management¹¹ undertaken by the entity. Whilst

⁹ Agenda paper 4A

¹⁰ Similar to the disclosure requirements where hedge accounting frequently resets due to a dynamic risk process in the consequential amendments to IFRS 7 (24D) on the introduction of Chapter 6, Hedge Accounting in IFRS 9.

¹¹ Many, but not all, of the proposed disclosures are based on existing *risk* information which may not currently be used for financial reporting purposes, therefore the staff acknowledge that there will be an operational impact to providing this information. We would like to obtain a better understanding of this issue from preparers in obtaining feedback on the Discussion Paper

there are some similarities in the way entities dynamically manage particular risks, eg between banks managing interest rate risk, they will not be exactly the same. Therefore, it is debatable whether a user of financial statements would find it more beneficial for all preparers to provide the same quantitative disclosures¹² on dynamic risk management, in order to provide comparable information on risk management activity, or whether it is preferable to provide disclosures on the risk measures the entity actually uses for risk management. The staff are inclined to think that the disclosures would be more useful if they are tailored to provide information about the particular entity. However, the benefits of this, relative to the benefits of comparability is a matter that the staff think should be raised in the Discussion Paper.

How has the entity applied the portfolio revaluation approach?

22. The aim of these disclosures is to provide users of financial statements with information that provides a clear indication of the extent to which the accounting represents risk management, and how dynamic risk management is reflected in the financial statements.
23. A full description of the entity's accounting policy for the application of the portfolio revaluation approach will already be required by IAS 1 *Presentation of Financial Statements*. This should provide sufficient detail for users of financial statements to understand how and where the portfolio revaluation approach has impacted the financial statements.
24. If the final model includes an element of choice¹³ by the preparer, as to which exposures within the dynamic risk management the approach is applied to, qualitative disclosures may be required. The aim of these disclosures would be to provide users of financial statements with an understanding of why the approach has not been applied holistically and which dynamically managed exposures were not selected by the entity for inclusion in the scope of the portfolio revaluation approach.

¹² A standard methodology and suite of disclosures could be developed to enhance comparability, even though not all entities would manage risk using the selected method.

¹³ No decisions have yet been made on the scope of application of the portfolio revaluation approach, see agenda paper 4B from the May 2013 meeting.

25. Furthermore, if any aspects of risk management activity are ultimately ineligible for inclusion within the scope of the portfolio revaluation approach, additional disclosures on those activities or exposures may be required to provide full information on dynamic risk management activities.

Quantitative and qualitative information on the impact dynamic risk management has had, and is expected to have on the performance of the entity.

26. The aim of these disclosures is for users of financial statements to gain a better understanding of the importance of risk management on reported results in the current and future periods.
27. In May 2013 the IASB discussed two alternative income statement presentations for the portfolio revaluation approach. Although no decisions were taken by the Board there was clear support for the ‘actual net interest income’ presentation¹⁴. This presentation should provide users of financial statements with information on reported net interest income for the reporting period both *before* and *after* risk management activity.
28. Users of financial statements often analyse information to understand potential earnings for future periods. The impact of risk management activity to date on future earnings is therefore of great interest to users of financial statements. However, a question could be asked as to whether the proposed disclosure themes go far enough in providing users of financial statements with sufficient information to make realistic earnings predictions for the future.
29. For example, users of financial statements are likely to be interested in information on the sensitivity of future net interest income to changes in interest rates after risk management, based on the risk position on the reporting date¹⁵. However, such information is likely to be considered proprietary by preparers and may be operationally difficult to provide, at least in some cases, so suggestions from preparers of ways to provide information that is helpful for users of financial

¹⁴ Although two income statement presentations will be included in the Discussion Paper, there was minimal support for the stable income presentation. However, if this changed based on the Discussion Paper feedback, then additional disclosures providing gross interest income and expense information before risk management may also be required.

¹⁵ It should also be noted that any such disclosure would need to be used with caution, as it would usually involve subjective forecasts with respect to the risk position that exists at the reporting date and cannot account for future actions.

statements while being mindful of these considerations would be useful for redeliberations.

30. Users of financial statements may also find it helpful to understand the drivers of the profit or loss from the portfolio revaluation approach, such as providing disclosures on the sensitivity of both reported net interest income and the revaluation effect in the period. This could include a sensitivity disclosure for changes in the managed risk and key judgements or subjective factors. Alternatively quantitative and/or qualitative information on the sources of revaluation profit or loss volatility could be provided.

Scope of disclosures

31. It is usual practice for the scope of disclosures to follow the scope of the application of relevant accounting guidance¹⁶. However, as noted above, the Board has discussed (and some have suggested) that the scope of the application of the portfolio revaluation approach could perhaps be narrower, possibly with an element of choice included, if more holistic disclosures were provided about dynamic risk management. Also, it may be the case that ultimately the portfolio revaluation approach would not be applicable for all items subject to dynamic risk management so extra disclosure may be needed to enhance understandability – for example, if for arguments sake the model ultimately excluded the equity model book, then to fully understand the risk management of the entity, information may need to be provided about the exposures within the equity model book even though it was not included within the portfolio subject to revaluation.
32. Consideration is required as to whether the proposed disclosures for dynamic risk management should only be required if and when the portfolio revaluation approach has been applied or whether there is a case for broader scope for these disclosures. A key factor in this debate is whether the Board believe that the main aim of the disclosures is to provide information to users of financial statements on how the portfolio revaluation approach has been applied, or holistic information on dynamic risk management.

¹⁶ For example the IFRS 7 hedge accounting guidance is only applied to items subject to hedge accounting.

33. Let us consider the potential different disclosure scope alternatives using an example: A banking group has two banking subsidiaries, one of which (Sub A) manages all interest rate risk dynamically, and the other (Sub B) manages interest rate risk on a more static basis. The interest rate risk dynamically managed by Sub A comprises a number of sub portfolios: Portfolio A1, Portfolio A2 and Portfolio A3. Portfolio A1 includes the deemed interest rate risk from the equity model book (EMB).

	Scope of application of <u>portfolio revaluation approach</u>	Alternatives for scope of <u>disclosures</u> on dynamic risk management
1	Holistically: to include all portfolios in Sub A (assume all exposures are eligible)	<p>a) Holistically (Sub A only): <i>to match the application of the portfolio revaluation approach</i></p> <p>b) All exposures in Sub A and Sub B: <i>wherever the managed risk exists and some dynamic management occurs. So even though only Sub A dynamically manages interest rate risk, the fact that interest rate risk exists in Sub B also brings those exposures into the disclosure requirements</i></p>
2	To all eligible dynamically managed exposures (if we make the assumption for the purposes of illustration that EMB is ineligible): the approach is applied to all portfolios in Sub A, but excludes any deemed risk from EMB	<p>a) All eligible exposures (Sub A only): <i>to match the application of the portfolio revaluation approach</i></p> <p>b) All eligible exposures (Sub A only), plus disclosures on the interest rate risk from EMB: <i>to match the application of the portfolio revaluation approach, but also to make users of financial statements aware that the accounting and risk management are not fully aligned.</i></p> <p>c) All exposures in Sub A and Sub B: <i>same as for 1b) above</i></p>
3	Choose only to apply to Portfolio A2. (assume all	a) Portfolio A2 only: <i>to match the application of the portfolio revaluation approach</i>

	exposures are eligible)	<p>b) Holistically (to Sub A): <i>Linked to instances of dynamic risk management, regardless of accounting application</i></p> <p>c) All exposures in Sub A and Sub B: <i>same as for 1b) and 2c) above</i></p>
4	Not at all (assume all exposures are eligible)	<p>a) Not at all: <i>to match the application of the portfolio revaluation approach</i></p> <p>b) Holistically (to Sub A): <i>same as for 3b) above</i></p> <p>c) All exposures in Sub A and Sub B: <i>same as for 1b), 2c) and 3c) above</i></p>

34. The staff think that it is difficult to argue that the disclosures should be applied comprehensively to a managed risk (as described in 1(b), 2(c), 3(c and 4(c) above), simply because in some circumstance or parts of the business, dynamic risk management of that risk occurs. This would undermine and/or conflict with existing disclosure requirements for financial instruments and also may not actually provide relevant information on dynamic risk management at all. For example, if the disclosures were required by corporates that dynamically hedge a particular risk somewhere in the business, disclosures would then be required wherever that risk occurred, which could encompass the whole business. Therefore it is unlikely to provide useful information on dynamic risk management.
35. Another alternative is to mandate appropriate disclosures for each industry where dynamic risk management occurs, for examples interest rate risk in banks¹⁷. This approach may result in meaningful disclosures in each industry (although the issue raised in paragraph 35 could still apply), but it would be almost impossible to ensure completeness of any disclosure requirements as risk management practices continue to evolve. In addition, such an industry specific approach

¹⁷ It should be noted that banks and some other industries have industry specific disclosure requirements as part of their regulatory regime, eg Basel regulations for banks in some jurisdictions.

would be inconsistent with IFRS that does not typically establish industry specific standards.

Summary

36. The staff would like to include the four identified disclosure themes within the Discussion Paper to obtain specific input on useful and feasible disclosures from users of financial statements and preparers.
37. Furthermore, the staff would also welcome input on the scope of the disclosures, specifically whether holistic disclosures should arise by virtue of applying the portfolio revaluation approach in some capacity, whether the scope should be aligned with the parts of the business for which the approach is applied (which may not comprise all exposures included in holistic dynamic risk management) or whether it is more appropriately linked to the existence of dynamic risk management.