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Accounting for Dynamic Risk Management

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Accounting for Dynamic Risk Management

- Two roundtables held in Australia
    - Video-linked Melbourne and Sydney with IASB Board member / staff in London
- Participants included:
    - Major Banks, Credit Unions
    - Regulator
    - Accounting profession / Auditors
    - Insurance industry
    - Electricity industry
- Eight comment letters received

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- Preference for improvements to be made to existing hedge accounting requirements
- Significant past investment by banks to get to ‘business as usual’ – including use of proxy hedging
- Need to carefully consider relative costs to preparers in changing systems & processes versus the benefits to users of improved information
- Areas of potential focus for improvement:
  - core demand deposits
  - disclosures

Accounting for Dynamic Risk Management

- If the PRA is applied, the preference is for:
  - a risk mitigation scope with elective application
  - this is consistent with the original objective of reducing operational complexity of fair value hedge accounting for open portfolios
- Key concerns for PRA:
  - equity model book & pipeline transactions – conceptual basis?
  - defining the boundaries of the PRA
  - whether accounting for risk management is consistent with the objective of financial reporting
  - a revaluation approach may be inconsistent with risk management activities

Question 1 Scope of application

The key objectives of the DP were to develop an accounting model to better reflect DRM activities in entities' financial statements and decrease operational complexities.

Considering the marked preference for a scope focused on risk mitigation can we still achieve the stated objectives?

a) Can the approach still provide useful information?
b) Can the approach result in a decrease in operational complexity?

It appears the DP combined two distinct objectives. We recommend separating these as two distinct projects:

- a **Standards-level project** on targeting improvements to hedge accounting of interest rate risk of open portfolios as a first priority; and

- a **Research project** on the topic of accounting for risk management activities, ideally as part of the on-going work on the *Conceptual Framework*.

Question 2 Is revaluation the only way?

According to the feedback received, some think that the DP illustrates only one approach used by banks to manage interest rate risk (ie a current value approach).

An alternative approach is to consider the stabilisation of the net interest income through the management of the cash flows by taking a cash flow perspective.

a) Do you think the PRA as explored in the DP should also consider a cash-flow perspective? If yes, how?

- In the context of a **research project** - we encourage the IASB to explore whether alternative accounting approaches could achieve the objective of improving the reporting of dynamic risk management activities

- We do not support the IASB increasing the use of OCI until further progress is made in the *Framework* project concerning the basis for using OCI.

- However, in the context of a **standards-level project** - we would support exploring opportunities to improve the existing cash flow hedge accounting model

Question 3 Behaviouralisation, core demand deposits, pipeline transactions and EMB

Considering the feedback received in this area:

a) How much guidance on behaviouralisation should the IASB provide?
b) How can we minimise lack of comparability and the risk of earnings management?
c) Inclusion of core demand deposits, pipeline transactions, EMB would decrease the need for proxy hedging and would contribute to reflecting DRM activities better. However, the inclusion of these exposures also raises critical conceptual issues. How can we reconcile this tension?

- EMB and pipeline transactions: not assets or liabilities in the *Framework* - we prefer disclosure to recognition

- Core demand deposits: we recommend further research on measurement of liabilities, including consideration when expected cash flows differ from contractual terms – ideally as part of work on the *Framework*

- An improvement to hedge accounting might be possible for core demand deposits ie. by permitting designation of an interest rate risk component as an eligible hedged risk

Question 4 Disclosures

Considering the feedback received in this area:

a) Should the scope of disclosures be different from the scope of the approach (ie should the impact of unhedged positions in future net interest income only be reflected through disclosures)?
b) Should the project try and explore solutions based on disclosures rather than purely recognition and measurement?

- We think the recognition & measurement approach, including its objective, should be determined before deciding the scope of disclosures

- We recommend considering existing regulatory reporting eg. the Australian Prudential Regulation Authority (APRA) requires banks applying the Basel III Advanced Approach to apply a capital charge for interest rate risk in the banking book and make public disclosures

- We recommend the IASB considers whether disclosure of such information is within the scope of financial reporting, or whether disclosure to regulatory bodies is sufficient.