ASAF Meeting—Agenda Paper 5.A

Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

2 June 2014

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At a glance—Objective of today’s meeting

- The IASB is exploring an accounting approach to better reflect **dynamic risk management** (DRM) activities in entities’ financial statements.
- The approach considered in the Discussion Paper is the Portfolio Revaluation Approach (PRA), which intends to better reflect entities’ dynamic risk management in financial statements. Operational feasibility has also been one of the considerations that has been taken into account when developing the PRA.
- We would like to gather your views on some of the questions that are included in the DP that relate to key areas of the PRA.

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Dynamic Risk Management (DRM)

- DRM is a continuous process. It is undertaken for open portfolio(s), to which new exposures are frequently added and in which existing exposures mature. As the risk profile of the open portfolio(s) changes, DRM is updated frequently in reaction to the changed net risk position.
- Current hedge accounting requirements are often difficult to apply to DRM.

Question 1—Assessing the need for an approach

Do you think there is a need for a specific accounting approach to represent DRM in entities' financial statements? Why or why not?

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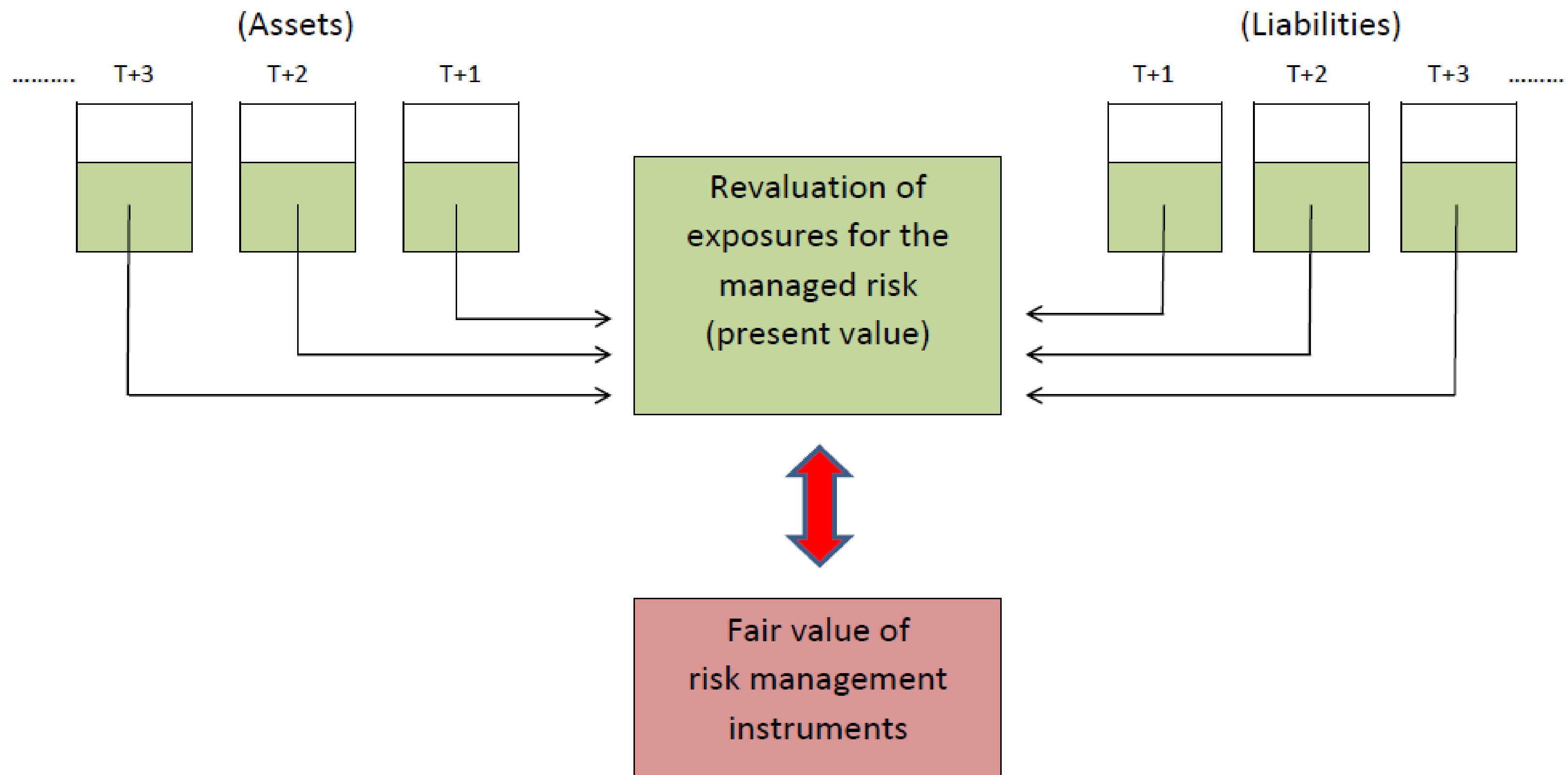
The Portfolio Revaluation Approach (PRA)

- Exposures within open portfolios are revalued with respect to the managed risk (for example, interest rate risk).
- Not a full fair value model.



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Expected improvements with the PRA

- ✓ **enhances information** about DRM;
- ✓ **reduces operational complexities** such as tracking and amortisations;
- ✓ captures the dynamic nature of risk management on a **net basis**;
- ✓ considers **behavioural** factors;
- ✓ considers **different types of risks** managed in open portfolios.

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Behaviouralisation and revaluation of the managed exposures

Question 2—Behaviouralisation

For the purposes of applying the PRA, should the cash flows be based on a behaviouralised rather than on a contractual basis, when the risk is managed on a behaviouralised basis?

Question 3—Core demand deposits

Do you think that core demand should be included in the managed portfolio on a behaviouralised basis when applying the PRA if that is how an entity would consider them for DRM purposes?

Question 4—Revaluation of the managed exposures

Do you think that the revaluation calculations provide a faithful representation of DRM? Why or why not?

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Transfer pricing transactions

- The DP's preliminary views are that transfer pricing transactions can be considered for the purpose of identifying the level of the managed risk (numerator of the revaluation calculation) and the revaluation of the latter (denominator of the revaluation calculation).

Question 5—Transfer pricing transactions
Do you think that transfer pricing transactions would provide a good representation of the managed risk in the managed portfolio for the purposes of applying the PRA? To what extent do you think that risk transferred to ALM via transfer pricing is representative of the risk that exists in the managed portfolio?

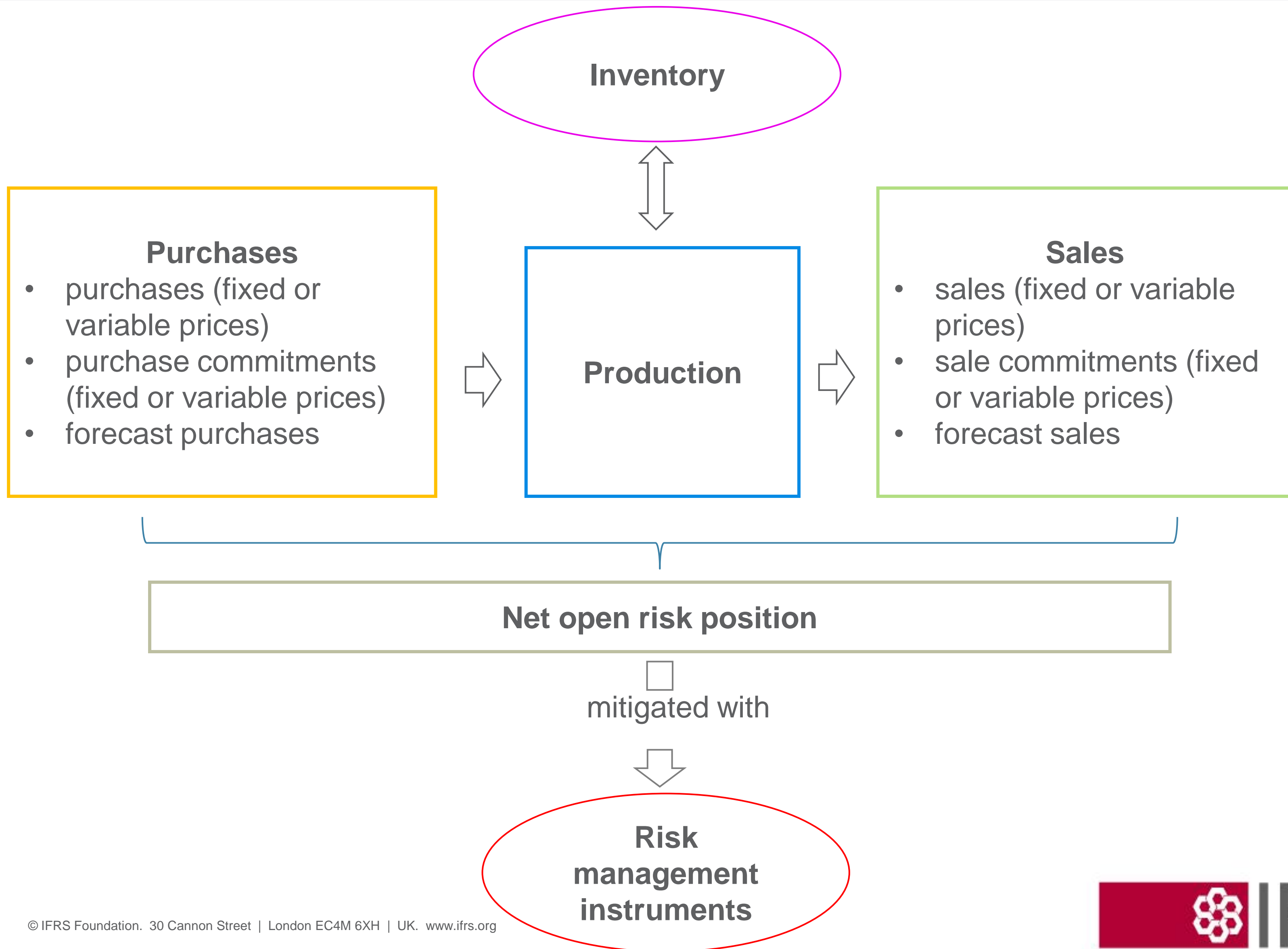
Scope of the application of the PRA

- The scope has significant implications for the information provided to users of financial statements and on how operationally feasible the application of the PRA will be for an entity.
- The DP considers two scope alternatives:
  - Focus on dynamic risk management
  - Focus on risk mitigation (sub-portfolio approach, proportional approach)

Question 6—Scope of the application of the PRA

Do you think that the PRA should be applied to all managed portfolios included in an entity's DRM or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging? Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

Applying the PRA to other risks



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Applying the PRA to other risks

Question 7—Applying the PRA to other risks

Should the PRA be available for DRM other than banks' DRM? Why or why not? If yes, for which additional fact patterns do you think it would be appropriate?

Alternative approach–PRA through OCI

- Under the alternative approach, the net effect of the revaluation of the future cash flows of the managed portfolios and the changes in the FV of risk management instruments (eg interest rate swaps) is recognised in OCI rather than in P/L.
- However, there are important conceptual and practical issues:
  - It breaks an assumption in the DP that all risk management instruments are measured at FVTPL;
  - Gross presentation of internal derivatives no longer nets to zero in P/L;
  - Recycling from OCI to P/L.

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Alternative approach–PRA through OCI

Question 8—PRA through OCI

Do you think that an approach incorporating the use of OCI should be considered? Why or why not? If you think the use of OCI should be incorporated in the PRA, how could the conceptual and practical difficulties identified with this alternative approach be overcome?

Questions or comments?—Thank you

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