Tuesday 30 September 2014
The Grange City Hotel (London)

Meeting documentation

World Standard-setters Meeting

Smaller group sessions: Macro hedge accounting

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Smaller group sessions
Macro hedge accounting

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International Financial Reporting Standards

World Standard-setters Meeting
Accounting for Dynamic Risk Management:

A Portfolio Revaluation Approach to Macro Hedging

30 September 2014

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At a glance

- The IASB is exploring an accounting approach to better reflect **dynamic risk management** (DRM) activities in entities' financial statements.
- The Discussion Paper sets out the Portfolio Revaluation Approach (PRA), which aims to better reflect entities' DRM in financial statements. Operational feasibility was considered when developing the PRA.
- We would like your views on some of the questions 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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Banks' profit source and interest rate risk management

- Customer margin is the responsibility of Business Units (branches).
- In this example, if variable funding rate increases (decreases), Net Interest Income (NII) decreases (increases). Interest rate risk for *current* and *future* NII is dynamically managed by ALM using derivatives (eg Interest Rate Swaps).

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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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The PRA—*continued*

- Net effect of the revaluation adjustment of the managed exposures and the fair value changes of the risk management instruments (for example, interest rate swaps) is reflected in profit or loss.

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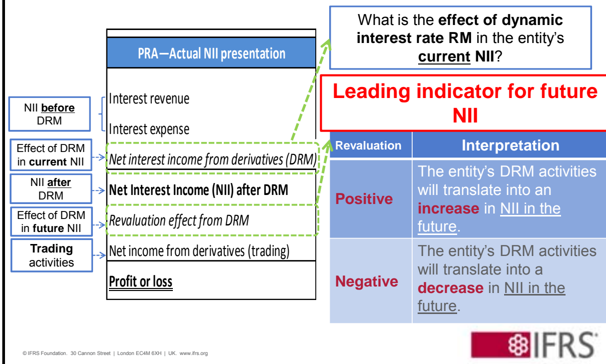
Information arising from PRA (Actual Net Interest Income presentation)



What is the **effect of dynamic interest rate RM** in the entity's **current NII**?

Leading indicator for future NII

Revaluation	Interpretation
Positive	The entity's DRM activities will translate into an **increase** in NII in the future.
Negative	The entity's DRM activities will translate into a **decrease** in NII in the future.

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Expected improvements from 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; and
- ✓ considers **different types of risks** managed in open portfolios.

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Behaviouralisation (*core* demand deposits)

- 'Contractually' the demand deposits have a variable rate and can be withdrawn at any time.
- But at a portfolio level, the 'sticky' nature of demand deposits leads to the identification of a stable portion in the amount outstanding.
- These **core demand deposits** are deemed to be **fixed rate deposits** with longer maturities for risk management purposes (behaviouralisation).

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 deposits 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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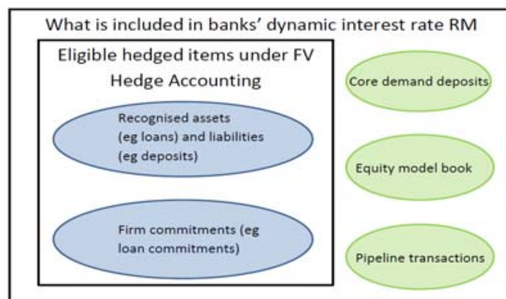
Hedge accounting and the managed portfolios in DRM



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Pipeline transactions and EMB

Pipeline transactions	EMB
✓ A colloquial expression that refers to the forecast issue of fixed interest rate products at advertised interest rates (say 3%). ✓ A bank may consider that its fixed interest rate offers are binding and may decide to include them as a fixed interest rate exposure for DRM purposes, even though there is no contractual commitment yet.	✓ A bank may determine a base return on its own equity similar to interest (ie the bank determines a target compensation for its equity holders for providing finance). ✓ A bank may replicate the base return of equity and include it as a fixed interest rate exposure for DRM purposes.

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Conceptual issues (pipeline transactions and EMB)

Pipeline transactions	EMB
✓ Result in the recognition of an asset or a liability even before an entity becomes a party to the transaction. ✓ Constructive obligations?	✓ Revaluation adjustment for EMB arises from items that do not satisfy the definition of assets and liabilities under the *Conceptual Framework for Financial Reporting.* ✓ Today entities use other exposures indirectly when applying current hedge accounting to reflect risk management based on EMB (eg cash-flow hedge accounting for variable rate assets).

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Pipeline transactions and equity model book (EMB)

Question 5—Pipeline transactions

Do you think that pipeline transactions should be included in the PRA if they are considered by an entity as part of its DRM? Why or why not?

Question 6—EMB

Do you think that EMB should be included in the PRA if it is considered by an entity as part of its DRM? Why or why not?

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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 7—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?

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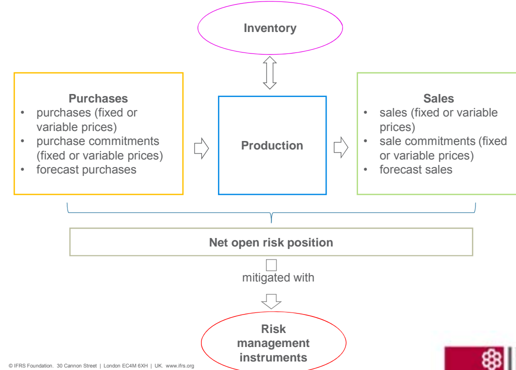
Applying the PRA to other risks



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Applying the PRA to other risks

Question 8—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?

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Alternative approach–PRA through OCI

- The DP includes an alternative approach. In this case 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 (for example, interest rate swaps) are 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; and
  - ➢ recycling from OCI to P/L will not happen if the managed exposures are sold or derivatives are terminated.

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Alternative approach–PRA through OCI

Question 9—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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