

STAFF PAPER

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IASB Meeting

Project	Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging		
Paper topic	Feedback summary: general overview		
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Purpose of paper

1. This paper provides a high level summary of the comments received on the Discussion Paper DP/2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (hereafter ‘DP’). Where appropriate, the staff will provide a more detailed breakdown of the comments in future meetings.

Comment letters and outreach meetings undertaken

2. The six-month comment period ended on 17th October 2014. To date, the IASB has received 126 comment letters. Appendix A provides a summary by type of respondent and geographical region.
3. Over the last six months, the staff along with Board members have conducted over 50 outreach meetings with constituents across jurisdictions. In addition, the ASAF discussed the topic on more than one occasion and have provided members’ views on the DP. A similar process was also followed with the GPF. Whilst many of the meetings were in person others were video/telephone conferences. The purpose of the outreach meetings ranged from providing an overview of the DP to getting feedback on the IASB’s preliminary views. The outreach meetings covered a wide variety of constituents, including preparers (eg banks, insurance companies and non-financial institutions), users, prudential and securities regulators, accounting standard-setters, accountancy bodies and accounting firms.

4. Outreach meetings took place in various regions, including Europe (Belgium, France, Germany, Italy, Netherland and the UK), Asia and Oceania (Australia, Hong Kong, Japan, Korea and Singapore), North and South America (Brazil, Canada and Mexico) and Africa (South Africa).

Overall comments

Identification of current problems and the necessity of the project

5. Many respondents commented that the DP comprehensively analysed the limitations of the current IFRS accounting requirements when risk management is dynamic. The respondents also broadly agreed that the DP had captured the critical elements of dynamic risk management (hereafter, ‘DRM’) through its analysis of the issues arising from open portfolios such as behaviouralisation and deemed exposures. They also stated that the characteristics of DRM were broadly captured in the DP.
6. Accordingly, many respondents supported the necessity of the project, even though many of them also acknowledged that the alignment between financial reporting and DRM is a challenging task. Some respondents commented that the PRA as discussed in the DP is too ambitious, and expressed their reluctance to support the project.
7. For those respondents who supported the project, the clear preference was a scope focused on risk mitigation.
8. Respondents who disagreed with either the whole or part of the model considered in the DP found it difficult to come up with alternatives that would meet the set objectives of the Board for undertaking the project.
9. Some European respondents expressed their hope that the project would address the EU carve-out.

The purpose of the project and the PRA

10. The support for the necessity of a project to address the issue of DRM does not necessarily translate into support for the approach discussed in the DP, namely the

Portfolio Revaluation Approach (PRA). Broadly two types of concerns were raised over the PRA:

- (a) First, the idea of ‘revaluing’ exposures as proposed in the PRA does not necessarily reflect DRM in all circumstances and consequently has its limitations. For instance, a cash flow hedge accounting model reflects DRM activities better when interest rate risk is managed in terms of cash flow variability. However, suggestions on how this could be implemented or how existing cash flow hedge accounting models could be improved were not elaborated upon.

- (b) Second, even amongst those respondents who state that the PRA correctly represents DRM activities, there are concerns that if an entity applies the PRA with a scope focused on DRM (ie to revalue all of the dynamically managed exposures), it will lead to profit or loss volatility as a result of revaluing unhedged risk exposures. Their messages included:
 - (i) the objective of the project should be ‘macro hedge accounting’, which addresses accounting mismatches between assets and liabilities that are accounted for at amortised cost and derivatives that are accounted for at fair value through profit or loss ie limited to resolving accounting mismatches. Currently, entities such as banks tend to rely on ‘proxy’ or artificial hedge accounting in order to address accounting mismatches due to the lack of a proper hedge accounting model that is applicable when risk management is dynamic. The purpose of the project should be to address this problem. Revaluing all dynamically managed risk exposures is inconsistent with this objective.

 - (ii) it was noted that many banks usually manage current and future net interest income (hereafter, ‘NII’) based on an accrual (or cash flow) view. This means that interest rate risk in banking book assets and liabilities and the effects of DRM on *future* NII should be shown in profit or loss in *future* periods, as they unfold over time. They say this view is consistent with IFRS 9 *Financial Instruments*, which requires both financial assets and liabilities to be accounted for at

amortised cost for the majority of the banking book exposures (eg loans and deposits), *regardless of* the existence of the net open interest rate risk positions between assets and liabilities.

- (iii) Even though the profit or loss under the PRA with a scope focused on DRM shows the effect of DRM on future NII, this is merely ‘point-in-time’ information.
- (iv) Under a scope focused on DRM, the profit or loss of a bank that dynamically manages interest rate risk in the banking book may report more profit or loss volatility than another bank that does not manage interest rate risk at all. This is counterintuitive.
- (v) For the purpose of conveying useful information about the ‘holistic’ picture of interest rate risk on future NII, including the effects of both hedging and unhedging of the net open positions, disclosures are better placed than the statement of comprehensive income and the statement of financial position. In that respect, some also mentioned that it would be worthwhile for the IASB to consider reviewing IFRS 7 *Financial Instruments: Disclosure*. For instance, some commented that disclosures of sensitivity of NII before and after DRM would be the best way to convey useful information to users of financial statements.

11. On the basis of the views mentioned above, most respondents who agreed that the PRA correctly represented DRM, supported a scope focused on risk mitigation in the application of the PRA, rather than a scope focused on DRM. This is because they believe it provides for the revaluation of risk exposures *to the extent that they offset fair value changes of derivatives* (ie risk management instruments), through incorporating the aspects and techniques used in actual DRM (eg behaviouralisation and the bottom layer approach) into the PRA. This enables them to show the results of DRM in a way that is consistent with their risk management view.
12. Although many of the respondents, especially banks, recognise that the PRA with a scope focused on risk mitigation is operationally more challenging than that with a scope focused on DRM, they say that the benefit (ie accounting results that are consistent with their risk management view) exceeds the operational costs.

13. Most respondents stated that the PRA with a scope focused on risk mitigation, in conjunction with the hedge accounting requirements in IFRS 9, would provide a faithful representation of risk management. This is based on the view that, because risk management is different among different entities, allowing a broad range of choice in terms of the approaches that can be used, would more accurately present each entity's risk management activities. Along with this view, they favoured an optional, rather than mandatory, application of the PRA. However, the issue of comparability that inevitably arises under these circumstances would pose a challenge that was not addressed.
14. Some respondents expressed a concern that an optional application of the PRA would reduce comparability and mentioned the need to establish additional safeguards to avoid 'cherry-picking' leading to earnings management.
15. Users of financial statements broadly supported the *concept* of the PRA with the a scope focused on DRM because:
 - (a) the PRA focuses on NII, which is a critical driver of profit for banks;
 - (b) the PRA splits NII into customer margin within business units and the result of net open interest rate risk positions within ALM thereby providing users with an understanding of its composition, drivers and associated risks. This provides information about the quality and sustainability of earnings as earnings arising from customer margins is very different from those that result from net open risk positions within ALM. Users also noted that the information about the effect of ALM activities is of critical importance, because it could overshadow other components such as customer margin, and thus distort the view of NII, if not presented appropriately.
 - (c) the PRA differentiates derivatives that are used for DRM purposes from those that are used for trading purposes.
16. However, there was no common view among users on *where* (profit or loss, OCI or note disclosures) and *how* this information should be shown.

Behaviouralisation

17. Many respondents welcomed that the DP had addressed the issue of how financial reporting could deal with behaviouralisation. In particular, most respondents strongly advocated that the behaviouralisation of core demand deposits should be incorporated in the PRA because :
- (a) demand deposits are an important source of profits for banks and they manage the corresponding interest rate risk based on behaviouralisation. Behaviouralisation of core demand deposits is widely used and is an integral part of DRM in this sector; and
 - (b) the inability to show the effect of DRM through behaviouralisation directly necessitates the use of ‘proxy hedging’, thereby leading to less transparent information and operational burdens.
18. However, a wide range of concerns about incorporating behaviouralisation in the PRA were also raised by respondents. The issues raised included:
- (a) concerns over the possibility of earnings management;
 - (b) the implications for comparability arising from the use of different assumptions in behaviouralisation that can vary by jurisdiction and by entity;
 - (c) accounting for changes in assumptions in behaviouralisations; and
 - (d) disclosures (right balance between information necessary for users to understand the implications of behaviouralisation whilst respecting commercial sensitivity for preparers).

Pipeline transactions and equity model book

19. Mixed views were expressed about the inclusion of pipeline transactions and equity model book in the PRA. Respondents who currently include them in their DRM supported the inclusion in the PRA because this enables them to show their DRM activities faithfully without resorting to proxy hedging. However, they do acknowledge that conceptual concessions would be necessary in order to represent

such aspects of DRM *directly* rather than relying on an *indirect* representation through proxy hedging.

20. In contrast, however, many other respondents have shown concerns over the inclusion of pipeline transactions and equity model book in the PRA because of the conflicts that arise with the *Conceptual Framework for Financial Reporting*.

Insurance companies

21. Insurance companies have expressed their interest in the project. The high level messages from them can be summarised as follows:
 - (a) Insurance companies find their risk management activities to be dynamic in nature as in many cases they manage risks, such as interest rate risk in insurance liabilities and financial assets, dynamically, on occasion using derivatives to manage such risks.
 - (b) There is a need for an accounting solution to address accounting mismatches between insurance liabilities, financial assets and derivatives that could arise under the IFRS 4 phase II project.
 - (c) Generally insurers found it difficult to provide answers to all the questions in the DP because of its focus on mismatches arising from loans and deposits being at amortised cost and derivatives being at fair value through profit or loss which is relevant for banks and not insurance companies.

Application of the PRA to other risks

22. The number of comment letters received from the non-financial sector was limited. The staff consider that this is partly because it was thought that the applicability of the DP would be limited, as some respondents indeed stated.
23. However, some non-financial entities such as utility and commodity companies expressed an interest in the project including providing fact patterns in their comment letters to demonstrate how DRM was implemented in their sectors eg for commodity price risk, and how the PRA could be of use to them. However, it was noted that the

treatment of forecast transactions would be a hurdle if the PRA were to be extended to other risks.

24. Some respondents also recommended that the IASB should further analyse DRM for non-interest rate risk in non-financial industries given that the focus of the DP is interest rate risk management in banks.
25. Some respondents expressed concerns about extending the application of the PRA. According to them, the PRA should be seen as an exception and therefore its applicability should be kept narrow and be limited to dynamic interest rate risk management for open portfolios in banks alone. For instance, a view was raised that the project needs to address the EU carve-out, while the general application of the PRA to other types of risks or other industries should be avoided because it would involve audit and enforcement challenges.

Alternative approach—PRA through Other Comprehensive Income

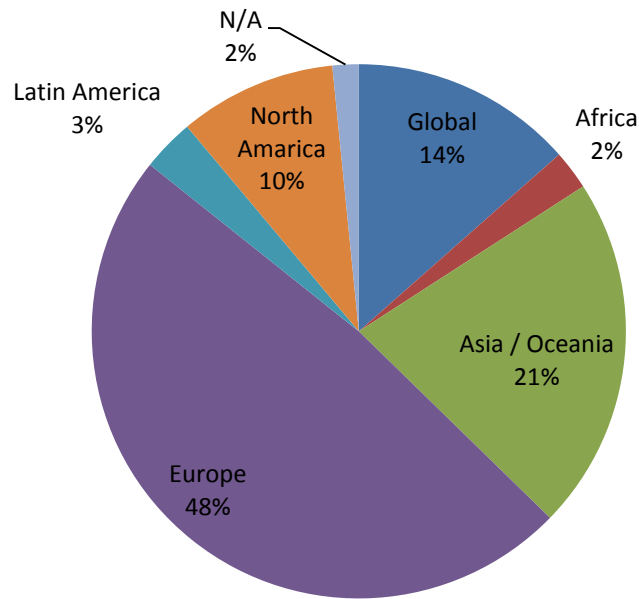
26. Respondents’ views were mixed. Many disagreed with the alternative approach because:
 - (a) they agreed with the conceptual and practical difficulties considered in the DP including the interaction with the assumption in the DP that derivatives should be accounted for at fair value through profit or loss, the treatment of internal derivatives and the issue of recycling from OCI to profit or loss;
 - (b) ‘ineffectiveness’ arising due to hedge accounting is shown in OCI; and
 - (c) volatility in equity. Some banks mentioned that this approach would only be worth exploring if the prudential regulators provided a filter which allowed them to eliminate any volatility that might arise from the application of the model through OCI.
27. Other respondents stated that the IASB should consider this alternative approach because:
 - (a) showing the revaluation of managed exposures in OCI would alleviate concerns that the PRA with a scope focused on DRM would increase

volatility in profit or loss, while at the same time providing a holistic picture about the effects of DRM on future NII; and

- (b) it could address the issue of accounting mismatches in insurance companies.

Appendix A—Comment letter demographic information

A1. This pie chart illustrates the breakdown of comment letters by geographical region:



A2. This pie chart illustrates the breakdown of comment letters by respondent type:

