STAFF PAPER

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IASB Meeting

Project	**Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging**
Paper topic	Proposed project plan

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Background

1. The Discussion Paper (DP) *Accounting for Dynamic Risk Management – a Portfolio Revaluation Approach to Macro Hedging*[1] was the IASB's first step in developing an accounting model for dynamic risk management (hereafter 'DRM'). The objective of the project was to simplify and improve the usefulness of financial statements by developing accounting requirements for hedging within the context of open portfolios that are more closely aligned with a company's risk management activities. The DP was published in April 2014, with a comment period of 180 days. In addition to receiving 126 comment letters the staff along with Board members conducted over 50 outreach meetings with stakeholders across a range of jurisdictions.

2. During February and March 2015 the IASB discussed the high level feedback received from comment letters and outreach activities on the 9 sections covering 26 questions included in the DP.

3. The DP focussed on capturing a particular activity for a particular risk in the financial statements of an entity ie the activity of DRM through measurement and recognition and disclosure. This was analysed using interest rate risk as an example. In order to achieve this, the DP explored ideas reflecting risk

[1] http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Phase-III-Macro-hedge-accounting/DP-April-2014/Documents/Discussion-Paper-Accounting-for-Dynamic-Risk-Management-April-2014.pdf

management, some of which presented significant conceptual and practical challenges, for example the revaluation of core demand deposits for changes in interest rate risk.

Purpose of the paper and staff recommendation

4. From the analysis of the feedback received on the DP it is evident that there is significant diversity in views regarding what the objectives of the project should be. In particular, on occasion the proposed outcomes of different stakeholder groups cannot be reconciled to each other, or to a single overriding objective.

5. In view of the above the staff believe that the IASB needs to first determine (or confirm) the overall objective or objectives for the project prior to entering into detailed re-deliberations on specific aspects of the proposals in the DP. Once that has been established, the staff believe the IASB can more easily determine which elements in the DP are most suited to achieving that objective, and what, if any, amendments are necessary. It is also possible that the IASB may need to rethink certain aspects of the proposals.

6. In this paper the staff have outlined a proposed approach. The staff are of the view that comment letters to the DP and the outreach dialogues conducted provided useful, albeit not complete, insight into the information that are thought to be useful by users of financial statement (hereafter 'users') as well as preparers. These information needs are core to the project as a whole. The staff believe that the IASB should first consider information requirements through disclosures, then follow on to recognition and measurement requirements. This in the staff's view has a number of advantages:

    (a) It directly deals with information that both users and preparers believe to be useful;

    (b) Decisions concerning recognition and measurement can then be built on the information needs with a greater degree of certainty concerning transparency; and

(c) This approach should give the IASB the flexibility and the methodology to try and explore how best to address the diversity in views.

7. Please note that the staff are not proposing that this be a disclosures only project. What the staff are proposing is that the IASB consider the disclosure aspects first, then followed by recognition and measurement.

8. The balance of the paper explores the above proposal in more detail.

9. The staff are asking the IASB whether or not they agree with the future direction of the project as proposed in the paper.

Analysis

10. Many commentators agreed that the DP had correctly identified the current challenges associated with the accounting when risk management is dynamic in nature. They also believed that there was a need for a project in the area to address these challenges. However, there was considerable diversity in views as to what the aims of the project should be.

Conflicting views on the project objective

11. Paragraphs 12 to 22 of the paper summarise the key differences in views amongst stakeholders regarding what should be the objective of the project.

Preparers

12. Overall, preparers believe the project should address the current challenges of applying hedge accounting that aims to manage volatility in profit or loss arising from accounting mismatches. Consequently, they believe that the project should focus primarily on addressing accounting mismatches rather than attempting to represent DRM in the financial statements. In their view, given the diversity in risk management practices amongst entities, the focus on a single methodology to represent all DRM activities will be a challenging if not impossible task. They suggested that the flexibility to apply fair value or cash flow hedge accounting, the Portfolio Revaluation Approach (hereafter 'PRA') and the fair value option in order to best reflect business and risk management activities should be something

that is considered by the IASB in its future deliberations. In addition preparers in general believe that elements of the DP that considers incorporation of risk management activities, for example behaviouralisation, should be accepted (and is in fact essential) to achieve better alignment between DRM and financial reporting, in spite of conceptual challenges.

13. However, *amongst* preparers, there are differences in views on the methodology that should be used to achieve the above objective. Banks with primarily variable interest rate exposures believe that the IASB should consider a cash flow hedge accounting type model as that is how DRM is conducted in such entities. On the other hand, entities with primarily fixed interest rate exposures agree with the proposals in the DP in the form of the PRA, subject to various conditions especially concerning the scope of application.

14. Insurers on the other hand commented that although they dynamically manage open portfolios of insurance contracts, their problems were different from those of banks because of the accounting mismatches that could arise from the finalisation of IFRS 4 phase II. Some of them went on to state that those problems should be addressed within the insurance contract project and only if that is not possible, it should be included in the project on DRM.

15. In the case of non-financial entities, the comments received reveal that only a small number of them dynamically manage risks such as commodity price risk and foreign currency risk. Of those stakeholders who responded to the DP, some were of the view that the new requirements in IFRS 9 were sufficient to address their hedge accounting requirements.

16. Overall from the preparers' perspective the objective of transparent representation of DRM *per se* in the financial statements was not considered to be a priority that the project should try and achieve.

Users

17. The users on the other hand generally supported the project and the concept of the PRA. Users generally felt that it was a step forward in terms of better alignment between financial reporting and DRM. One of their key requirements is to be able

to analyse net interest income (hereafter 'NII') by the profit source (or driver) and derivatives by their use, which is fulfilled by the proposals in the DP.

18. In addition some users supported the PRA with a scope focussed on DRM (ie applied to all items subject to DRM) as they noted that they are interested in both what is hedged and what is unhedged, and that a holistic perspective is important for them to understand how successful or otherwise DRM has been. This is based on the logic that both hedging and keeping open positions unhedged are important drivers of NII and consequently the management decision not to hedge is just as important as the decision to hedge from users' perspective. It was also noted that neither general hedge accounting nor the PRA with a scope focused on risk mitigation provides this information. In addition, users expressed a concern over the lack of comparability, if the application of the accounting for DRM is optional. This is in contrast with preparers who believe that the project objective should not be to represent DRM *per se* but instead to focus on addressing accounting mismatches.

19. However, there was no common view amongst users on where (profit or loss, other comprehensive income (hereafter 'OCI') or note disclosures) and how the information should be shown. Some mentioned that it should be presented in profit or loss given the critical nature of the information, while some others mentioned that OCI would be a better place to capture the revaluation effect from DRM. Others mentioned that disclosures alone would be adequate and may be more appropriate given that the revaluation of future cash flows including behaviouralisation is dependent on entity specific judgements.

20. Users generally supported behaviouralisation being reflected. However, they also expressed concerns about the subjectivity involved in behaviouralisation, as it could lead to the lack of comparability and earnings management. They stressed the importance of disclosures on, for instance, behavioural assumptions.

Regulators

21. Securities and prudential regulators in general were of the view that the accounting model for DRM should not expand the application of (quasi) fair value measurement. However, at the same time they acknowledged the need for a

solution in the area whilst emphasising the importance of discipline, safeguards and disclosures, in order to facilitate comparability between entities and to prevent earnings management.

22. Reflecting that their view is a mixture of that of preparers and users, they suggest that a good balance is important between conflicting considerations, for instance, between flexibility and discipline, and between faithful representation of DRM activities and consistency with the Conceptual Framework for Financial Reporting (hereafter 'Conceptual Framework').

Challenges

23. The staff note that it will be difficult for any single accounting model to satisfy the different objectives mentioned above given the conflict between them. For instance, preparers' preference for broad flexibilities in accounting choices contradicts the users' and regulators' requirement for discipline and comparability. In addition, the very different preferences in scope of application for the PRA are difficult to reconcile.

24. As reflected in the comments above, striking a balance between various objectives and needs of stakeholders is likely to be challenging, given the extent of some of the contradictions.

Possible Approaches

Maintain Status Quo

25. As mentioned in paragraph 10 of the paper there is clear consensus about the need for a project that addresses the current challenges faced by preparers, users and regulators in the area of accounting for hedges of open portfolios. The use of proxy hedge accounting to accommodate circumstances where *direct* representation of risk management in the financial statements through hedge accounting is not possible results in the 'black box' phenomena[2] of reporting risk management in the

[2] An example is a bank that manages interest rate risk using core demand deposits. The bank may enter into receive-fixed pay-variable interest rate swaps with a view to manage *deemed* fixed interest rate exposures in

financial statements. In addition proxy hedge accounting introduces a significant level of operational complexity. Therefore it has resulted in the need for significant investments in processes and systems to frequently re-designate hedge relationships. The staff continue to believe that this is not an optimal situation.

26. In addition there was broad support among respondents to the DP that behaviouralisation be incorporated within any model that is developed. In particular, revaluation of exposures based on deemed cash flows be accepted for core demand deposits, but only with safeguards such as disclosures, recognising the risks inherent in behaviouralisation such as earnings management.

27. The staff further consider that the issue of core demand deposits is likely to become *more* important due to the exceptionally low interest rate environment prevailing in many jurisdictions. This is because the low interest rate environment makes time deposits *less* attractive for depositors in comparison to demand deposits. It also makes demand deposits *stickier* when people expect the low interest rate environment to persist. One European bank noted in its comment letter to the DP that in 2014 it failed to find eligible hedged items for proxy hedge accounting for core demand deposits in applying the 'fair value hedge accounting for a portfolio hedge of interest rate risk (AG114-AG132 of IAS 39)'.

28. It was also noted that the accounting policy choices available to entities for hedge accounting under the current requirements in IFRS 9 made comparability a challenge. For a fair value hedge of interest rate exposure of a portfolio of financial assets or financial liabilities, an entity may apply the IAS 39 model for 'fair value hedge accounting for a portfolio hedge of interest rate risk (AG114-AG132 of IAS 39)' and when an entity applies IFRS 9, it may choose as its accounting policy to apply either the hedge accounting requirements in IFRS 9 or IAS 39 in its entirety. BC6.104 of IFRS 9 states:

> …The IASB therefore decided to provide entities with an accounting policy choice between applying the hedge accounting requirements of IFRS 9 (including the scope exception for fair value hedge accounting

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core demand deposits. As *direct* representation of this risk management activity is not possible under existing requirements, the bank may try to represent it *indirectly* by finding items that are eligible for cash flow hedge accounting (eg variable interest rate exposures in assets) as a proxy. Information on what the bank actually did in risk management is lost through this process, resulting in the 'black box' phenomena in financial statements.

for a portfolio hedge of interest rate risk) and continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting **until its project on the accounting for macro hedging is completed**. The IASB noted that an entity could subsequently decide to change its accounting policy and commence applying the hedge accounting requirements of IFRS 9 at the beginning of any reporting period (subject to the other transition requirements of IFRS 9)…

[emphasis added]

29. Considering the significance of the issues involved the staff believe that maintaining these choices is not an optimal situation.

Risks other than interest rate risk

30. Based on the comment letters received, the need for a solution in the area of 'other risks' was not something that was considered to be a priority. Respondents were broadly of the view that the existing hedge accounting requirements in IFRS 9 would be adequate for 'other risks'.

31. On the other hand, staff note that:

(a) Existing difficulties are the most prominent in the area of dynamic interest rate risk management. The inability to directly apply hedge accounting to core demand deposits is a key challenge in accounting for interest rate risk management and is expected to become more important over time under a low interest rate environment;

(b) Based on the responses in comment letters to the DP, the staff believe that proxy hedge accounting is a less urgent issue for non-interest rate risks as the magnitude of the problem seems to be smaller; and

(c) Many respondents to the DP broadly agreed that the DP had correctly identified the main issues and challenges currently facing stakeholders in accounting for dynamic interest rate risk management.

32. The staff therefore recommend that the IASB prioritise dynamic interest rate risk management as its focus. The staff further recommend that the IASB consider

'other risks' at a later stage. So the staff recommend that the potential scope of application of any approach is not be limited at this time.

33. The staff acknowledge that IFRS 9 is only recently issued and it is likely that not all aspects of representing DRM for 'other risks' has been explored at present. For this understanding to be gained we need to allow time to elapse. The above direction better accommodates this.

Suggested alternative models

34. Some respondents have suggested that the IASB should explore approaches other than the PRA. The suggestions included:

    (a) Amend the 'fair value hedge accounting for portfolio hedge of interest rate risk (AG114-AG 132 of IAS 39),' to allow for the designation of core demand deposits, sub-benchmark instruments and the bottom layer in the managed portfolio as eligible hedged items;

    (b) Use the cash flows of derivatives to calculate the adjustments to offset fair value changes arising from the hedged items, if it can be demonstrated that derivatives used for risk mitigation purposes do mitigate the risk of, for example, the sensitivity of future NII to changes in interest rates; and

    (c) Defer the fair value changes in derivatives in OCI under specified conditions.

35. Whilst the above are brief summaries of the approaches mentioned in the comment letters, the alternative approaches suggested were more in nature of possible future directions to be explored rather than being fully developed solutions.

36. For instance, the proposal to amend the current 'fair value hedge accounting for a portfolio hedge of interest rate risk' requirements in IAS 39 proposes that core demand deposits be made eligible hedged items. However, it is silent on how to address the issues and concerns regarding reliability, comparability and earnings management that were highlighted in the DP.

37. Nor do any of the alternatives address the issue of information usefulness for users and consistency with the Conceptual Framework. However, there could be

elements in the proposals that could prove useful depending on the direction of the project. Consequently, the staff do not have any specific suggestions at this stage on how to take these alternatives forward. As the project progresses the staff will provide more detailed analysis on the proposals as a whole or elements of the same as required.

Identifying the information requirements

Disclosures first

38. One of the key themes of the feedback received is the varied information needs that exist amongst different stakeholders in respect of DRM activities. Exacerbating the difficulties that arise from these varied needs are the conceptual challenges that underpin any recognition and measurement accounting model.

39. From the perspective of information usefulness concerning DRM activities, one key message from users was that there is an existing lack of clarity in the information provided about such activities in the financial statements. It was also noted by preparers that the current disclosure requirements under IFRS 7 *Financial Instruments: Disclosures* do not necessarily fit with such activities as well. The comment letter analysis to the DP shows that there seems to be less diversity in views in this area. For example, users do not have a shared view on *where* information about the 'holistic' picture of dynamic interest rate risk management be shown (profit or loss, OCI or note disclosures) but have a common view as to its need. Many preparers were ready to countenance disclosures with a 'holistic' scope despite their preference for a scope focused on risk mitigation in the application of the PRA, though many others commented that the scope of disclosures should be identical to the recognition and measurement approach.

40. Therefore, the staff propose that the IASB consider an approach that addresses the information gap from the perspective of what should be the appropriate range of information through disclosures in the financial statements first, and then with that knowledge, consider recognition and measurement requirements. The staff is of the view that that this approach has a number of advantages:

(a) It directly deals with information that both users and preparers believe to be useful;

(b) Decisions concerning recognition and measurement can then be built on the information needs with a greater degree of certainty concerning transparency; and

(c) This approach should give the IASB the flexibility and the methodology to try and explore how best to address the diversity in views.

41. This approach should first consider information that is currently provided to users by entities in the form of existing GAAP, non-GAAP measures and regulatory requirements and build on the previous work done by staff when developing the DP in the area. The key focus of this would be to consider how best to address the needs of stakeholders to be able to better present and analyse the drivers and source of an entity's NII. In the area of behaviouralisation since a key issue is transparency when dealing with management estimates and judgements, the staff plan to explore regulatory requirements that are present in some jurisdictions requiring entities to submit details about behaviouralisation assumptions and models for core demand deposits.

Disclosures only

42. Performance as reported in the primary financial statements also satisfies a key information need of stakeholders. Consequently, recognition and measurement play an equally important part in addressing the information needs of stakeholders. Therefore,the staff believe that the way forward cannot be a disclosures only project. The staff believe that better disclosures alone cannot address existing problems explained in the paragraphs 25 to 28 nor the information needs of stakeholders in its entirety.

43. What the staff is proposing is that the IASB consider the disclosure aspects first and then recognition and measurement. The aim should ultimately be to develop a set of consistent recognition, measurement and disclosure approaches.

Expert Advisory Panel

44. Given the diversity in views and conflicting requirements of stakeholders and the specialized nature of the topic, the staff believe that in due course it may be appropriate to constitute an Expert Advisory Panel to assist the IASB in its deliberations on the project.

45. However, for the group to be effective in aiding the IASB in its deliberations the staff believe that it would be more appropriate to consider forming the group at a later stage. This will enable us to create a term of reference within which the group could advise the IASB and to identify the appropriate skill set for participants. Given the status of the project today, the staff believe establishing such a term of reference for the group without further deliberations by the IASB would be difficult. Consequently, the staff is recommending that the IASB consider forming such a group at a later stage in the project.

Staff recommendations

46. The staff recommends that the IASB commence its deliberations on the project by first considering the information through disclosures to better reflect the activities of entities which engage in DRM, followed by recognition and measurement requirements. The staff is not recommending that this be a disclosures only project.

47. The staff also recommend that the IASB prioritise dynamic interest rate risk management.

48. In addition the staff believe that the IASB consider forming an Expert Advisory Panel at a later stage in the project for the reasons outlined in paragraphs 44 to 45.

Question to the IASB

Question
Does the IASB agree with the staff recommendations outlined in paragraphs 46 to 48?