Dynamic risk management—accounting in an age of complexity

Steve Cooper, a member of the IASB, discusses an accounting approach for dynamic risk management

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Interpreting financial statements can be difficult at the best of times. It can be an even greater challenge when an entity has a complex business model or undertakes complex and diverse transactions. IFRS provides disclosures and comparability in recognition and measurement with the aim of helping investors better understand entities' financial statements. Entities may also choose to provide supplementary information for especially complex transactions or exposures. Nevertheless, in some areas of reporting, even the best of intentions can leave investors struggling.

One of these is risk management—particularly, dynamic risk management. Many entities are exposed to market price movements that affect their profitability. For example, a bank's net interest income is often the most significant contributor to profitability. However, net interest income is exposed to changes in interest rates. How well a bank manages this risk affects its profitability. Managing these risks on a continuous and dynamic basis is one of the key elements of financial risk management. Dynamic management of interest rate risk is therefore a critical component of a bank's ongoing risk management activities.

Understanding that financial reporting needs to provide more clarity about these types of activities, the IASB has just published the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the 'DP'). The DP explores the accounting aspects of dynamic risk management and discusses preliminary views on a new accounting approach that may improve financial reporting in this area. The particular focus of the DP is the management of interest rate risk by banks; however, it also applies to other dynamic risk management activities in other industries (for example, commodity price risk).

Developing a new approach does not mean that current accounting practices are necessarily failing investors. IFRS already includes a general hedge accounting model, which provides for the fair value and cash flow hedge accounting with which most investors will be familiar. The model has recently been improved through the new financial instruments Standard IFRS 9 *Financial Instruments* (IFRS 9). However, even the general hedge accounting approach has limitations in which risk management practices are more complex and the risks being

hedged are more dynamic.

Why a new approach?

Many of you may recall the reason we have a general hedge accounting model, which is largely a result of the mixed measurement approach applied in financial reporting. For example, IFRS requires that all derivatives should be measured at fair value. Given the nature of these instruments (for example, little or no initial cost with significant leverage and exposure), the IASB (and many stakeholders) consider fair value as the most appropriate measurement basis; particularly considering that cost-based measurement may poorly reflect the leverage inherent in most derivatives and the significant changes in value that can occur.

However, IFRS does not require fair value measurement for many of the assets and liabilities that create risk exposures that may be hedged by those derivatives. For example, banks' loans and deposits are generally measured at amortised cost. The accounting focuses on the net interest income generated over the life of the instruments rather than changes in value. Most commentators also believe that this approach better reflects the banking business model and provides the best depiction of performance for these instruments. However, the fair value measurement of derivatives and the cost-based measurement of bank loans and deposits do not sit well together when the objective of holding those derivatives is to manage the interest rate risks (fluctuations in net interest income) of that business activity. This is when hedge accounting becomes necessary to provide investors with clear, transparent information about the related activity.

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The general hedge accounting model of IFRS 9 can be applied to dynamic risk management and, in many cases, is adequate to enable the economics of the activity to be faithfully reflected in financial statements. However, applying the general hedge accounting model to risks managed dynamically can present challenges and complexity for preparers, and can result in financial statements that are difficult for investors to understand. There are also certain dynamic risk management activities that are difficult to reflect properly in financial statements and that may consequently result in volatility that is not reflective of the underlying situation. It is for these reasons that the IASB wishes to consider an alternative accounting approach.

The Portfolio Revaluation Approach

In the DP we refer to the potential new method of accounting for dynamic risk management as the Portfolio Revaluation Approach (PRA). The aim of the PRA is to provide an alternative to the present general hedge accounting model that will be easier for preparers to apply and that will better represent and be more consistent with risk management activities, resulting in better

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Mechanics of the PRA

The PRA involves identifying a portfolio of exposures that is subject to dynamic risk management, and remeasuring these for the risk being managed. For a bank this could be a portfolio of loans and deposits. This is not a full fair value approach, as only one component of changes in value would be recognised in the revaluation adjustment. For example, for dynamic interest rate risk management only changes in value of the loan or deposit due to the hedged benchmark interest rate risk component would be included in the revaluation. Other components of the change in fair value including credit risk, expected credit losses and other components of the credit spread such as liquidity are not included in the adjustment.[1] This revaluation adjustment is then reported in profit or loss together with the full fair value changes of the derivatives that the bank is using to manage that risk.

There are two key advantages of this approach over the general hedge accounting model.

The PRA can be more easily applied to open portfolios

The general hedge accounting model essentially relies on a one-to-one designation of the hedged item (the loan or deposit) with the hedging instrument (the derivative). Therefore, while the general model works well for closed portfolios it has significant limitations when applied to open and dynamically managed portfolios.

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Problems in the general hedge accounting model arise when derivative positions are adjusted in response to changing risk exposures (for example, new bank loans being added to portfolio, early loan repayment of existing loans or changes in the levels of deposit). All such changes affect the extent of the 'natural hedge'. Under the general hedge accounting model these changes may cause an entity to 'dedesignate' the original hedge relationship and re-establish it in a different form. Not only is this operationally burdensome for the bank, but the resulting accounting adjustments can result in volatility in profit or loss, making the hedge appear to be ineffective when in reality it is not.

The PRA would enable entities to better reflect their dynamic risk management practices in their financial statements

Some dynamic risk management activities that are designed to manage or stabilise the net interest income of banks are difficult to accommodate in the IFRS 9 general hedge accounting model. A good example relates to the effects of so-called core demand deposits. Some bank deposits (for example, bank current accounts) can create a stable source of funding at a low or even zero interest rate. If these effective fixed interest rate liabilities

[1] Note however that credit losses are separately captured through the amortised cost impairment allowance.

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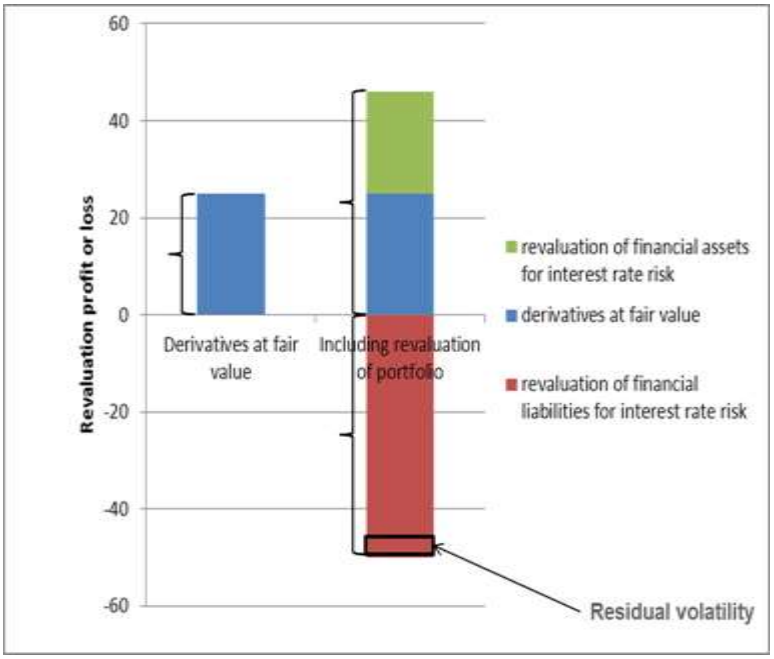
fund variable interest rate assets, the bank may wish to hedge (stabilise) the resulting volatile net interest income through an appropriate derivative position. Normally, fixed interest rate funding can be designated in a fair value hedge in the general hedge accounting model, but this is not possible with core demand deposits, because most of the deposits are repayable on demand, which means that there is no fair value change that can be recognised.

Banks can adopt different approaches under the IFRS 9 general hedge accounting model to mitigate the profit or loss effects of this problem, such as applying a cash flow hedge to the variable interest rate asset or by finding a completely unrelated financial instrument to offset against the derivative as a 'proxy fair value hedge'. However, neither of these 'work-arounds' are satisfactory. The former creates volatility in other comprehensive income (OCI) that is not reflective of the risk management approach. The latter is operationally complex and becomes extremely difficult for investors to understand since the hedge accounting is only indirectly related to the risk being managed.

The PRA would provide an alternative and more transparent solution. Using this approach, banks would be able to apply a so-called behaviouralised approach to the core demand deposits such that a revaluation gain or loss could be offset against the derivatives being used to manage that risk, thus better reflecting dynamic risk management in the financial statements.



The PRA is designed to result in a recognition and measurement approach that better reflects the economics of risk management, to provide for a presentation that shows how dynamic risk management has impacted net interest income for the current period and to separate this impact from the ineffectiveness of

risk management and the financial effect of risks that are unhedged.

We need your feedback

This article provides a simplified explanation of the IASB's preliminary model. There are many aspects of the potential approach that I have not mentioned here, including the scope of items that could be included in the PRA, whether OCI might be used and how internal derivatives are accommodated. These issues are covered in the DP and will be explored in more detail in the coming months. What is certain is that we will receive a variety of feedback and that not everyone will agree that a model for dynamic risk management is even necessary. The IASB has already considered some alternatives such as a different measurement basis for derivatives or applying a full fair value model to all financial instruments. Both these approaches have significant disadvantages and are not favoured by the IASB. Nevertheless, we are keen to hear views on all potential approaches, even those we have not considered thus far.

We would particularly welcome views from investors on the preliminary views in the DP, including whether the approach would provide you with better information. Details about how to respond are available on the IASB website. Alternatively, you can email me directly about the specific items in the DP or to simply provide your views on what is helpful or unhelpful about current accounting and disclosures related to dynamic risk management activities for banks and other entities. I look forward to hearing from you.

Respond to the author

Steve Cooper is a member of the IASB. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB or the IFRS Foundation. The IASB/IFRS Foundation encourages its members and staff to express their individual views. This article has been developed by the author as an individual. It is has not been subjected to any due process of the IASB/IFRS Foundation. Official positions of the IASB/IFRS Foundation are determined only after extensive due process.

If you would like to discuss this topic or other areas of accounting, please contact Steve Cooper at scooper@ifrs.org or Barbara Davidson, IASB Investor Liaison, at bdavidson@ifrs.org