



Australian Government  
Australian Accounting Standards Board

# Memorandum

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| <b>To:</b>      | <b>AASB members</b>  | <b>Date:</b>        | 7 October 2014 |
| <b>From:</b>    | <b>Sue Lightfoot</b>   | <b>Agenda Item:</b> | 11.2 (M141)    |
| <b>Subject:</b> | <b>Accounting for Dynamic Risk: A Portfolio Approach to Macro Hedging: Notes from Accounting for Dynamic Risk Management Roundtables</b> |                     |                |

## Action

Consider feedback from outreach activities to date and consider key issues in AASB Invitation to Comment – ITC 31 on IASB Discussion Paper (DP) 2014/1 *Accounting for Dynamic Risk: A Portfolio Approach to Macro Hedging*.

## Background

The AASB hosted two roundtables on ITC 31.

### 1) By-invitation roundtable

A by-invitation roundtable was conducted on 19<sup>th</sup> August 2014. Sue Lloyd (IASB Board member), Mariela Isern and Yuji Yamashita (IASB staff) participated in the roundtable via video-conference from London.

Representatives from the four major Australian banks participated in the roundtable (ANZ Bank, Commonwealth Bank, National Australia Bank and Westpac Bank). Representatives from the four large accountancy firms and the Australian Prudential Regulatory Authority (APRA) also participated.

The following AASB board members participated: Peter Carlson, Anna Crawford, Regina Fikkers, John O'Grady and Marc Smit (also representing National Australian Bank). Angus Thomson and Sue Lightfoot from the AASB staff also participated.

### 2) Open roundtable

An open invitation roundtable was held on 4<sup>th</sup> September 2014. Sue Lloyd and Kumar Dasgupta (IASB staff) participated in the roundtable, again by video-conference from London.

Participants included preparers from the electricity industry, financial services including from the insurance industry, professional bodies, and large and mid-tier accountancy firms.

The following AASB board members participated: Peter Carlson, Anna Crawford, Kimberley Crook, Regina Fikkers, John O'Grady, Carmen Ridley, Brett Rix, and Marc Smit (also representing National Australian Bank). Angus Thomson, Sue Lightfoot and Jim Paul from the AASB staff also participated.

## Consideration of Key Issues

The Discussion Points for the meeting are provided as [agenda paper 11.2](#) to the September AASB meeting. The questions were slightly modified and curtailed for the open invitation roundtable.

### IASB background to DP

- 1 At the first roundtable those from the IASB provided some background on the IASB's objectives, making the following points:
  - the Dynamic Risk Management (DRM) project is not just a 'hedge accounting' project. Rather the IASB is exploring a radical new approach to accounting for risks and how they are managed in order to increase transparency around entities' risk management activities and how they 'macro hedge';
  - the IASB is considering increasing the use of behavioural factors;
  - although some banks may just want to expand hedge accounting, the IASB is seeking to do more than just reduce profit and loss / OCI volatility. It is looking to achieve more than can be achieved with just applying 'proxy hedging';
  - a key question is the scope: how closely should accounting follow risk management(?); and
  - (later in the discussion those from the IASB indicated) it may be that the PRA is too radical and an alternative such as increasing risk-related disclosures might be considered. They also indicated that it is too early to say what the next steps in the project would be (eg. another discussion paper).
- 2 At the second roundtable, the IASB provided a presentation on the Discussion Paper. The slides are provided as agenda paper 11.3.

### Comments from Participants

- 3 Below is a summary of the key points raised in the meeting by the participants:

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| <b>1</b> | <b>Need for a new approach?</b>   |
| 1.1      | Do you think there is a need for a specific accounting approach to represent DRM in entities' financial statements? What issues could it address? |
| 1.2      | Rather than introducing a new approach, could the existing hedge accounting requirements be modified to address existing issues? If so, how?      |

- 4 The general view was that there are current issues that could be addressed; however, some were of the view that this could be achieved through the new IFRS 9 hedge accounting model rather than a dynamic risk management (DRM) model.
- 5 It was acknowledged that banks generally centralise then externalise selected risks and this gave rise to difficulty with the existing model due to limitations on hedge accounting for internal trades.

- 6 One participant raised a scenario whereby a fair value option (FVO) had been applied to loans instead of hedge accounting. This introduced a need to remeasure the credit risk for those loans. In his view FVO accounting does not reflect the business model. He also had the view that, where risk mitigation has not been used, accrual accounting may be sufficient. In response to a question concerning a scenario of two entities where the first hedges 60% and the second hedges 90% of an exposure, his view was that the difference could be addressed through disclosure – a difference in recognition and measurement already exists in IFRS 9 based on the business model for certain assets. It was noted by another participant that the difference in the extent of hedging would eventuate through the emerging profit or loss impact.
- 7 Another participant was concerned that introducing the PRA could result in more non-IFRS measures of profit being used.
- 8 Another participant commented that the existing hedge accounting approach could be easier to implement and to reverse out/include to see the impact of the hedge accounting. He also thought that DRM looks like a fundamental rethink of accounting and is a very ambitious project.
- 9 Another participant was concerned about introducing more complexity. He made the point that monitoring already exists through regulatory bodies. A capital charge for interest rate risk in the banking book is already calculated under APS 117<sup>1</sup> which is publicly disclosed<sup>2</sup>. However it was noted that the regulatory view of banks may not be comparable between banks. The disclosure requirements in AASB 7 *Financial Instruments: Disclosures* were also noted.
- 10 A different participant commented that he did not think that PRA reflected how banks manage their books (PRA seems to imply that books are managed on a fair value basis). For instance books may be managed on a ‘gap’ basis which is neither a fair value nor cash flow approach. As well as managing net interest income (NII) banks also manage economic value.
- 11 Another participant thought that proxy hedge accounting is simple to apply so did not see the need for a new approach.
- 12 A comment was made that the ‘noise’ from economic hedging was less than 1% for banks; so, although it is important, the existing accounting outcome is still acceptable.
- 13 It was noted that IFRS 9 includes improved hedge accounting for the energy industry, in what can be designated in a hedging relationship. This takes pressure off the need for a radical new approach.
- 14 A participant thought that the DP is brave and creative and worth exploring. However, defining the boundaries for the accounting approach would be the critical question since exposures refresh continuously. In an extractives industry the boundaries extend from what is in the ground through to sales.
- 15 Another participant discussed application to agricultural industries and raised a similar concern around defining the boundaries around the processes to be included in the accounting approach.

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<sup>1</sup> [APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book \(Advanced ADIs\)](#)

<sup>2</sup> [APS 330 Public Disclosure](#)

- 16 Another concern was raised that remeasurement of different items might be based on different level inputs. For example, some remeasurements may be based on quoted prices (level 1), some may be based on observable prices other than quoted prices (level 2) and some may be based on unobservable inputs (level 3). Some were concerned about presenting different level remeasurements in the same accounting approach.

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| <b>2</b> | <b>Application and availability of a new approach</b>  |
| 2.3      | Should any new approach continue to be elective (similar to hedge accounting and fair value option designations)?  |
| 2.4      | Should the new approach be available for risks other than interest rate risks (eg foreign currency risk)?  |
| <b>3</b> | <b>Scope</b>   |
| 3.1      | If the PRA is introduced, do you think the scope of the PRA should include: <ul style="list-style-type: none"> <li>(a) all managed portfolios with dynamic risk management (ie. remeasure in full)?</li> <li>(b) only portfolios for which the entity has undertaken risk mitigation?</li> </ul> |
| 3.2      | If (b), would a 'sub-portfolio' approach, or a 'proportional' approach be preferable?  |
| 3.3      | If (b), how would those portfolios be ring-fenced for accounting purposes and how would the accounting be impacted when items enter and leave the PRA approach?  |

- 17 The general view was that the scope would drive whether the PRA would be mandatory or not. If the focus is on DRM it would be mandatory; if the focus is on risk mitigation, it would need to be elective.
- 18 A question was raised as to how the approach works if it is mandatory – is it intended to be an overlay to other standards?
- 19 One participant's preference was for any new approach to be focused on risk mitigation activities, driven by the instruments used for risk mitigation purposes (eg interest rate swaps).
- 20 Another participant questioned whether different ALM portfolios could be selectively chosen for the PRA.
- 21 A suggestion was made that a shorter term project could focus on enhancements to hedge accounting and a longer term project could look at accounting for dynamic risk.
- 22 A concern was expressed that if the PRA is made mandatory the cost could be significant, especially for smaller entities.
- 23 A further concern was raised that a selective unbundled measurement model could be misleading because it fails to pick up all the costs associated with a particular return from a particular exposure.
- 24 A participant from the energy industry indicated agreement that there are very significant challenges, and a risk that analysts and investors may not understand the information. To translate risk management into meaningful numbers and or disclosures would be very

complicated. Some exposures could also be very long dated; eg, for power companies the exposures could go out twenty years.

- 25 Another participant commented that there could be difficulties in probability weighting different scenarios in different industries. For example, forecasting customer obligations for electricity delivery.
- 26 Another participant made the point that the implication of extending PRA to non-financial items would need to be considered. Some assets could be highly illiquid and very difficult to value.
- 27 A participant asked about the impact for an entity that actively sought to increase risk. This had not been considered in the DP. Others agreed that a risk modification is just as valid as a risk mitigation.
- 28 A concern was raised that associated disclosures might be commercially sensitive. Complex disclosures may also not provide clarity.

#### **4 Remeasurement for managed risk**

- 4.1 The IASB DP discusses remeasurement of items which are included in the PRA only for the 'managed risk'
- 4.2 Do you think that internal transfer pricing transactions could 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 asset-liability management (ALM) via transfer pricing is representative of the risk that exists in managed portfolios?

- 29 A general view was that an internal rate could be a practical way to determine a rate for remeasurement of managed risks (for example for core demand deposits). However, there was some concern that although internal pricing may be based on a core risk free curve, it may then be adjusted (for example for long term funding, incentives or disincentives) and the adjustments may not be consistent between banks.
- 30 A separate concern was raised about the inability to use internal derivatives for hedge accounting purposes (unless linked to an external hedging instrument). This was generally something which was seen as desirable. Some banks are taking on external positions for the sole purpose of meeting hedge accounting criteria.
- 31 The IASB representatives clarified that this was not proposed to be changed – only external positions would qualify for hedge accounting. If this was of concern Sue Lloyd encouraged participants to raise the issue in their comment letters. In the DP there is only discussion about introducing a gross-up presentation for internal positions, (although the internal positions would net out in the financial statements themselves).
- 32 Further support was given for considering internal pricing; but it was noted that, outside of banking, internal pricing was not common.

#### **5 Accounting based on expected behaviour (rather than contractual terms)**

- 5.1 The IASB DP discusses a number of items that might be accounting for in the PRA using expected behaviour rather than contractual terms. These include:
  - Core demand deposits

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|     | <ul style="list-style-type: none"> <li>• Prepayable items</li> <li>• Forecast pipeline transactions</li> </ul>   |
| 5.2 | Do you think these items, if included in the PRA, should be remeasured based on expected cash flows rather than contractual cash flows?  |
| 5.3 | If yes, how could concerns about the extent of discretion in management judgement and the reliability of the remeasurement (including for audit and regulatory purposes) be addressed? |

- 33 There was generally a view that data is already available for core demand deposits and prepayable items, but forecast pipeline transactions would be more ‘crystal ball’. Pipeline transactions were generally not included in models at present – it was noted that this may be due to the lesser extent of fixed rate products in the Australian market, compared with, for example, Europe and Japan where fixed-rate exposures are extensive and are actively managed.
- 34 Concern was expressed about the degree of flexibility in forecasting.
- 35 Some were of the view that accounting for pipeline transactions should be determined by whether the exposures are mitigated.
- 36 It was noted that a pipeline exposure is a fair value risk (not a cash flow risk). A concern was raised that accounting for the change in the value of a pipeline transaction could give rise to accounting for items that do not meet the definition of an asset or liability in terms of the Conceptual Framework.

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| <b>6</b> | <b>Equity Model Book</b>  |
| 6.1      | The IASB’s DP discusses accounting for an equity model book (EMB).                                    |
| 6.2      | Do you think, in a PRA approach, it would be appropriate to include a remeasurement for a deemed EMB? |

- 37 It was noted that most of the banks do have an equity model book. One participant was of the view that, in a risk management focused approach, EMB should be reflected. The issue was how to offset the derivatives used for risk mitigation – currently proxy hedge accounting is used for this.
- 38 A question was asked of about how far from the Conceptual Framework the IASB might be prepared to go in its DRM project. In response, those from the IASB indicated there would need to be a cost-benefit justification for doing so.

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| <b>7</b> | <b>Use of other comprehensive income (OCI)</b>                                   |
| 7.1      | Do you think that an approach incorporating the use of OCI should be considered? |

- 39 The point was made that OCI is not defined – albeit users are accustomed to OCI.
- 40 Some participants were of the view that a cash-flow-hedge (CFH) type of approach, with revaluation of risk mitigation instruments being taken to OCI would be preferable to a profit or loss approach. An advantage of this would be that, similar to CFH accounting, the change in the fair value of prepayment options in the risk mitigated position is then not recognised in

profit and loss (hence profit or loss volatility is not introduced by the change in value of the prepayment option).

- 41 Others were of the view that shifting volatility from profit or loss to OCI would not necessarily result in an improved presentation. They consider that amounts in OCI still need to be meaningful.