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Agenda paper 11.3 (M141)

International Financial Reporting Standards

Outreach with Australian constituents

Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

4 September 2014

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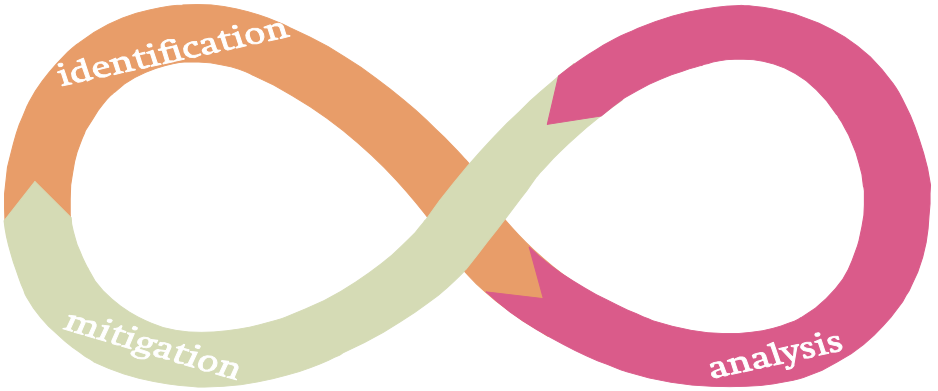
At a glance

- The IASB is exploring an accounting approach to better reflect **dynamic risk management** (DRM) activities in entities' financial statements.
- The Discussion Paper (DP) uses dynamic interest rate risk management by banks for illustrative purposes. However, the approach considered in the DP is intended to be applicable to other risks (for example, commodity price risk and FX risk).

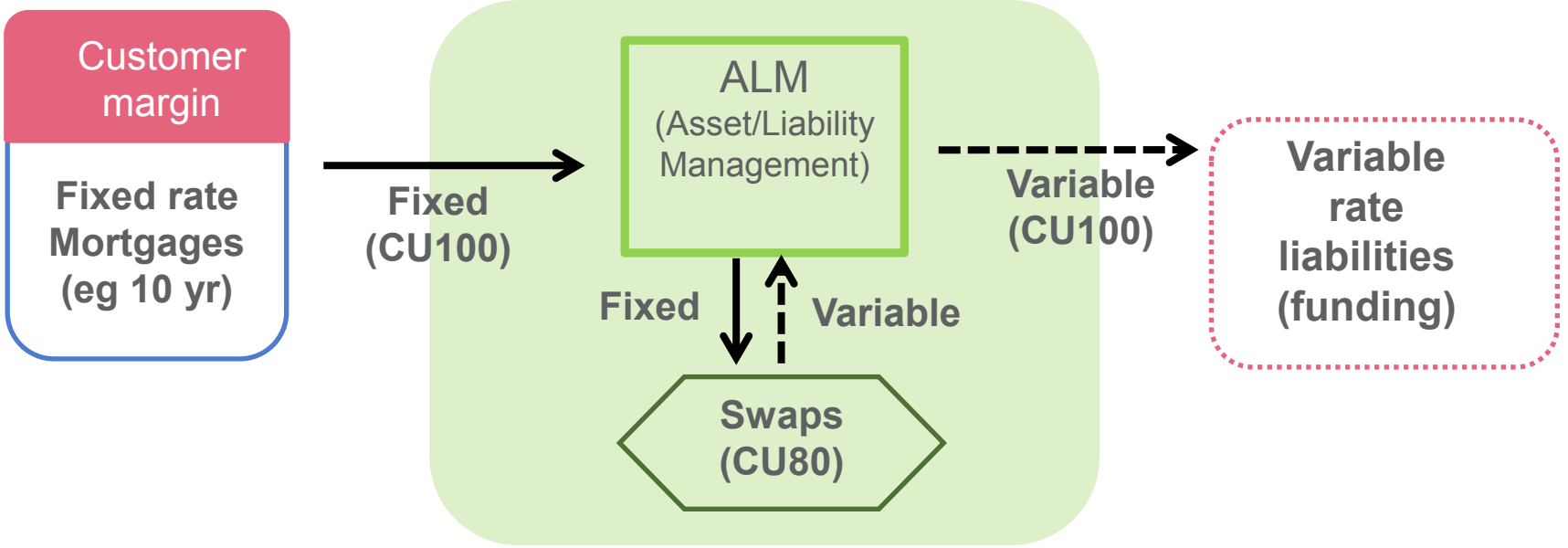
Dynamic Risk Management (DRM)

- DRM is a continuous process.
- Major characteristics of DRM include:



- ✓ DRM 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.

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).

Accounting under existing Standards for Financial Instruments (IFRS 9 Classification and Measurement)

Limited information on interest rate risk management (RM)

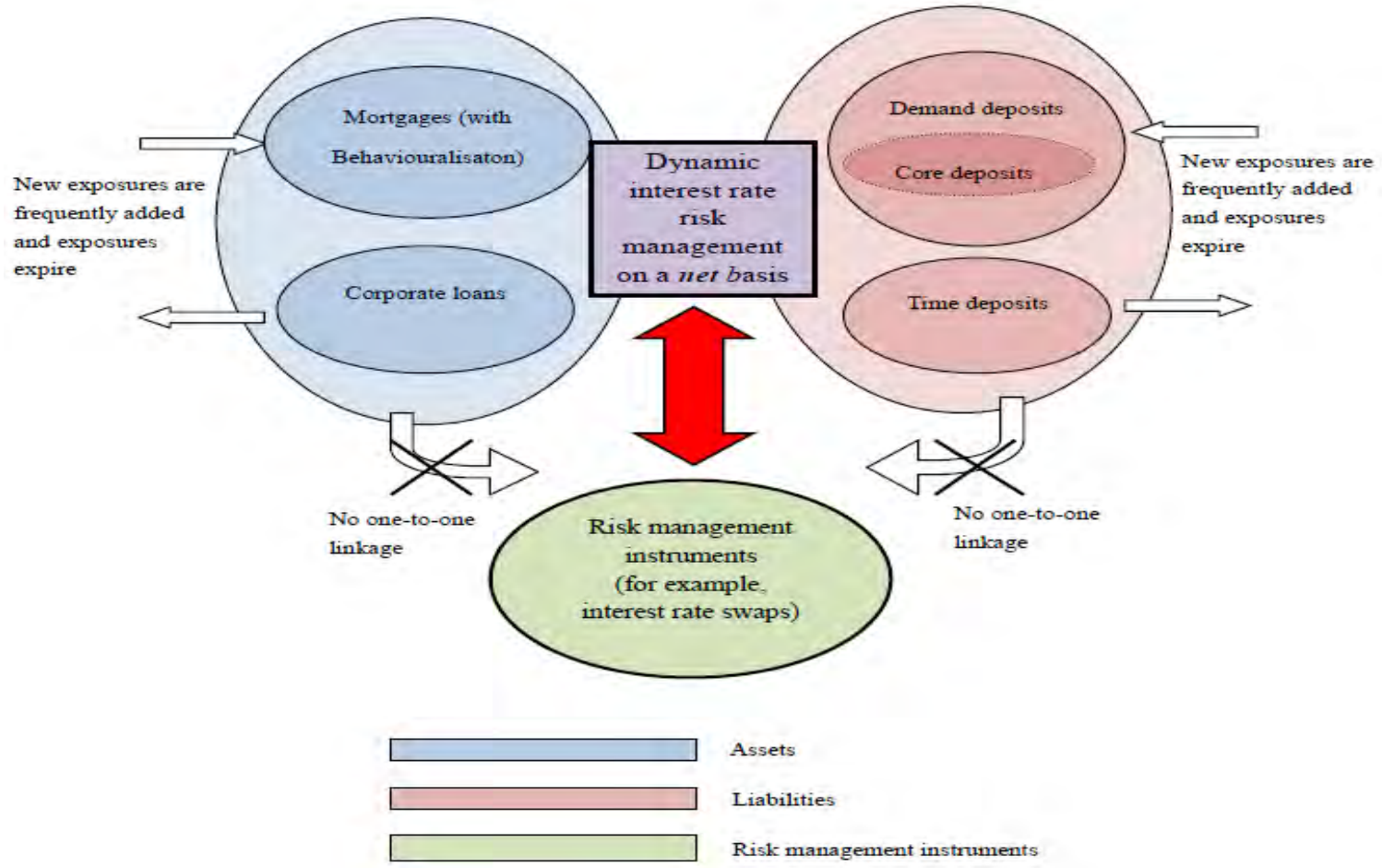
No distinction in derivatives used for interest rate RM and trading

IFRS 9			
	T1	*T2*	*T3*
Interest revenue	XXX	XXX	XXX
Interest expense	XXX	XXX	XXX
Net Interest Income (NII)	**XXX**	**XXX**	**XXX**
Net income from derivatives	XXX	XXX	XXX
Profit or loss	**XXX**	**XXX**	**XXX**

NII is shown as if RM (hedging) is not implemented

FV changes in derivatives are shown as if they were all used for trading

Dynamic interest rate risk management in banks



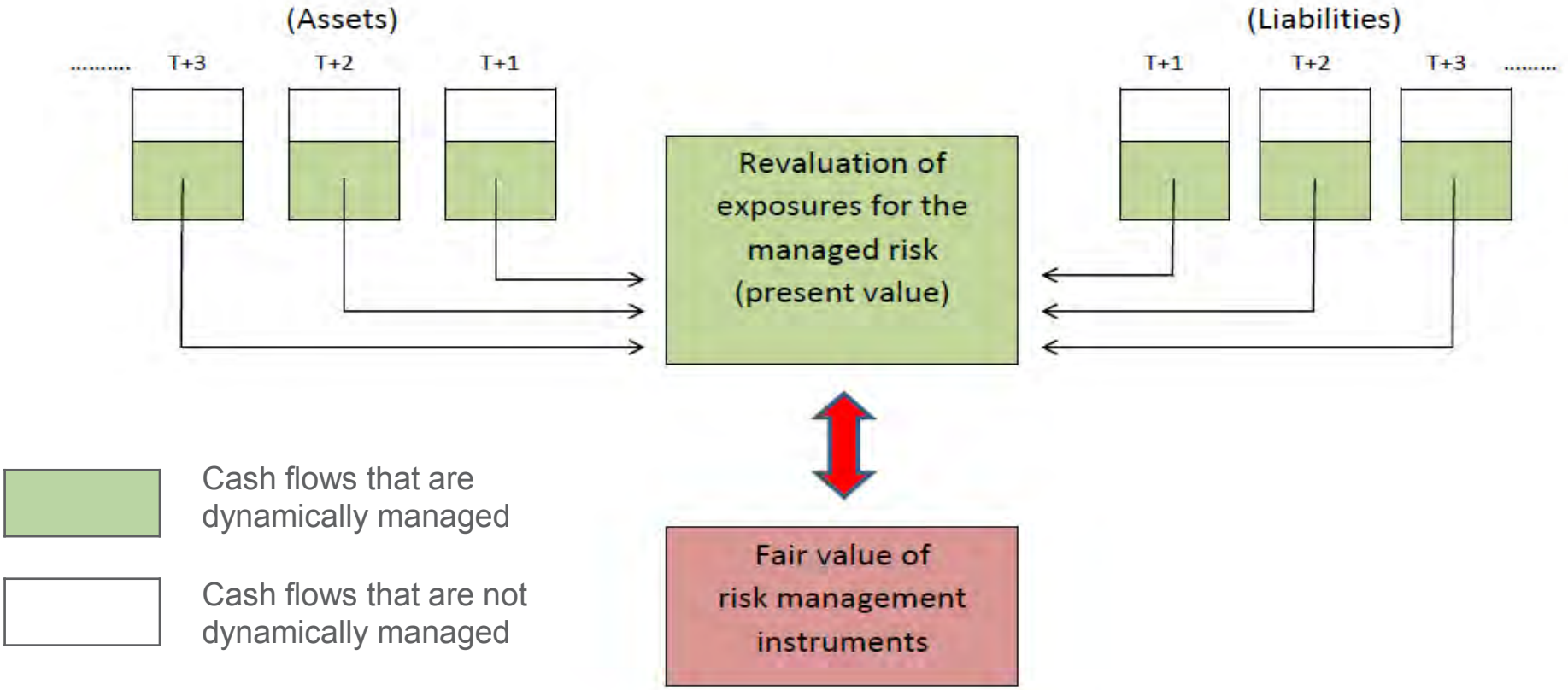
The purpose of dynamic RM is usually to manage **Net Interest Income**

Challenges under IAS39/IFRS9 hedge accounting

- Current hedge accounting requirements are often difficult to apply to DRM because:
  - ✓ One-to-one linkage between what is being hedged and the hedging derivative;
  - ✓ Can only indirectly accommodate DRM on a net basis through gross designation;
  - ✓ Can only accommodate open portfolios by treating them as a series of closed portfolios with short lives;
  - ✓ Allows for a degree of behaviouralisation of exposures but this is limited.

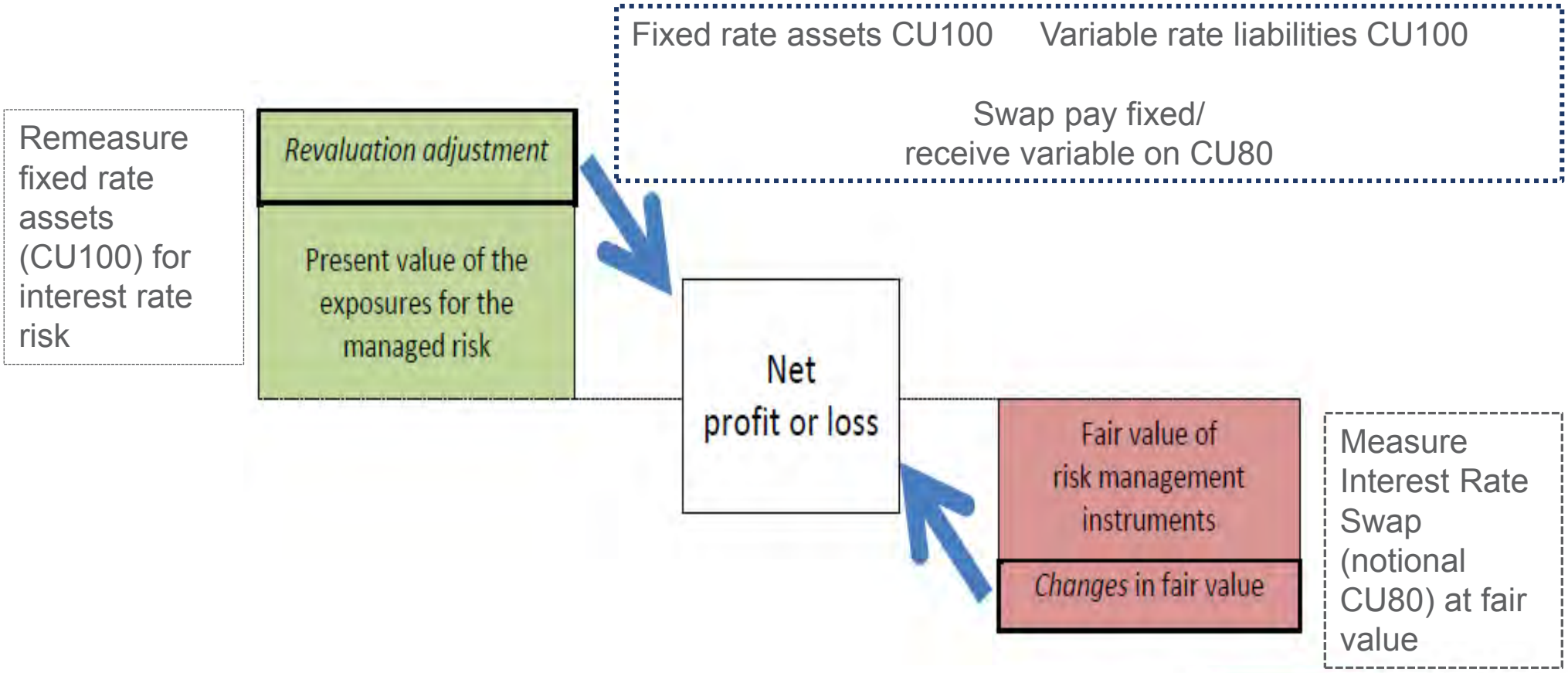
The Portfolio Revaluation Approach (PRA)

- Exposures within open portfolios are revalued with respect to the managed risk (for example, interest rate risk), using a normal Present Value technique.
- Not a full fair value model.

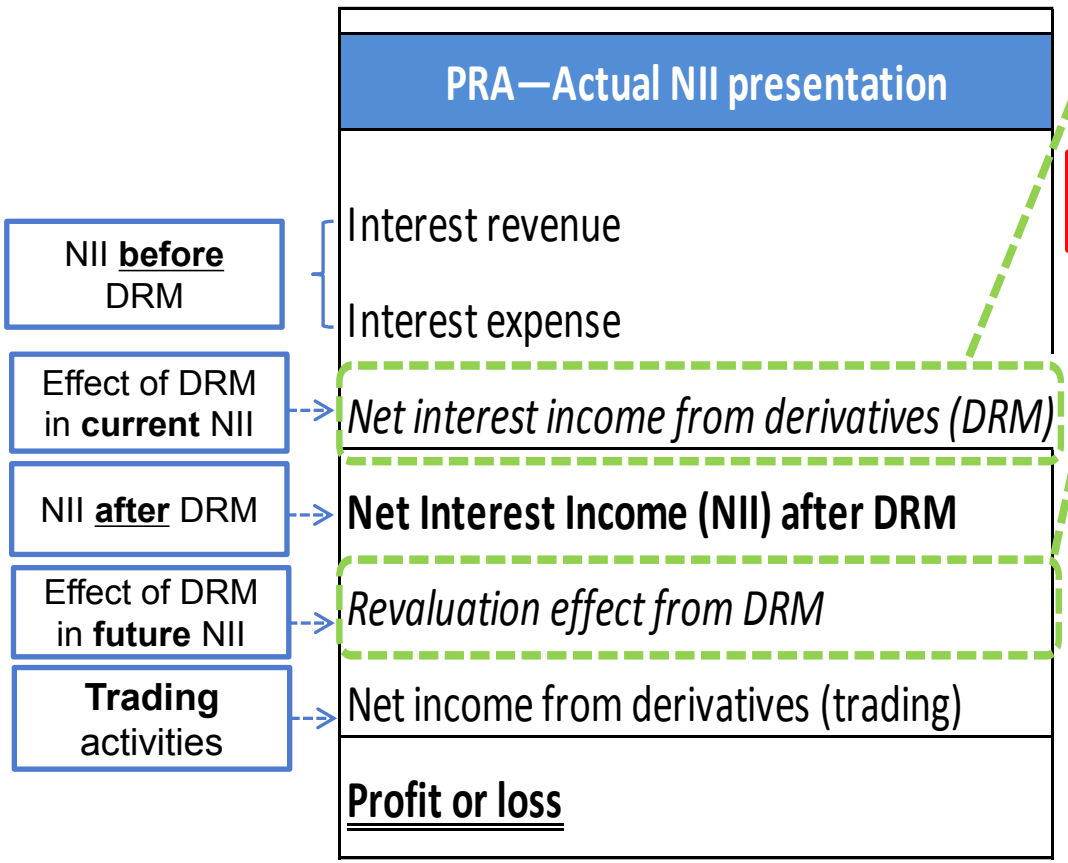


The PRA—*continued*

- 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.



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.

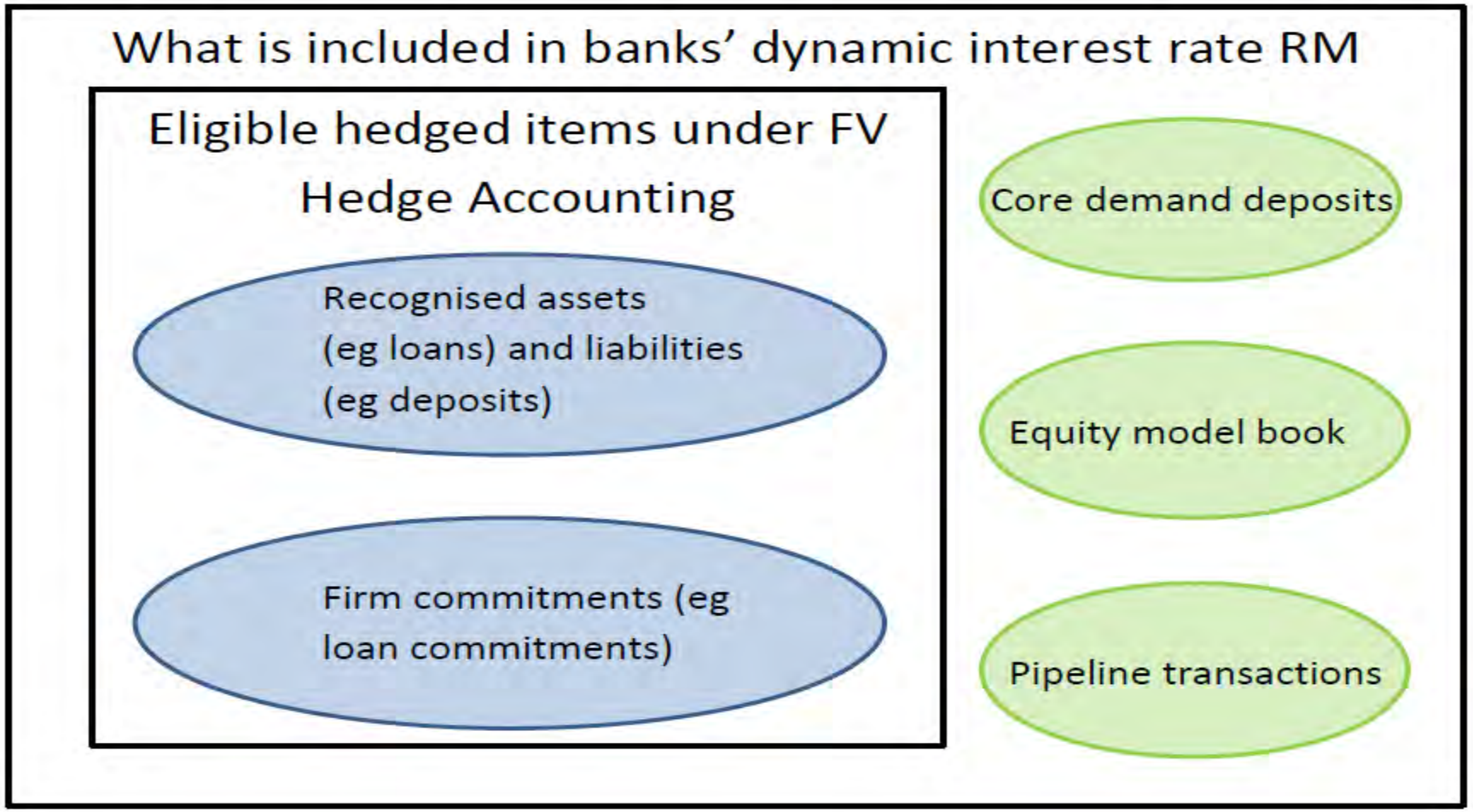
Expected improvements with the PRA

- ✓ 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;
- ✓ considers different types of risks managed in open portfolios.

Behaviouralisation (‘core’ demand deposits)

- Contractually demand deposits have a variable interest rate and can be withdrawn at any time.
- At a portfolio level, however, 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).
- Conceptually challenging, because deposits that are payable on demand are assumed to have zero fair value risk with regard to interest rate risk.

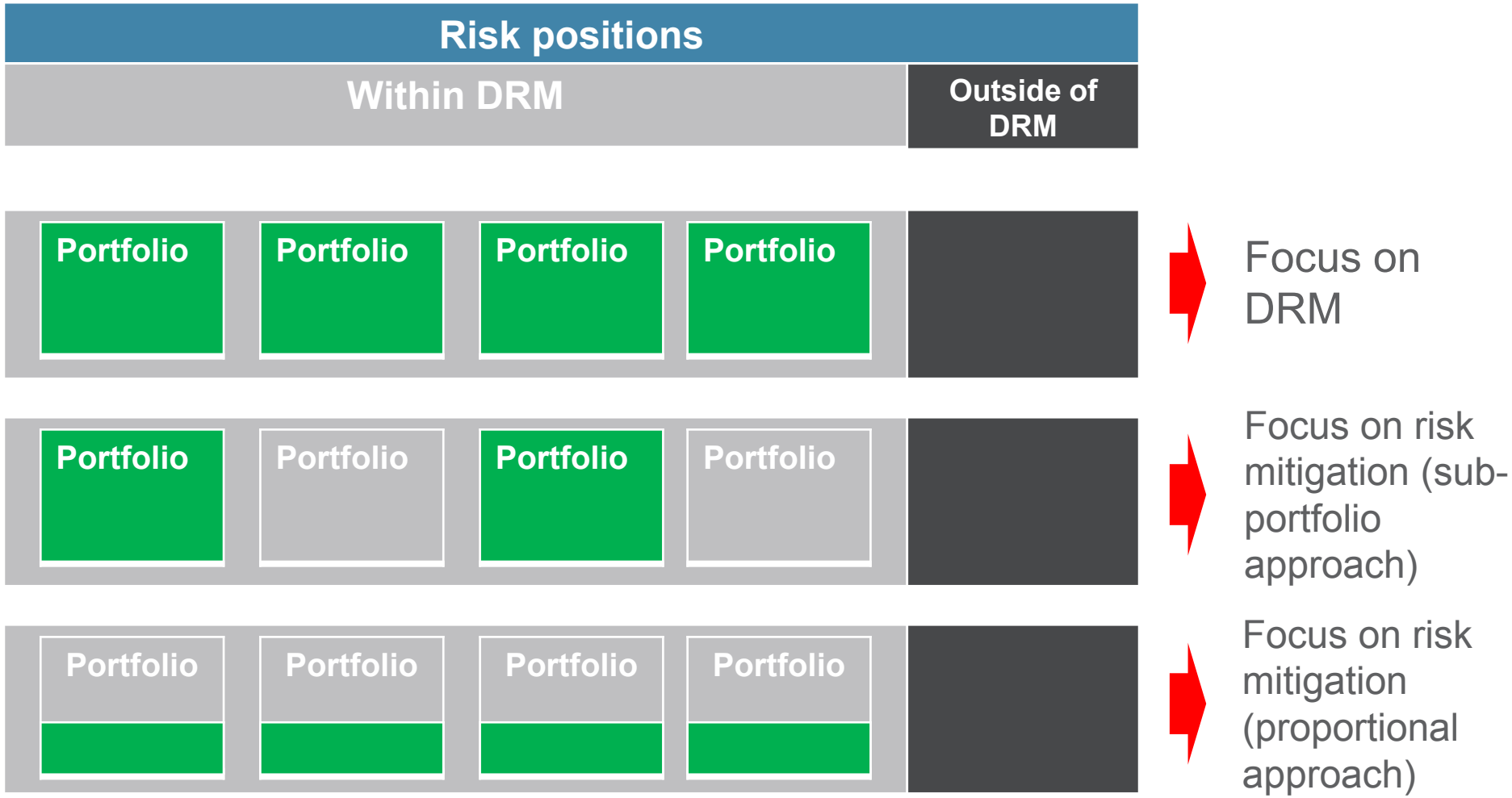
Hedge accounting and the managed portfolios in DRM



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)

Scope of the application of the *PRA*—*continued*



Presentation

Statement of financial position

- Line-by-line gross up
- Separate lines for aggregate adjustments to assets and liabilities
- Single net line item

Statement of comprehensive income

- Actual net interest income presentation
- Stable net interest income presentation

Disclosure themes

1. Qualitative information on the objectives and policies for DRM.
2. Qualitative and quantitative information on the net open risk position(s) and its impact on the application of the PRA.
3. The extent to which the PRA represents DRM.
4. Quantitative and qualitative information on the impact of DRM on the current and future performance of an entity.

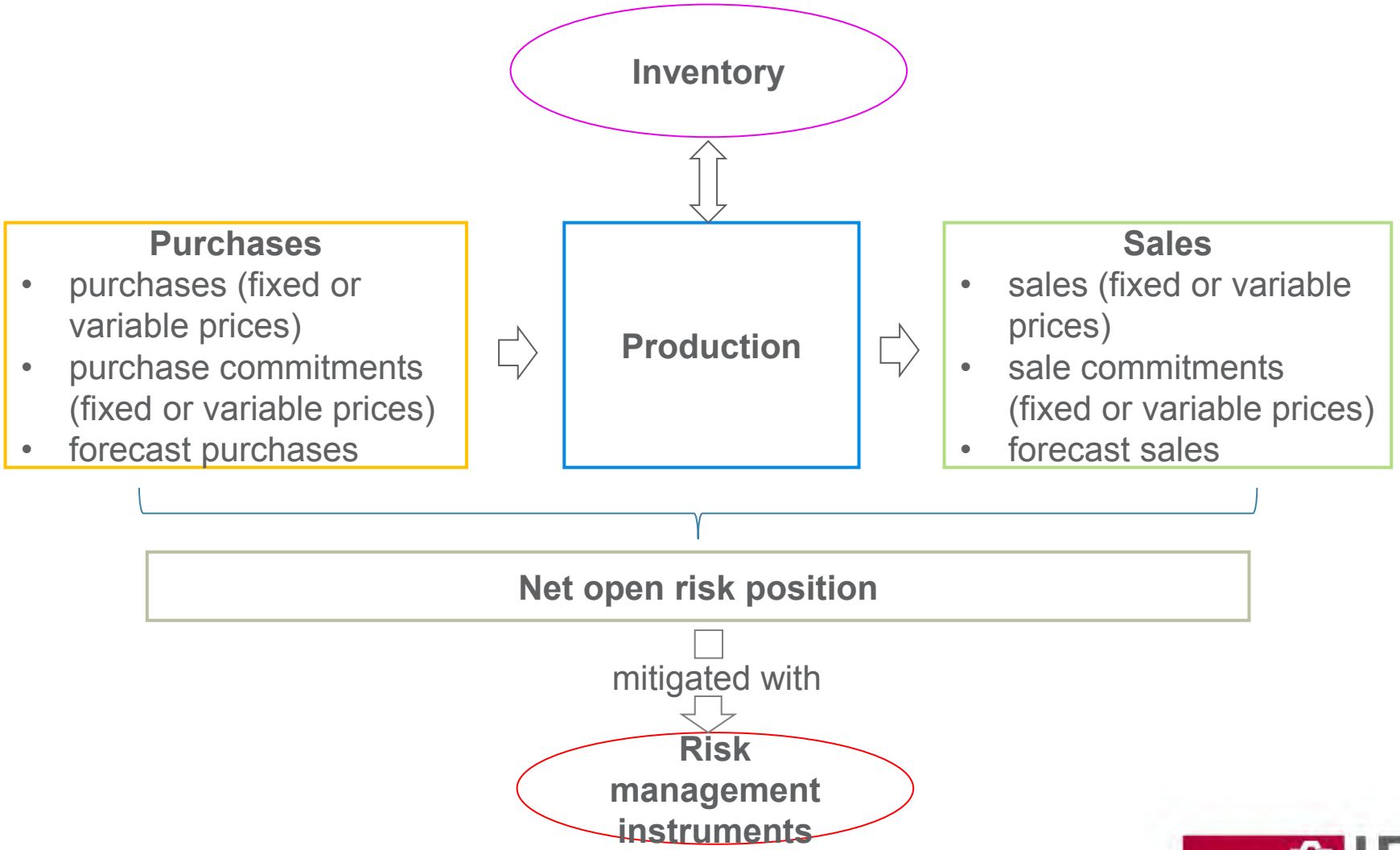
Other risks (1)

- The IASB would like to obtain specific input on:

✓ whether, and if so how and when, the PRA could be applied to dynamic RM other than interest rate risk management in banks; and

✓ whether there is a need for an accounting approach for other risks.

Other risks (2)



Other risks (3)

- Similarities between banks and entities in other industries regarding DRM:

✓ new exposures are added and existing exposures mature over time, with DRM undertaken on the net position;

✓ price risk is often considered in time bands;

✓ hedging strategies may not fully eliminate identified risks. This may be due to strategic management decisions to leave the positions unhedged.

Other risks (4)

Potential issue 1 : Unhedged positions

- It is common for entities to build up hedge positions over time.
- For instance, a RM policy may be to hedge 40% of exposures in the 2-3 year band, 70% in the 1-2 year band and 100% in the12 month band.
- Hence, if all the dynamically managed exposures are required to be included in the PRA, it could result in significant volatility in profit or loss from the revaluation of such open positions.

Other risks (5)

Potential issue 2 : Forecast transactions

- It is common for entities to include forecast transactions within managed risk portfolios.
- However, there are conceptual difficulties in recognising revaluation effects of forecast transactions for accounting purposes, even if such exposures are considered to be highly probable.

Alternative approach—PRA through OCI

- Under the alternative approach, 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 (eg interest rate swaps) is 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 may no longer net to zero in P/L;
  - Recycling from OCI to P/L.

More information

- The deadline for comments on the DP is **17 October 2014**.

- To have access to the DP, the Snapshot and to stay up to date with the latest developments, please visit the project homepage on:

  http://go.ifrs.org/Dynamic_Risk_Management

Questions or comments?—Thank you