

Deutsches Rechnungslegungs Standards Committee

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

6 June 2014

The views expressed in this presentation are those of the presenter,
not necessarily those of the IASB or IFRS Foundation

- 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).

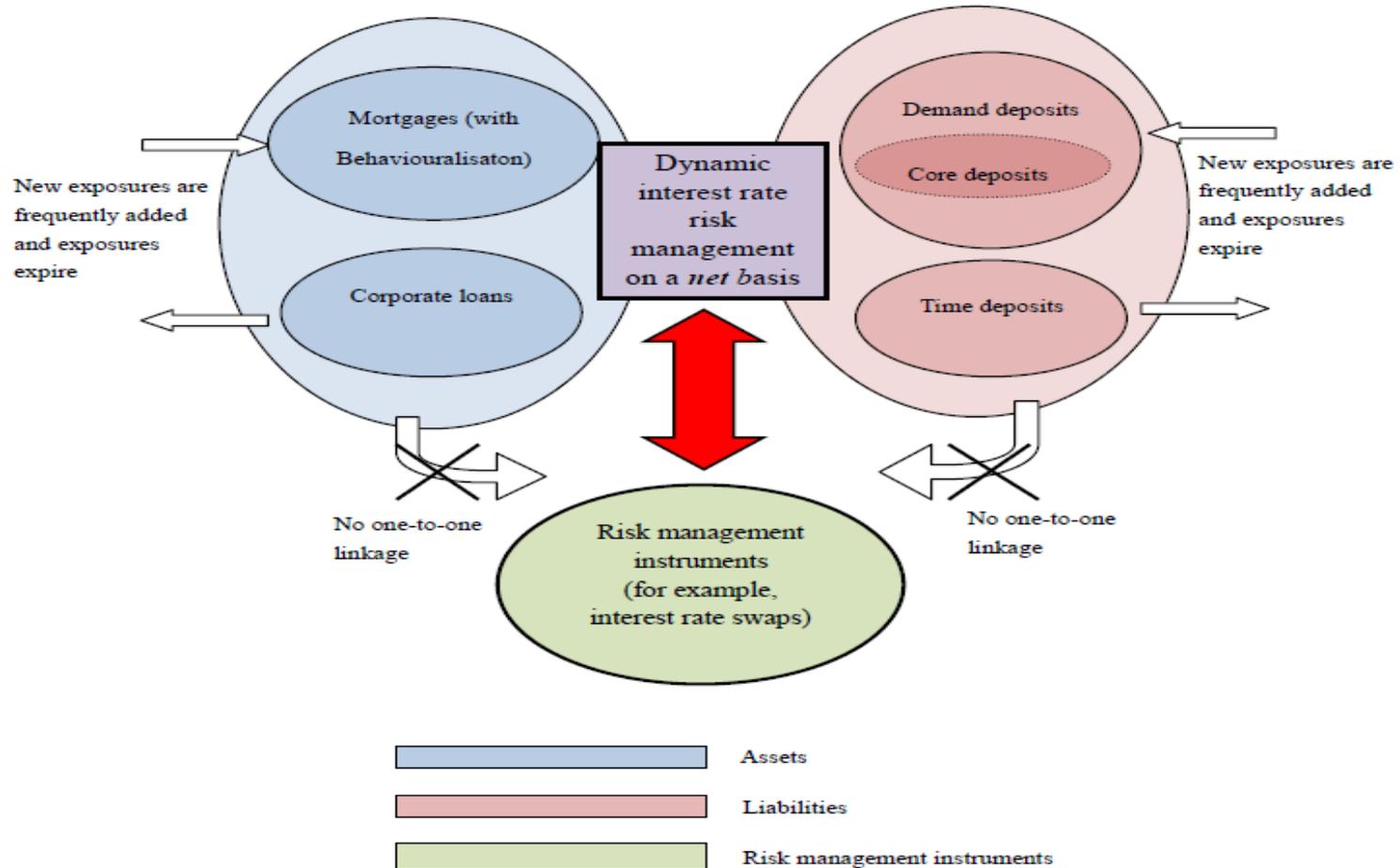
Dynamic Risk Management (DRM)

- 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.

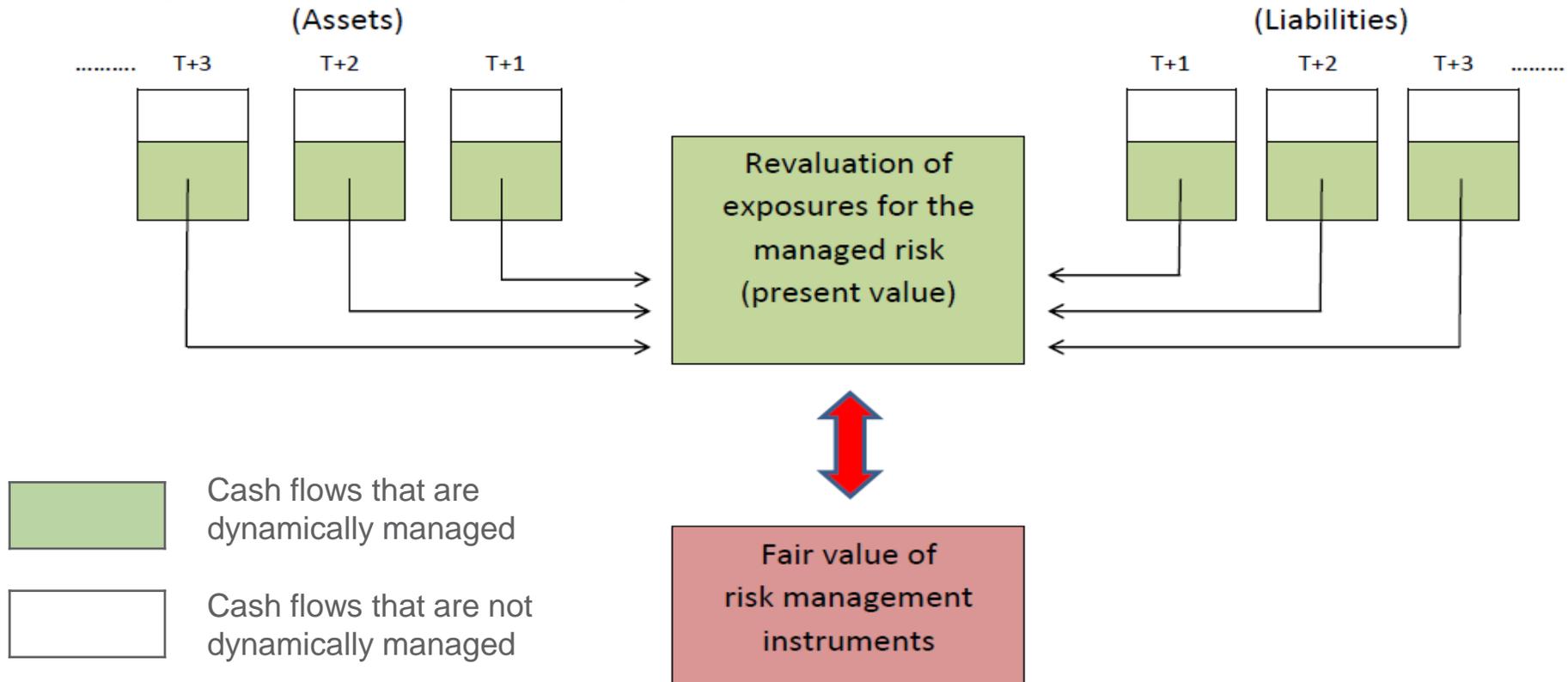
- Current hedge accounting requirements are often difficult to apply to DRM because:
 - ✓ One-to-one linkage between what is being hedged and the hedging derivative;
 - ✓ Can only indirectly accommodate DRM on a net basis through gross designation;
 - ✓ Can only accommodate open portfolios by treating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



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

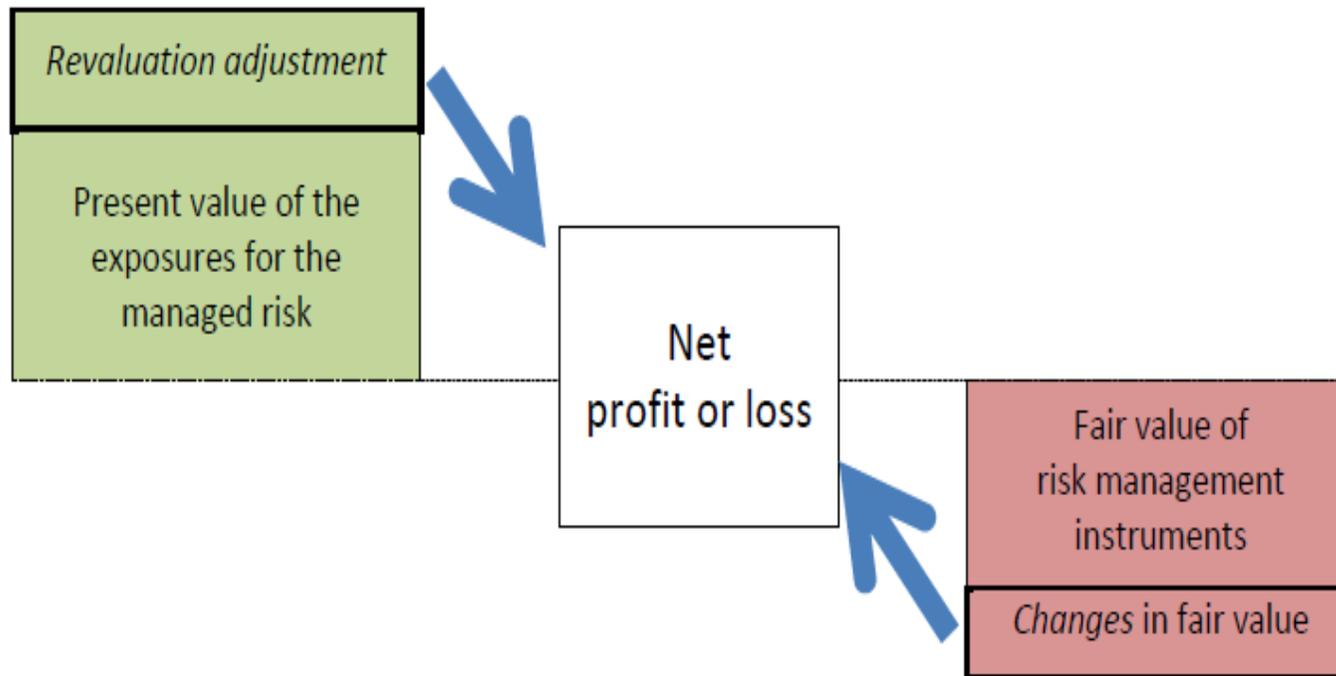
The Portfolio Revaluation Approach (PRA)

- 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*)

- The net effect between 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.



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.

What is included in banks' dynamic interest rate RM

Eligible hedged items under FV Hedge Accounting

Recognised assets
(eg loans) and liabilities
(eg deposits)

Firm commitments (eg
loan commitments)

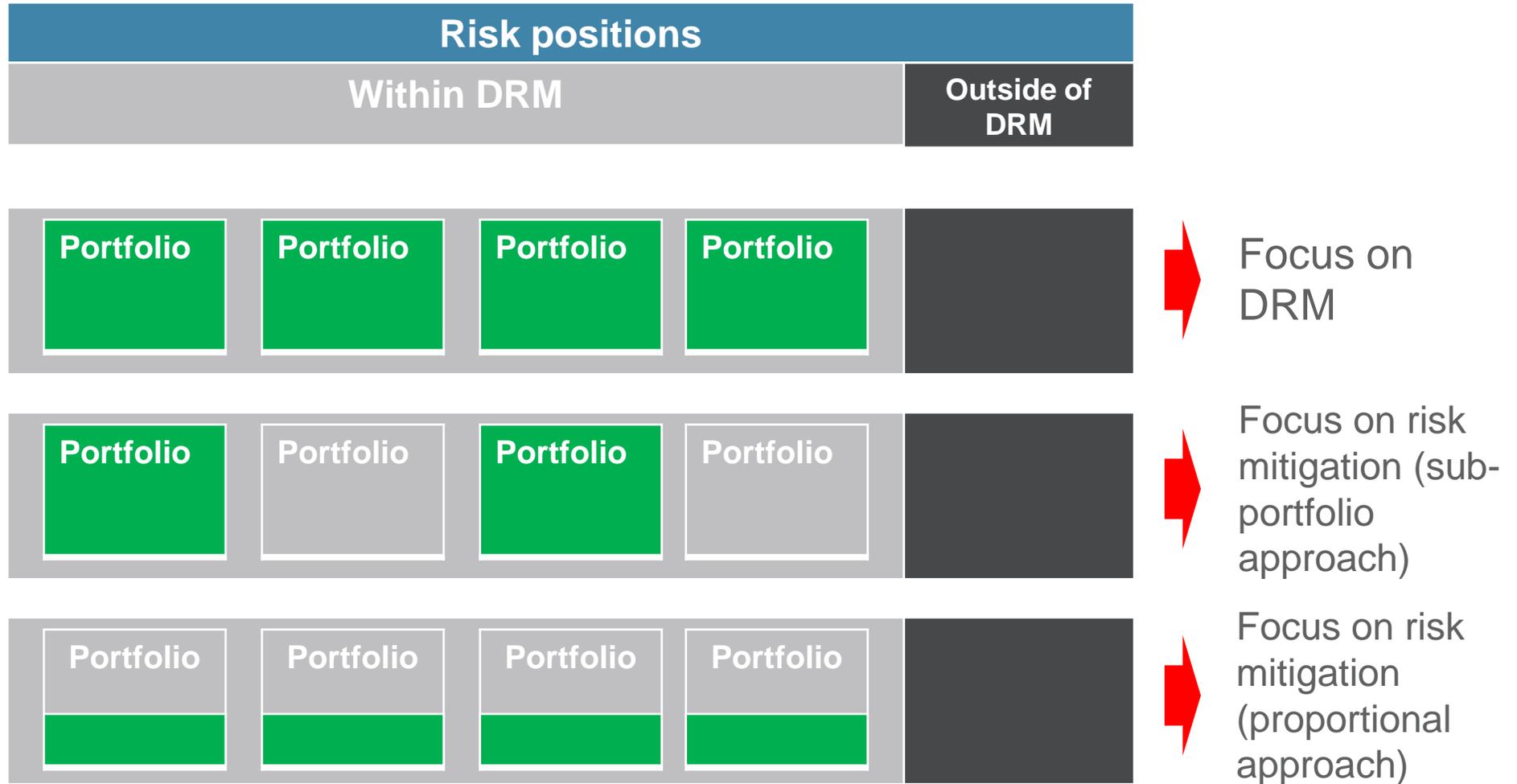
Core demand deposits

Equity model book

Pipeline transactions

- 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*)



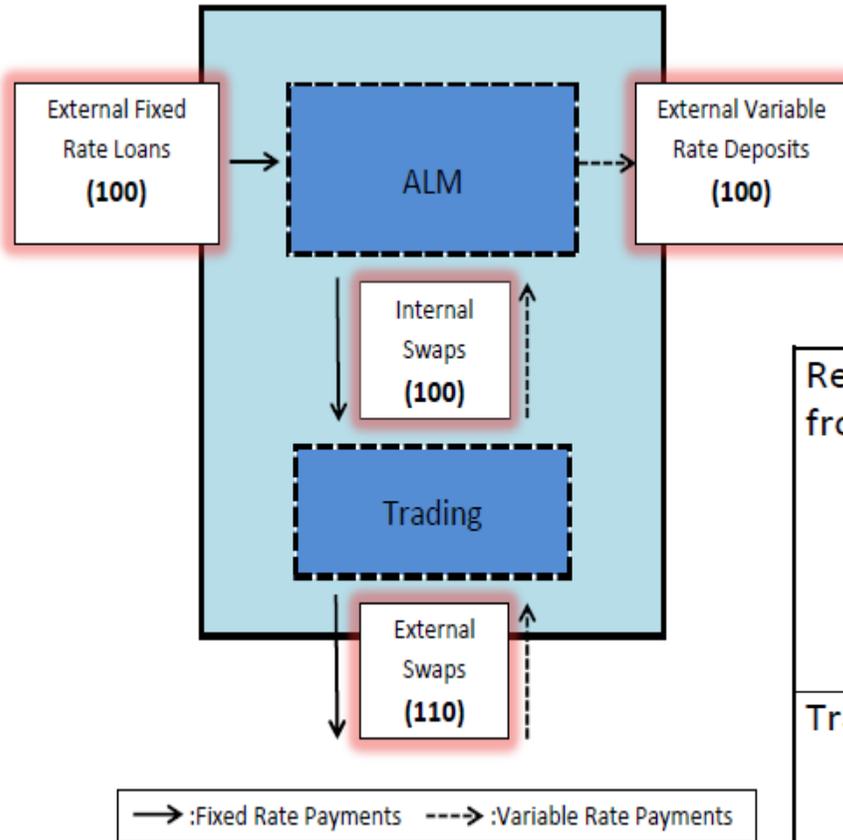
Statement of financial position

- 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

Presentation of internal derivatives



- Revaluation adjustment due to the decline in the benchmark yield curve for fixed interest rate exposures
- ALM shows a stable NII due to its DRM activities
- Trading reflects their position
- Net effect in P/L due to the use of internal derivatives is NIL

[P/L]

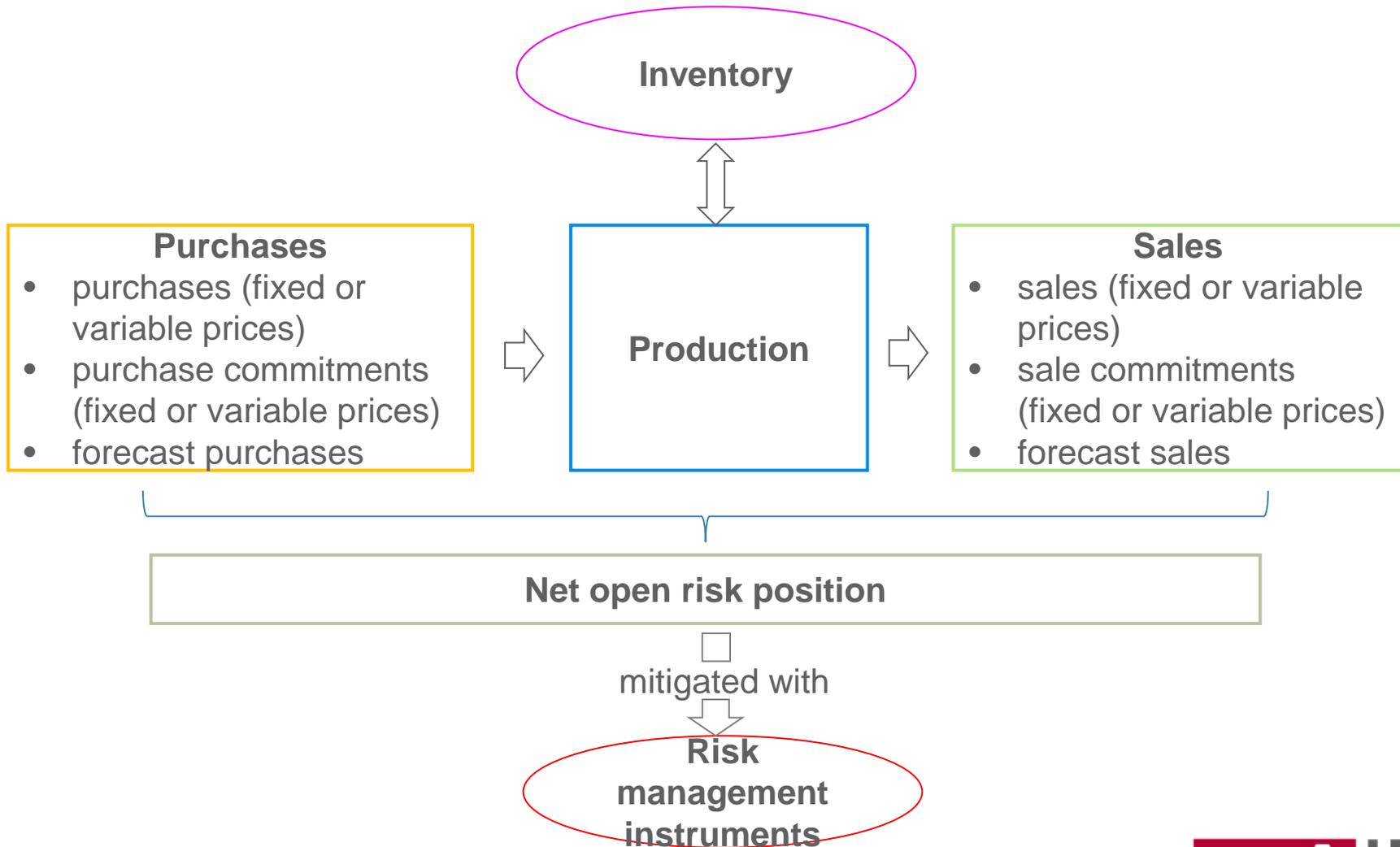
Revaluations from DRM	0	Revaluation of managed exposures	20
		Internal derivatives	(20)
Trading	(2)	Internal derivatives	20
		External derivatives	(22)
Total	(2)		

Net effect of gross presentation is zero in P/L

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.

- 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)



- 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.

- 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?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenters. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.



