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Discussion Paper

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

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At a glance

The IASB explores an accounting approach to better reflect dynamic risk management activities in entities' financial statements.

Risk management is a common activity that is applied by many entities. Entities often manage risk based on open portfolios (ie portfolios that change over time). Consistent with this, the risk management process is dynamic, with frequent monitoring of the net risk positions arising from open portfolios and corresponding reassessment of the risk activities.

The Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* explores a possible approach to accounting for an entity's dynamic risk management activities. The approach is the portfolio revaluation approach (PRA). When applying the PRA, exposures within open portfolios would be revalued with respect to the managed risk. This revaluation would offset the effect of measuring any risk management instruments (derivative instruments) that are used to manage those risks at fair value.

The current hedge accounting requirements are often difficult to apply to dynamic risk management, because one-to-one designation is usually required between the hedged item and the hedging instrument. In addition, there are restrictions imposed by the current hedge accounting requirements regarding what can be considered as eligible hedged items. These constraints make it difficult to faithfully represent dynamic risk management in entities' financial statements and can increase operational complexity.

The Discussion Paper uses dynamic risk management of interest rate risk, particularly as managed by banks, for illustrative purposes. However, the approach considered in the Discussion Paper is intended to be applicable to the dynamic management of risks arising from both financial and non-financial items.

The International Accounting Standards Board (IASB) will use the feedback received on the Discussion Paper to evaluate whether, and how, the new approach would result in an enhancement of the usefulness of the information provided by the financial statements. The feedback will be also useful to the IASB to assess whether the approach being explored is operational and to evaluate whether, and how, it could be applied to other risks.

The comment period of the Discussion Paper ends on 17 October 2014.

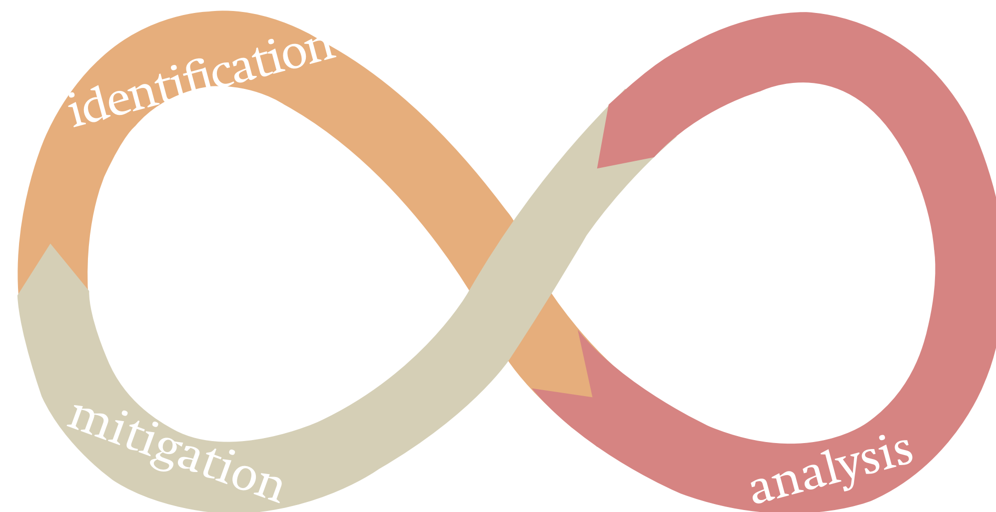
Dynamic risk management

Many entities are exposed to market price movements that affect their profitability. Managing these risks on a continuous and dynamic basis is one of the key elements of financial risk management.

For example, for a bank, net interest income is a significant, 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. Dynamic risk management of interest rate risk is therefore a critical component of banks' ongoing risk management activities.

Dynamic risk management is a continuous process that involves identifying, analysing and deciding on whether, and how, to mitigate a risk(s).

Dynamic risk management process



Dynamic risk management continued...

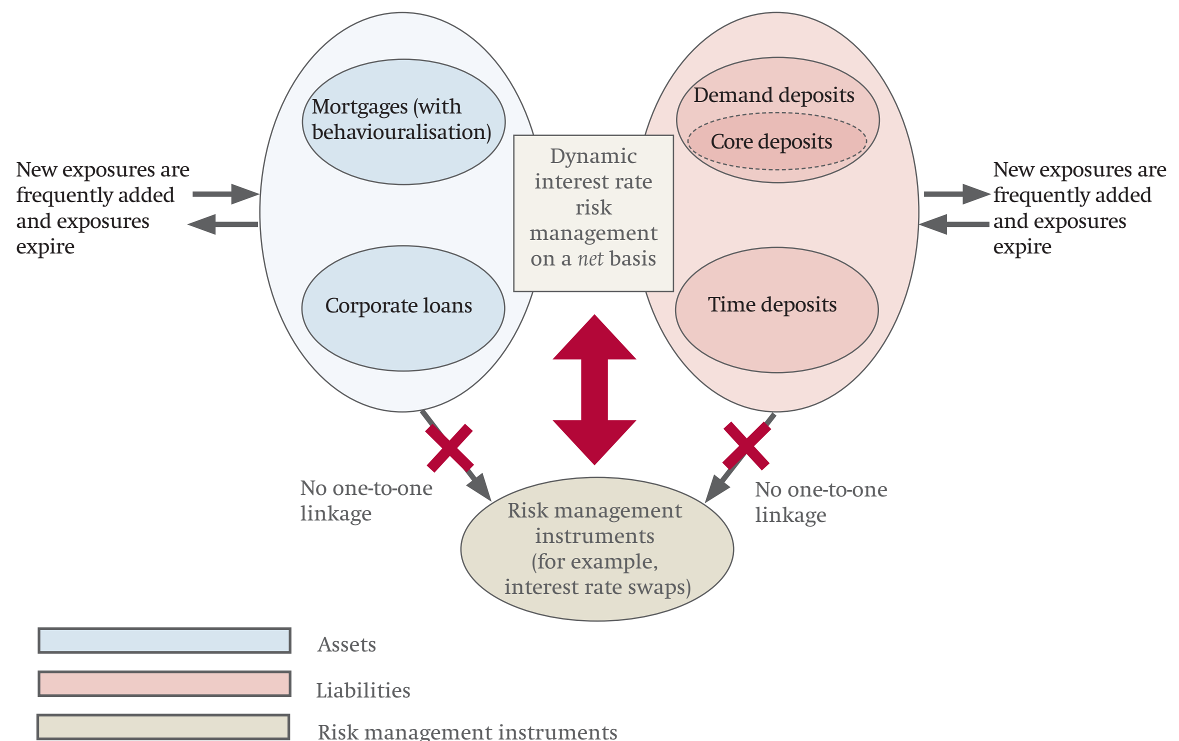
In banks, dynamic interest rate risk management is generally carried out on a portfolio basis.

Exposures in these portfolios change frequently, as new exposures are added and existing exposures mature or are prepaid (open portfolios). This changing nature of open portfolios requires banks to continuously reassess their exposure to interest rate risk in order to manage it.

Dynamic risk management is usually performed on a net basis. This means that an entity assesses its net risk position(s) arising from open portfolios in which a specific risk is being managed and decides whether it mitigates that risk by using derivatives.

The Discussion Paper sets out a possible approach for reflecting this dynamic risk management in the financial statements using interest rate risk as the basis of the analysis. However, it is not intended that the approach be limited to interest rate risk.

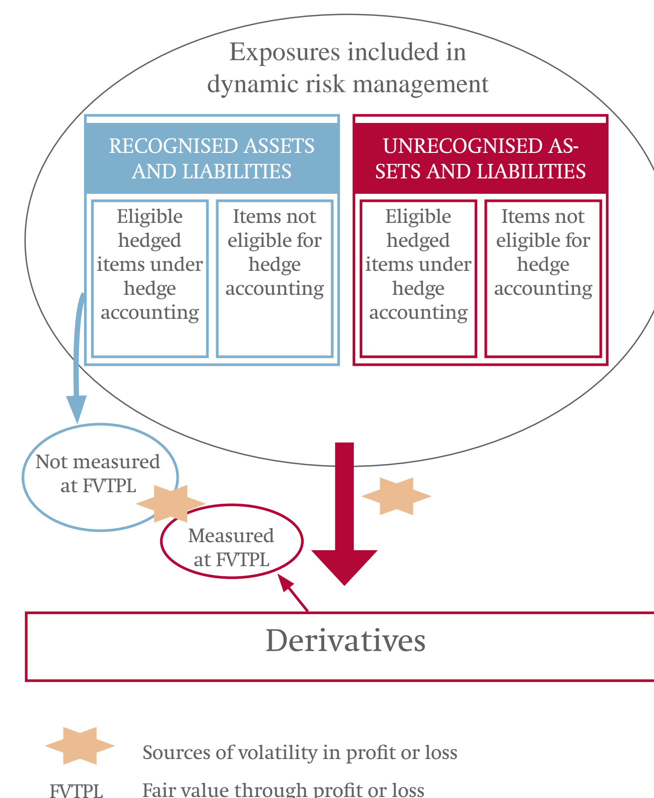
Dynamic interest rate risk management in banks



The current challenges

The current hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* provide limited accommodation for some key aspects of dynamic risk management.

Current challenges	Improvement opportunities for a new accounting approach
• One-to-one linkage between what is being hedged and the hedging derivative does not accommodate the dynamic nature of risk management.	• Enhances the information that entities provide about their dynamic risk management activities.
• Can only accommodate open portfolios by treating them as a series of closed portfolios with short lives. Is operationally challenging.	• Based more closely on risk management perspective and systems thereby reducing operational complexities such as tracking and amortisations.
• Can only indirectly accommodate risk management on a net basis through gross designation.	• Captures the dynamic nature of risk management on a net basis better.
• Allow for a degree of behaviouralisation of exposures (for example, prepayable mortgages) but this is limited.	• Considers behavioural factors affecting the risk arising from the exposures rather than purely contractual features.
• Limitations make it difficult to align with a risk management focus or systems.	• Considers different types of risks managed in open portfolios.



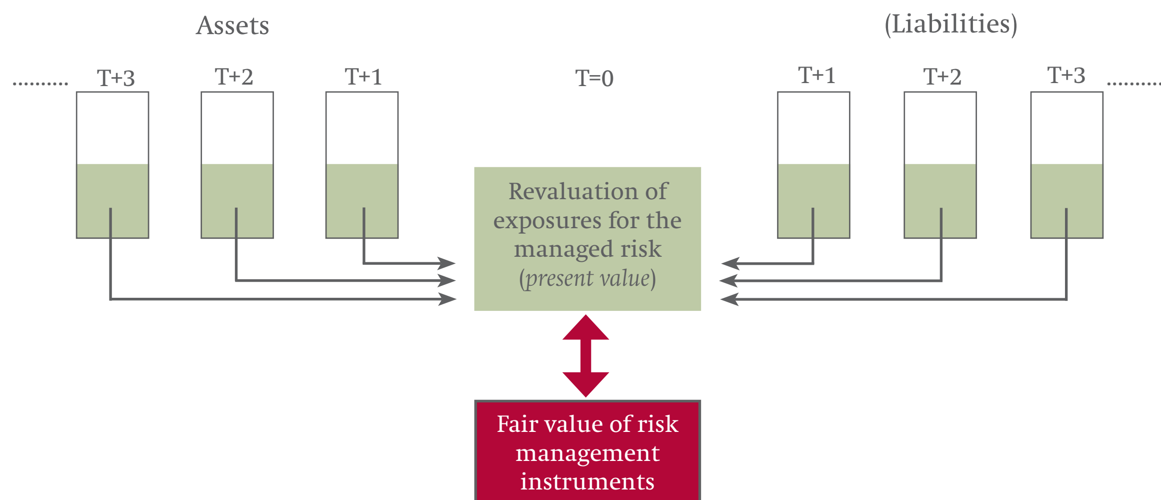
The portfolio revaluation approach

The Discussion Paper presents the PRA as a possible accounting approach to enhance the representation of dynamic risk management in entities' financial statements. At the same time the PRA would enable users of financial statements to better understand the performance of an entity by profit source and corresponding risk.

When applying the PRA, an entity would identify the risk being managed that has arisen from exposures within open portfolios and would revalue those exposures (managed exposures) only for changes in the risk being managed (represented by the green portion of the assets and liabilities in the following figure). Risks that are not dynamically managed (for example, credit margin, represented by the white portion of the assets and liabilities in the following figure) would not be included in the PRA. The PRA is accordingly *not* a full fair value model.

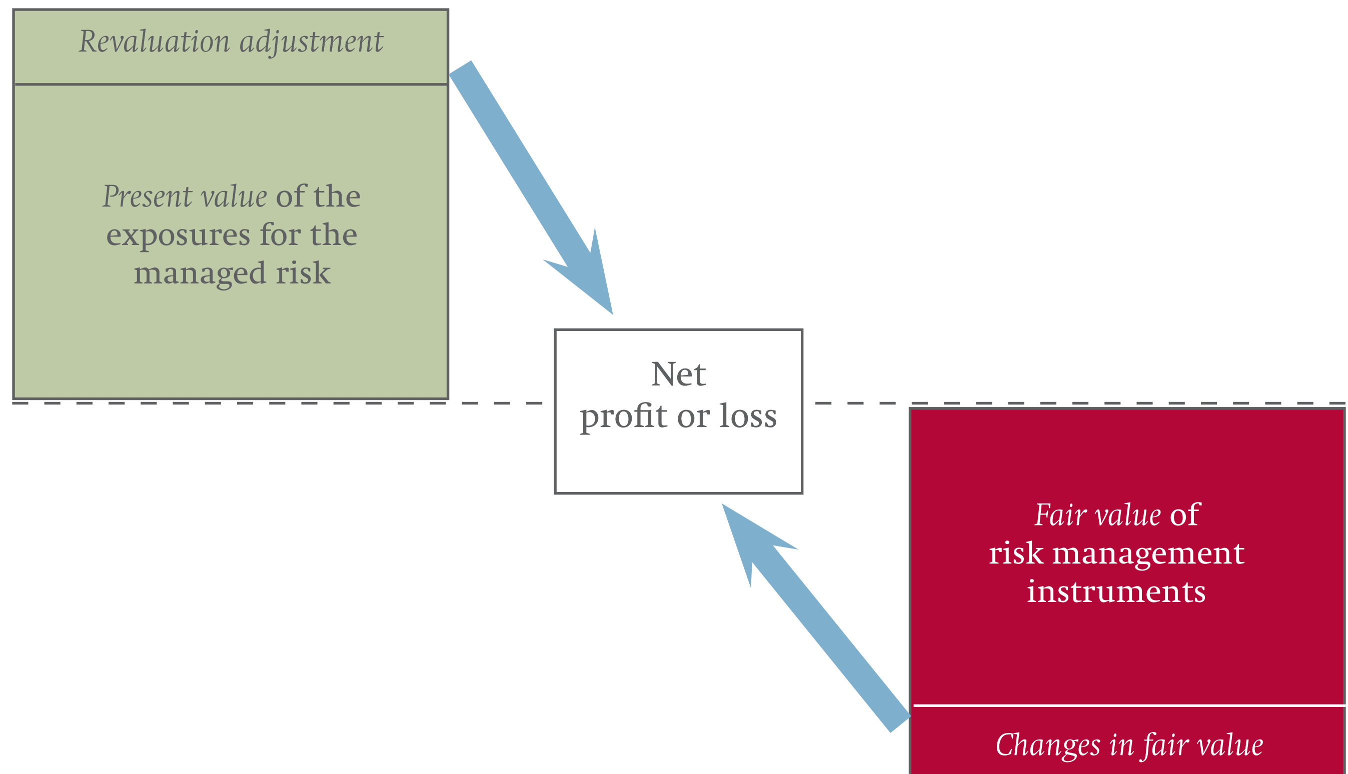
The revaluation of the managed exposures would be based on a present value technique. This revaluation would offset the effect of fair value changes of the risk management instruments (for example, interest rate swaps) used to mitigate those risks.

The PRA aims to achieve operational simplicity (see page 8) and to incorporate behavioural factors affecting the managed risk (see page 9). However, the PRA also poses some challenges (see page 10).



The portfolio revaluation approach continued...

The revaluation adjustment of the managed exposures arises from revaluing the cash flows of those exposures with respect to the managed risk. This revaluation adjustment would be recognised in profit or loss. The fair value changes of the risk management instruments would also be recognised in profit or loss.



Consequently, the net effect between the revaluation adjustment of the managed exposures and the fair value changes of the risk management instruments is reflected in profit or loss.

Operational simplicity

Some of the operational advantages of applying the PRA would be as follows:

One-to-one matching not required	Would reduce the complexities associated with one-to-one designations required under current hedge accounting.
Transfer pricing transactions	The PRA would leverage on transfer pricing mechanisms used by banks internally between asset and liability management (ALM) and the business units for the purposes of interest rate risk management. The Discussion Paper discusses the use of the interest rates and the cash flows arising from transfer pricing transactions in the application of the PRA as a proxy.
Presentation of internal derivatives	ALM typically manages exposures to interest rate risk by transferring risk to a trading unit using internal derivatives. The PRA discusses the possibility of reflecting the dynamic risk management undertaken by banks using such internal derivatives by grossing up offsetting internal derivative transactions between ALM and the trading unit in the statement of comprehensive income, with no net impact on the consolidated profit or loss.
Use of data for risk management purposes	There is a greater opportunity to use existing dynamic risk management data for accounting purposes.

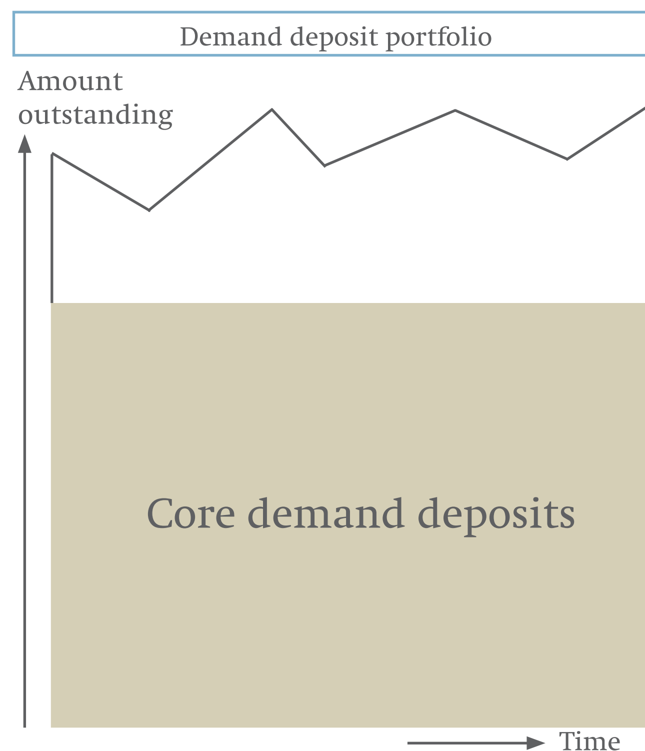
Behavioural factors affecting the managed risk (for example interest rate risk)

Core demand deposits

Even though contractually demand deposits have a variable interest rate and can be withdrawn at any time, because of their expected behaviour, banks consider core demand deposits as a source of stable fixed interest rate funding. They accordingly consider them as fixed interest rate liabilities for the purposes of dynamic risk management.

Consequently, dynamic risk management of interest rate risk considers the behavioural features of those deposits rather than their contractual features. For dynamic risk management purposes, the expected cash flow profiles of the exposures incorporate behavioural factors that affect the managed risk.

The Discussion Paper explores whether the cash flow of the exposures that are dynamically managed should be considered on a behavioural basis. In the case of core demand deposits, the consideration of behavioural factors represents a conceptual challenge because, for accounting purposes, deposits that are callable on demand are assumed to have zero fair value risk with regard to interest rate changes.



Prepayment risk

Another example of behaviouralisation can be seen with portfolios of prepayable instruments. Banks also typically consider the expected prepayment behaviour when managing portfolios of prepayable instruments. The Discussion Paper considers whether including these behaviouralised cash flows in the managed portfolio would be appropriate and whether it would contribute to a better reflection of dynamic risk management.

Challenges posed by the PRA

The most significant conceptual challenge when developing the PRA is to determine to what extent dynamic risk management should be reflected in the accounting. This could also have consequences for operationality and for the information that would be provided in the financial statements. Some specific challenges are as follows:

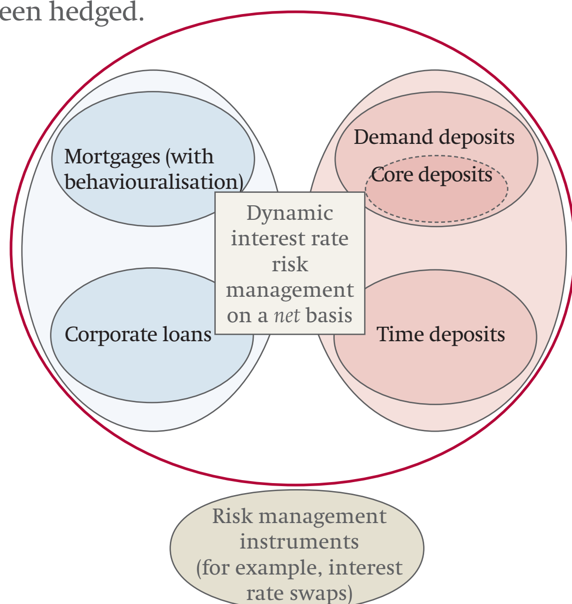
Which exposures to include in the PRA	Determining exposures that would be eligible to be included in the PRA is complex. This is because some exposures that risk managers would include in an open portfolio to achieve a risk management objective are exposures that may not be recognised for accounting purposes. For example, risk managers may consider exposures that have not yet been contracted or may target base returns on a bank's own equity that might not be deemed to be assets or liabilities for accounting purposes.
Behaviouralisation	Dynamic risk management is usually based on the expected cash flow profile of the exposures while accounting is usually based on their contractual lives. These different views raise conceptual issues as they lead to different recognition patterns of gains and losses.
Selection of the funding index representing the managed risk	The selection of a suitable funding index in the present value computation when determining the revaluation adjustment might require judgement, because it is not always possible to identify a 'known' funding source for particular exposures that will then provide a basis for determining the transfer price transactions that are to be used when applying the PRA.
Application of the PRA to other risks	The Discussion Paper focuses on the application of the PRA in the case of dynamic risk management of interest rate risk. The application of the PRA to other risks has not been explored with the same level of detail and hence it remains an area that would need further development. The IASB would like to understand the need for an accounting approach that would address other dynamically managed risks. Consequently, the IASB is requesting input about the application of the PRA to other risks (see page 13).

Scope alternatives presented in the Discussion Paper

The Discussion Paper presents two scope alternatives for the application of the PRA ('a focus on dynamic risk management' and 'a focus on risk mitigation').

A focus on dynamic risk management

In this case, the PRA would capture all the elements of dynamic risk management activity (ie risk identification, analysis and mitigation through hedging). The presence of *any* one of these elements would result in an entity applying the PRA to all net open risk positions regardless of whether they have been hedged.



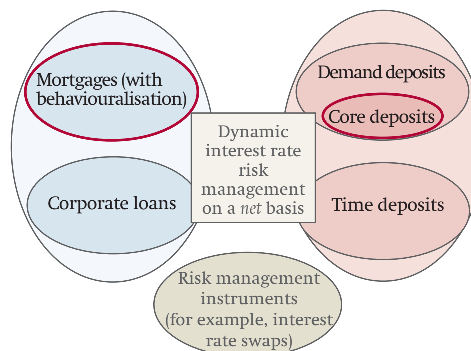
A focus on risk mitigation

In this case, an entity would apply the PRA only when *all* three elements of dynamic risk management have been undertaken (ie assuming risk identification and analysis have been undertaken, this approach would only apply to those circumstances in which an entity has undertaken risk mitigation activities through hedging).

Within this alternative, the Discussion Paper presents two additional approaches:

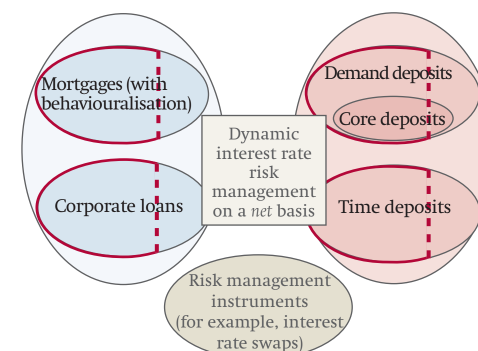
Sub-portfolio approach:

the PRA would be limited to only the dynamically managed sub-portfolios for which risk mitigating activities through hedging have been undertaken.



Proportional approach:

hedged positions may be determined as a proportion of a dynamically managed portfolio. In that case, the PRA would only be applied to that proportion.



Presentation alternatives of the PRA included in the Discussion Paper

Statement of financial position

The Discussion Paper suggests three alternatives for the presentation of the revaluation adjustments arising from the PRA in the statement of financial position:

- Line-by-line gross up—the carrying amount of exposures included within the managed portfolio would be adjusted to reflect the revaluation for the managed risk.
- Separate lines for aggregate adjustments to assets and liabilities—separate line items would be presented for both the revaluation adjustments for the exposures that are assets and those that are liabilities.
- Single net line item—the net revaluation adjustment for all exposures subject to the PRA would be presented in a single line item in the statement of financial position.

Statement of comprehensive income

The Discussion Paper considers two presentation alternatives for the statement of comprehensive income:

- Actual net interest income presentation—actual interest revenue and interest expense are presented along with an additional interest line item to present net interest income from risk management instruments. The revaluation effect from dynamic risk management activities would be presented in a separate line item and would provide information on mismatches in anticipated future net interest income.
- Stable net interest income presentation—net interest income would be reported on the assumption that a bank's risk management objective is to stabilise net interest income. The revaluation effect from dynamic risk management activities would provide information about how successfully a bank achieved its objective for both current and future net interest income.

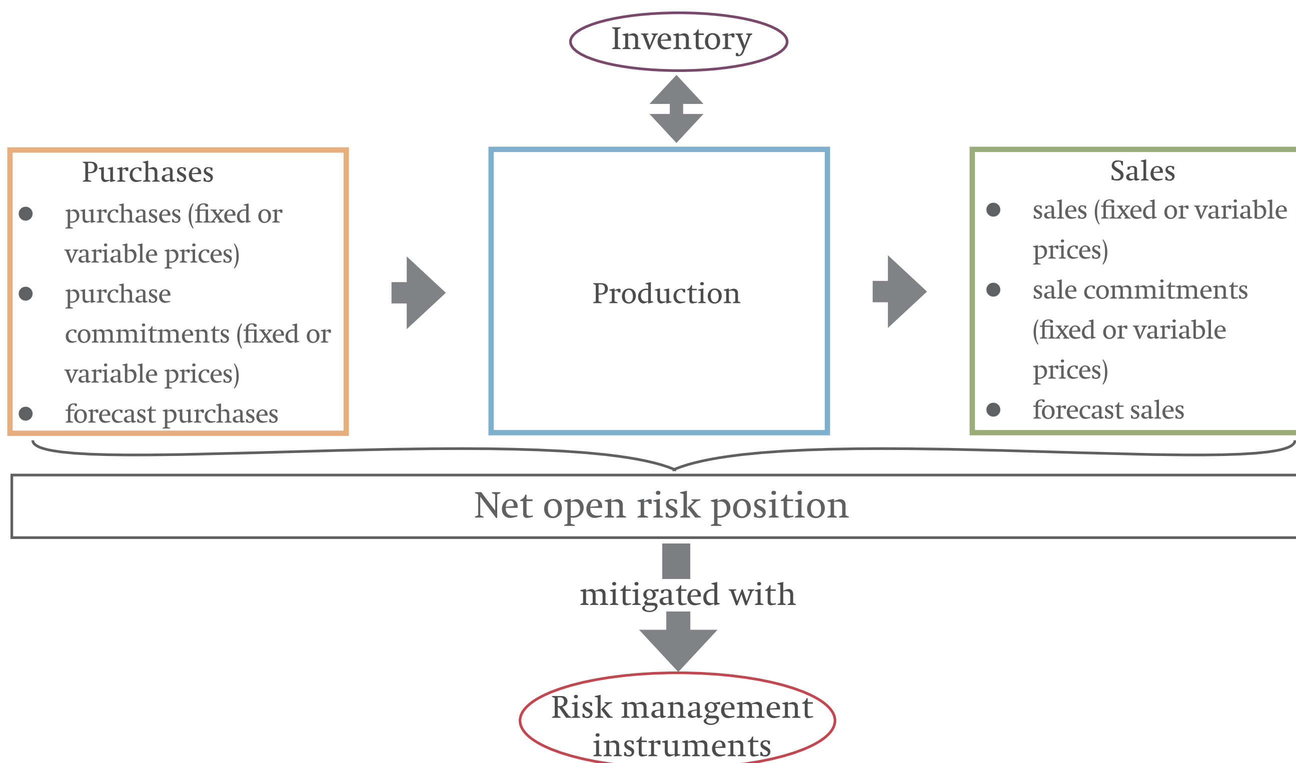
Net profit or loss would be the same under both presentation alternatives.

Applying the PRA to other risks

Entities in industries such as mining, utility or manufacturing also undertake dynamic risk management activities. This is because they are exposed to commodity price risk or foreign exchange (FX) risk that could significantly affect their profitability.

For example, one rationale for an entity to undertake dynamic risk management would be if the entity aimed to manage its gross profit from a particular portfolio of transactions with respect to commodity price risk. In such a case, commodity price risk may arise from purchases and sales (and inventory). In the event that the pricing of both purchase and sale contracts was based on the market price of the commodity, dynamic risk management might focus on identifying pricing mismatches between purchases and sales (and inventory), the absence of which could expose the entity to unstable gross profits.

The IASB is using the Discussion Paper as a basis for learning more about whether the PRA could be applied to other risks, such as commodity price risk or FX risk, and what, if any, special considerations would be necessary for risks other than interest rate risk.



Seeking your input

Who would be affected by the preliminary views in the Discussion Paper?

The preliminary views in the Discussion Paper are potentially relevant to all entities that manage risks in open portfolios on a dynamic basis. This is because the intention of the IASB is to understand whether the development of an accounting approach for dynamic risk management activities that would accommodate the management of different types of risks is necessary.

Nevertheless, the Discussion Paper includes a comprehensive overview on dynamic interest rate risk management in the banking sector because it is a well-known and documented dynamic risk management activity.

Seeking your input

The development of an accounting approach for dynamic risk management would not simply be a modification to hedge accounting requirements. It would represent a fundamental change in how risk management is considered for the purposes of financial reporting.

Given the complexities involved, the publication of a Discussion Paper provides the IASB with an appropriate context for seeking feedback on a broader range of alternatives and for asking interested parties more varied questions. The objective of this is to understand whether the development of an accounting approach that enhances the usefulness of the information provided by entities' financial statements and its operationality is necessary.

The Accounting for Macro Hedging project was initially part of IFRS 9 Phase III: Hedge Accounting. The IASB realised that the development of a thorough new accounting approach for dynamic risk management would take time and this conflicted with the time line for IFRS 9. Consequently, in May 2012 the IASB decided to separate the two projects, allowing it to continue the finalisations of IFRS 9 as planned while developing an accounting approach for dynamic risk management as a separate project.

- The IASB is particularly interested in understanding whether an accounting approach that reflects how entities manage risks dynamically would help users of financial statements to understand entities' dynamic risk management activities.
- IASB members and staff will undertake a range of outreach activities internationally during the comment period to discuss the Discussion Paper.

Further information

The Discussion Paper includes questions on the topics presented in the Discussion Paper. The IASB's discussions will take place in public meetings. To access information about those public meetings, to view the Discussion Paper and to submit your comments, please visit www.ifrs.org.

The deadline for comments on the Discussion Paper is **17 October 2014.**

Next steps

The IASB will consider the comments received on the Discussion Paper and the input gathered from further outreach to conclude on how to move forward in developing an accounting approach for dynamic risk management.

Stay informed

To stay up to date with the latest developments and to sign up for email alerts about the project, please visit the project homepage on http://go.ifrs.org/Dynamic_Risk_Management

Important information

This Snapshot has been compiled by the staff of the IFRS Foundation as guidance for interested parties. The views within this document are those of the staff who prepared this document and are not the views or the opinions of the IASB and should not be considered authoritative in any way. The content of this Snapshot does not constitute any form of advice or opinion.

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Notes

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