

## STAFF PAPER

July 2015

## IASB Meeting

<b>Project</b>	<b>Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging</b>		
<b>Paper topic</b>	The process to identify information needs		
<b>CONTACT(S)</b>	Yuji Yamashita	yyamashita@ifrs.org	+44 (0)20 7246 6470
	Mariela Isern	misern@ifrs.org	+44 (0)20 7246 6483

This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

**Background and the purpose of the paper**

1. At the May 2015 meeting, the IASB discussed the next steps for the project Accounting for Dynamic Risk Management Activities: a Portfolio Revaluation Approach to Macro Hedging (hereafter, ‘the project’).<sup>1</sup> In particular, the IASB acknowledged that any solution would need to consider the information needs of constituents concerning dynamic risk management activities, and that its approach should consider disclosures, recognition and measurement to arrive at a complete and consistent set of proposals to address those needs.
2. Accordingly, the IASB tentatively decided:
  - (a) that it should first consider how the information needs of constituents concerning dynamic risk management activities could be addressed through disclosures, before considering the areas that need to be addressed through recognition and measurement; and
  - (b) to prioritise the consideration of interest rate risk and consider other risks at a later stage in the project.
3. The objective of this paper is to set up the process to identify the information needs of constituents concerning dynamic risk management activities for interest rate risk.

<sup>1</sup> Agenda Paper 4 discussed in May 2015 can be found at:

<http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/May/AP04-Dynamic-Risk-Management.pdf>

4. At this meeting, we are seeking input on the direction in which we should proceed to ensure that the process for identifying the information needs of constituents is appropriate and complete.
5. This paper is structured as follows:
  - (a) Useful information concerning what?—(paragraphs 6–20)
  - (b) Whose information needs?—(paragraphs 21–24)
  - (c) Why this information is needed?—(paragraphs 25–28)
  - (d) Sources for obtaining information—(paragraphs 29–30)

### **Useful information concerning what?**

6. The qualitative characteristics of useful information, as stated in the *Conceptual Framework for Financial Reporting* (hereafter, ‘the *Conceptual Framework*’) will be our paradigm for deciding on the suitability of including any of the identified information needs within the model that we will be developing. In accordance with the *Conceptual Framework*, ‘if financial information is to be useful, it must be **relevant** and **faithfully represent** what it purports to represent. The usefulness of financial information is enhanced if it is *comparable, verifiable, timely* and *understandable*’ (see paragraph QC4 of the *Conceptual Framework*).<sup>2</sup>
7. Apart from the fundamental and enhancing qualitative characteristics of useful information, the process for deciding whether a specific piece of information should be included in the model should also consider the benefits and related costs of reporting that particular information. This, too, is in accordance with the *Conceptual Framework* (see paragraphs QC35–QC39).<sup>3</sup>

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<sup>2</sup> The staff note that the Exposure Draft (ED) *Conceptual Framework for Financial Reporting* (hereafter, the *Conceptual Framework ED*) published in May 2015 has not proposed any change to that paragraph of the current *Conceptual Framework*. That paragraph has only been renumbered in the *Conceptual Framework ED* (paragraph 2.4).

<sup>3</sup> The staff note that the *Conceptual Framework ED* has not proposed to change the section ‘The cost constraint on useful financial reporting’ of the current *Conceptual Framework*. The paragraphs of that section have only been renumbered in the *Conceptual Framework ED* (paragraphs 2.38–2.42).

8. Having set up the reference that we will use to measure against the usefulness of a specific piece of information (ie the *Conceptual Framework*), we will also need to precisely delineate the area for which useful information needs to be identified.
9. At its May 2015 meeting, the IASB tentatively decided to first consider how the information needs of constituents concerning *dynamic risk management activities* could be addressed through disclosures before considering the areas that need to be addressed through recognition and measurement. The staff think that, along with the information needs of constituents concerning dynamic risk management activities (see paragraphs 12–20), the following matter should also be considered within the scope of our work.
10. The feedback received on the DP revealed the concern of some constituents that any recognition, measurement or disclosure requirements for entities that carry out dynamic risk management activities could prevent those entities from being comparable with entities that do not carry out those activities. In some cases, these concerns also stemmed from the fact that any requirements for entities that carry out dynamic risk management activities could actually make them appear even riskier than entities that do not carry out those activities but that, however, face the same risk. In other words, if the scope of the work is only focused on useful information arising from *dynamic risk management activities*, entities that do not undertake dynamic risk management of interest rate risk but that, for example, have material net open interest rate risk positions will be outside the scope of any information requirements resulting from this project. However, users of financial statements (hereafter ‘users’) may find information about an entity’s net interest income (NII) by its source (ie customer margin and the result of net open interest rate risk positions) to be useful regardless of whether the entity undertakes dynamic risk management activities.
11. Consequently, the staff think that our work should not only focus on the information needs of constituents concerning dynamic risk management activities for interest rate risk. We think that we should also consider whether any piece of information that we decide to include in the model would also be useful even if it arose from entities that do not undertake dynamic risk management activities, if those entities are also exposed to interest rate risk. We think that by applying this

perspective to our work, we could also limit the cases in which comparability could be impaired between entities that undertake dynamic risk management and those that do not.

### Question for the IASB

Does the IASB agree that comparability between entities that undertake dynamic risk management activities and those that do not should be considered when identifying the information needs of constituents?

### ***Useful information concerning dynamic risk management activities***

12. The feedback received to the Discussion Paper ‘Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging’ (hereafter, ‘the DP’) reflects significant differences in views between users and preparers on what the objectives of the project should be (see Agenda Paper 4 that was discussed with the IASB at its meeting in May 2015).
13. This is obviously a major challenge that we will have to overcome while carrying out the exercise of identifying useful information concerning dynamic risk management activities. The staff think that one way of solving this challenge is to concentrate the analysis on the main features of dynamic risk management, the information needs and concerns of constituents concerning these features and contrast them against the qualitative characteristics of the Conceptual Framework.
14. We plan to discuss with the IASB the main features of dynamic risk management in detail in future meetings, but we thought that the following example could be useful for the purposes of illustrating this process.
15. When entities undertake dynamic risk management activities they typically use *behaviouralisation* as it allows them to focus on the expected cash flow profile rather than on the contractual lives of the exposures.
16. As discussed with the IASB at its meeting in February 2015, preparers generally supported cash flows being based on a behavioural basis, because this is considered

to better reflect the economics of the exposures. Users also generally shared this view.<sup>4</sup>

17. When assessing the usefulness of constituents' information needs against the qualitative characteristics of useful information in accordance with the *Conceptual Framework*, we think that information arising from behaviouralisation when employed in dynamic risk management should contribute to the faithful representation of dynamic risk management activities (ie the economic phenomena). The recently published Exposure Draft (ED) *Conceptual Framework for Financial Reporting* (hereafter, 'the *Conceptual Framework ED*') added the following consideration to faithful representation that we think it is key in the area of behaviouralisation:
  - 2.14 [...] A faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form. Providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation.
18. In terms of relevance, the information arising from behaviouralisation is relevant because it is capable of making a difference in the decisions made by users. This is because behaviouralisation provides information that has predictive value about an entity's profitability and liquidity. For the purposes of illustrating this point, consider information about an entity's expected access to a funding source (for example, information about the expected life of the entity's deposits) combined with information about the entity's current balance sheet structure (for example, its dependency on deposits as a funding source) and expectations about future interest rates (for example, an expected increase in interest rates). This set of information can help users conclude on how all these factors could affect the entity's future profitability, funding gap and, consequently, its liquidity profile.
19. However, constituents also have some concerns about the information that would arise from behaviouralisation. As discussed in previous meetings, one of the concerns raised is how the measurement uncertainty of the estimate could affect

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<sup>4</sup> Agenda Paper 4C discussed in February 2015 can be found at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/February/AP04C-Accounting%20for%20Dynamic%20Risk%20Management.pdf>

the usefulness of the information in terms of making it less relevant. Other concerns relating to behaviouralisation are that it may provide opportunities for earnings management and that it could impair comparability among entities' financial statements. We would also need to assess these concerns against the qualitative characteristics of useful financial information in accordance with the *Conceptual Framework*, because these concerns may contribute to impairing the usefulness of the information being considered. The qualitative characteristics of useful financial information that could be impaired by the concerns raised above are relevance, neutrality and comparability.

20. In summary, when considering the usefulness of information arising from any of the key features of dynamic risk management activities (ie in the case of the example above, behaviouralisation), constituents' needs and concerns should be analysed in detail for the purpose of assessing the usefulness of the information arising from that key feature. On the basis of that assessment we will decide whether or not to include that piece of information in the model.

### **Whose information needs?**

21. In identifying the information needs of constituents concerning dynamic risk management activities, as already discussed with the IASB at its meeting in May 2015, the staff will mainly focus on the information needs of two types of constituents: users and preparers.
22. Regarding the information needs of users, the staff will mainly focus on information that is useful to existing and potential investors, lenders and other creditors. These are the users who must rely on general purpose financial reports for much of the financial information they need—see paragraph OB5 of the *Conceptual Framework*.<sup>5</sup>
23. In the case of preparers, we have learnt that dynamic risk management activities are a critical part of their management of interest rate risk. Consequently, the representation of dynamic risk management activities and the information arising

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<sup>5</sup> The staff note that the *Conceptual Framework ED* has not proposed to modify the meaning of the terms *users* or *primary users* from the current *Conceptual Framework* (see paragraph 1.5 of the *Conceptual Framework ED*).

from this representation in the financial statements is an area of key interest for preparers.

24. The staff acknowledge that regulators also have a significant interest in this project. However, the staff do not think we need to specifically address their information needs because they can usually require entities to provide information directly to them.<sup>6</sup>

### **Why is this information needed?**

25. As discussed with the IASB at its meeting in February 2015, users generally think that a closer alignment between financial reporting and dynamic risk management would ultimately provide more useful information. On their side, preparers think that financial reporting would improve if they were able to convey information about their dynamic risk management activities in a direct manner to users.
26. A clear example of an area in which currently the information provided to users does not reflect what entities do is proxy hedging. Proxy hedge accounting takes place when an entity hedges an item, but then designates another item for accounting purposes. A well-known example of the use of proxy hedge is when an entity manages interest rate risk using core demand deposits. Because demand deposits are not eligible hedged items, an entity may try to represent the hedging of demand deposits indirectly by finding items that are eligible for hedge accounting as a proxy.
27. In the case of proxy hedging, both users and preparers would prefer to receive and provide information that would reflect what entities actually do. Proxy hedging results in information that does not faithfully represent an entity's dynamic risk management activities; it actually contributes to obscuring those activities and their effects in the entities' financial statements. Information about an entity's dynamic risk management activities that would closely match these activities would represent an enhancement in the usefulness of financial information.

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<sup>6</sup> General purpose financial reports are not primarily directed to regulators (see paragraph OB10 of the *Conceptual Framework* or paragraph 1.10 of the *Conceptual Framework ED*).

28. Other matters that support the need for information about dynamic risk management activities are as follows:
- (a) the existing accounting requirements (IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*) do not always adequately represent risk management when it is dynamic because they deal with one-to-one hedging relationships between the hedged item and the hedging instrument;
  - (b) it can help to promote better understanding of management's decisions. For example, the case of an entity deciding to intentionally leave net open risk positions unhedged can translate into useful information for users so that they can better understand and assess the entity's risk exposure and corresponding management's rationale; and
  - (c) it would allow users to assess the impact of an entity's dynamic risk management activities on its NII (ie NII pre- and post-dynamic risk management activities) and derivatives by use (ie dynamic risk management activities and trading).

### **Sources for obtaining information**

29. The most direct sources for identifying the information needs among users and preparers will be the comment letters on the DP and the feedback received from outreach activities during the comment period. Consequently, the staff will review the feedback received from respondents and from outreach meetings accordingly.
30. In addition, the staff plan to review various sources of information (for example, annual reports of major entities in various jurisdictions, information required by prudential regulators and information that entities prepare when communicating with investors) considering the approach discussed in this paper with the objective of having better insights into what users may need and on what preparers typically communicate.



## Question for the IASB

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Does the IASB have any comments on how we have described the process for identifying users' and preparers' information needs?

Is there anything else this process should consider?