STAFF PAPER

May 2016

IASB Meeting

Project	**Accounting for Dynamic Risk Management**		
Paper topic	Agenda Consultation		

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Purpose and structure of this paper

1. The purpose of this paper is to provide input for the International Accounting Standards Board ('the Board') to consider when it analyses the feedback received in the agenda consultation for the project *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* ('the project'). This paper does not include questions for the Board.

2. This paper is structured as follows:

    (a) Background of the project

    (b) Comments received from investors responding to the online survey

    (c) Comments relating to the objective and scope of the project

    (d) Who thinks this project is important and why?

    (e) Who thinks this project is unimportant and why?

    (f) Current status of the project

Background of the project

3. The Board began its deliberations on the project in September 2010. The drivers for initiating the project were the difficulties associated with applying existing

hedge accounting requirements to a dynamically managed portfolio and the fact that the existing portfolio hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* are limited to only interest rate risk.

4. In May 2012 the Board tentatively decided to develop a Discussion Paper as the initial due process step. The Board noted that the development of an accounting model for dynamic risk management would involve complexities that would take time to resolve. This conflicted with the timeline for IFRS 9 *Financial Instruments*. Consequently, in May 2012 the Board separated the two projects, allowing it to finalise IFRS 9 while progressing with the accounting for dynamic risk management as a separate project. This implied that while undertaking the project on accounting for dynamic risk management, the status quo of 'macro hedge accounting' under IAS 39 would broadly be maintained in the meantime. As explained in paragraph BC6.91 of IFRS 9, this meant that:

    (a) an entity could continue to apply IAS 39 for 'fair value hedge accounting for a portfolio hedge of interest rate risk', which is an exception to the hedge accounting model in IAS 39 and is strictly limited to that particular type of hedge;[1] but

    (b) all cash flow hedges would be within the scope of the hedge accounting model of IFRS 9—including those that are colloquially referred to as 'macro cash flow hedges' under IAS 39 today. It is worth noting that even though the Board decided not to carry forward the Implementation Guidance that accompanied IAS 39 and that illustrated 'macro cash flow hedge accounting', the Board had not rejected that guidance (see paragraph BC6.95 of IFRS 9).

5. While developing IFRS 9, the Board received feedback that some entities did not want to have to apply the hedge accounting requirements of IFRS 9 before the project on accounting for dynamic risk management was completed. Those entities cited various concerns such as uncertainty whether IAS 39-compliant practices for designating hedging relationships for portfolio hedging or macro

[1] The 'fair value hedge accounting for a portfolio hedge of interest rate risk' is included in paragraphs AG114-132 of IAS 39.

hedging activities would still be available, the costs of assessing whether those practices are IFRS 9-compliant and the risk of having to change those practices twice.

6. The Board considered that feedback and possible alternatives, such as providing a scope exception to the hedge accounting requirements in IFRS 9. The Board decided to provide entities with an accounting policy choice until the project on accounting for dynamic risk management is completed. The choice is between:

    (a) applying the hedge accounting requirements in IFRS 9 (but being able to apply IAS 39 for 'fair value hedge accounting for a portfolio hedge of interest rate risk'); and

    (b) continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting, including 'fair value hedge accounting for a portfolio hedge of interest rate risk'.

Comments received from users responding to the online survey

7. The investors providing input to the online survey carried out as part of the work on the Agenda Consultation stated the following:[2]

    (a) while acknowledging that this project is important for particular industries such as financial institutions, some investors commented that they were not sure whether a comprehensive accounting solution could be developed to reflect the economics of dynamic risk management activities; and

    (b) a few investors commented that enhanced disclosures would enable them to understand what entities do.

Comments relating to the objective and scope of the project

8. Some constituents provided comments relating to the objective or the scope of the project. Those comments can be summarised as follows:

[2] An overview of the investor feedback relating to the Agenda Consultation was discussed by the Board at its April 2016 meeting: http://www.ifrs.org/Meetings/MeetingDocs/IASB/2016/April/AP24C-Agenda-Consultation.pdf

(a) EFRAG and a representative body of preparers based in Europe commented that the objective of the project should be focussed on the development of a macro hedge accounting model and not on the accounting for dynamic risk management in general.

(b) An African standard-setter commented that the Board should focus more on simplifying and adapting the current requirements in IAS 39.

(c) A European representative body of preparers in the banking industry believed that, if the Board considers the project to be a major research project, the objectives of the project should be clearly defined. For this constituent and for another European representative body of preparers encompassing various industries, those objectives should be the enhancement of the usefulness of the financial information (ie an improvement of the disclosures relating to risk management activities in financial reporting). EFRAG and a professional accounting body based in Europe did, however, think that disclosure requirements could not be regarded as an appropriate alternative to the current accounting requirements in IAS 39.

(d) A few representative bodies of preparers in the energy and utilities industries commented that the scope of the project should include not only risks managed by banks, but also risks managed by energy companies (such as commodity price risks). These constituents think that how commodity price risks are hedged is not conceptually different from how banks may hedge their interest rate risk.[3] Another reason provided by one of these constituents is that the existing hedge accounting requirements are not fit for purpose for accommodating the needs of the energy industry. They stated that the following remain a burden: hedging of net positions in open portfolios, allocation of hedges to a specific time period in a dynamic environment, documentation requirements and effectiveness tests.

[3] In relation to this comment, it is worth noting that in May 2015 the Board tentatively decided to prioritise the consideration of interest rate risk and to consider other risks at a later stage in the project.

Who thinks this project is important and why?

9. Approximately half of the constituents providing feedback on the project stated that the project is important to them. This section summarises their feedback:

   (a) Most of the representative bodies of preparers in the banking industry and prudential regulators placed a high importance on this project. One of the main reasons is because of the obvious relevance of interest rate risk management to the banking industry and because problems are encountered when applying 'fair value hedge accounting for a portfolio hedge of interest rate risk' under IAS 39 to dynamic portfolio hedges (for example, because of frequent redesignations). One of these constituents stated, however, that the Board should proceed to an Exposure Draft only if the potential solutions were of high quality and were implementable. One of these constituents based in Asia provided another reason for viewing this project as highly important: that it was difficult for entities to have a complete assessment of the final impact of IFRS 9 before this project has been completed. A few of these constituents based in Europe also stated that the project could contribute to the removal of the European Union carve-out and had the potential to provide more transparency in the reporting of risk management activities in the financial statements.

   (b) Many national standard-setters in Europe and EFRAG also think that this project has a high importance. EFRAG stated that the project should be considered as part of the active agenda, not as a research project. The project was initially identified as a component of the IFRS 9 project and in EFRAG's understanding it has been postponed, but EFRAG indicated that it is important to make significant progress, because there is a lack of guidance in IFRS Standards. One national standard-setter commented, however, that there is a need to bring the project to its conclusion by either identifying a solution or concluding that no further work will be carried out.

(c) Energy companies ranked this project with a high importance.[4] The main reasons provided are, as previously mentioned, their view that the current hedge accounting requirements cannot cover the needs of energy/utility companies (ie a closer alignment between risk management principles and accounting is deemed necessary to make it easier to achieve hedge accounting and to reduce the administrative burden). The difficulties in applying the current hedge accounting requirements were also the reason pointed out by an Asian standard-setter and a professional accounting body based in Europe when backing up their views that the project was important.

(d) One accounting firm was of the view that the project had a high importance because of its interactions with IFRS 9. In particular, this constituent thought that the Board should provide a clear vision as to how and when it will require entities to adopt the general hedge accounting model in IFRS 9 if completion of this project is delayed for a protracted period.

(e) A European Securities regulator stated that this project has a high priority because of the existing carve-out requirements in IAS 39 in the European Union as well as the Board's recent decision to allow an accounting policy choice between IAS 39 and IFRS 9 until this project addresses the issue of hedge accounting for open portfolios. This constituent noted that that in the European Union, it is often unclear whether issuers take advantage of the carve-out or not, because that information is often not disclosed. An accounting firm also cited the EU carve-out as a reason for backing the high importance of the project. In their view, it would be helpful for the carve-out to be resolved in order that a clean transition from IAS 39 to IFRS 9 can be achieved.

(f) Insurance entities thought that the project had a high importance. However, most of them think that the extent of relevance of the project also depends on the final outcome of the insurance contracts project and

[4] These constituents also ranked the project as a high priority. The reason why they view this project as urgent is that non-financial companies are increasingly subject to financial regulation.

on the consistency between the accounting for insurance contracts and IFRS 9.

Who thinks this project is unimportant and why?

10. Approximately a third of the constituents providing feedback on the project stated that the project is unimportant to them. This section summarises their feedback:

    (a) The Asian-Oceanian Standard-Setters Group stated that the project should be deferred until IFRS 9 is implemented. In their view the Board needs to consider dividing the project into two parts:

        (i) a short- or medium-term project focussing on improving existing macro hedge accounting requirements; and

        (ii) a long-term project dealing with the implications of dynamic risk management for recognition and measurement.

    (b) Another national accounting standard-setter in Oceania also thinks that the Board should defer the project until after IFRS 9 has been implemented, to help gauge how the project should be progressed.

    (c) A European national standard-setter thinks that the project should be removed from the research programme. In its view, even though this project is linked to the carve-out, this issue concerns a limited number of entities in a limited number of countries.

    (d) A European professional accounting organisation thinks this project is not important because in its view current Standards already enable the reflection of risk management strategies.

    (e) A European representative body of preparers and a preparer in the health care industry in Europe do not consider the subject–matter of the project an urgent matter for non-financial service industry entities.

    (f) Two accounting firms expressed the view that this project has a low importance. One of them stated that the subject–matter of the project is a narrow-scope issue, while the other was of the view that the Board should allow IFRS 9 sufficient time to be implemented and applied in practice before any Standards-level activity on dynamic risk management is carried out. Another accounting firm commented that the project is of high importance for the entities concerned but has a low priority in general.

(g) Some members of IOSCO believe that the project could be a lower priority in order to make resources available for higher-priority projects.

Current status of the project

11. At previous Board meetings, the Board tentatively agreed that the work on this project should consider the information needs concerning an entity's dynamic risk management activities as a basis for determining how we may approach recognition, measurement and disclosure. This route has proved to be challenging. Because of this, we have returned the focus of our work to recognition and measurement.

12. We have held a limited number of meetings with European banks. The purpose of the meetings was to better understand the banks' activities concerning management of net interest income (NII) and the accounting for NII. These discussions gave us an opportunity to gain a better understanding of how those banks model their core demand deposits (CDDs).

13. The key element in both banks' interest rate risk management and also hedging strategies concerning management of NII is CDDs. Although we explored this in the Discussion Paper, our conversations have shown us other nuances, which would be worthwhile to look at as we consider the way forward. In particular we have learnt that banks consider customer behaviour mainly in the process of identifying the 'core' portion of demand deposits. Once the 'core' part is defined, banks typically construct replicating portfolios for the purposes of measuring the interest rate risk inherent in this funding source. The terms of the replication portfolio of CDDs (eg tenor, coupons, number/width of tranches etc) are often a reflection of the bank's risk management/board strategies and its view on the yield curve rather than being merely a reflection of customer behaviour.

Observing outreach exercise to be undertaken by EFRAG

14. EFRAG plans to approach some European banks for the purpose of better understanding the key drivers and parameters used in CDDs modelling. The exercise is a fact-gathering exercise whose outcome will be shared with us to help us to make progress in the development of the second Discussion Paper. We will be participating in this process as observers.

15. It is expected that the interaction with the banks will encompass the period May-July 2016.

Other key considerations

16. As mentioned in paragraph 6, when finalising IFRS 9, the Board provided entities with an accounting policy choice for hedge accounting until the project on accounting for dynamic risk management is completed. The accounting policy choice allows entities to either apply the hedge accounting requirements in IFRS 9 or IAS 39 with or without applying the ‘fair value hedge accounting for a portfolio hedge of interest rate risk’ in IAS 39. Eliminating that accounting policy choice depends on the successful completion of the project on accounting for dynamic risk management.

17. A key priority of this project is to enhance the reporting of interest rate risk management in open portfolios and also overcome the limitations in the current accounting requirements.

18. These limitations mainly refer to the difficulties of accommodating open portfolios and the inability to include modelled demand deposits as eligible hedged items. Any proposed solution to reflect more faithfully entities’ management of interest rate risk arising from open portfolios will need to incorporate to some extent critical elements of dynamic risk management, such as the modelling of demand deposits, while considering the conceptual framework and the principles of hedge accounting.

19. In addition to these conceptual hurdles, any solution would also need to:

    (a) be operationally feasible and to improve the existing accounting requirements; and

(b) provide information to enable users to better understand the effect of an entity's dynamic risk management activities on its net interest income.