ACCOUNTING FOR DYNAMIC RISK MANAGEMENT: A PORTFOLIO REVALUATION APPROACH TO MACRO HEDGING

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Summary

In April 2014, the International Accounting Standards Board (IASB) published a Discussion Paper DP/2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the DP). This outlines a possible accounting approach for an entity's dynamic risk management activities, often referred to as macro-hedging. The DP represents the first stage of the IASB's project to develop a new macro hedging model which will replace the existing requirements in IAS 39 *Financial Instruments: Recognition and Measurement* on fair value hedge accounting for a portfolio hedge of interest rate risk.

The DP considers a portfolio revaluation approach (PRA) as a possible way of better reflecting dynamic risk management in an entity's financial statements. Under the PRA, an entity would adjust the exposures that are being dynamically risk managed to reflect the effect of changes in value that arise from the managed risk i.e. only the managed risk is revalued – the managed exposures (assets and liabilities) would not be measured at fair value in their entirety. Any derivatives used to mitigate the risk would be measured at fair value through profit or loss (FVTPL). Consequently, the net effect of the risk management activities would be reflected in profit or loss.

The DP explores the possible inclusion of exposures that are within the managed portfolio that are currently not eligible hedged items under IFRS 9 *Financial Instruments* or IAS 39. These include:

- Behaviouralisation (i.e. managing cash flows based on behavioural expectations rather than contractual terms)
- Deemed exposures arising from pipeline transactions (e.g. forecast drawdowns on fixed rate products at advertised rates)
- The equity model book (in which dynamic interest rate management is used with the intention of achieving a notional base return on an entity's own equity).

The DP also explores different presentation and disclosure alternatives with the aim of providing more useful information and to more faithfully represent the dynamic risk management activities of an entity.

The IASB has requested comments on the DP by 17 October 2014.

Financial institutions often manage its exposure to interest rate risk dynamically and if the proposals in the DP are finalised it would represent a significant change in accounting. In addition, the IASB's intention is that the PRA would be also be applicable to dynamic risk management of other risks e.g. foreign exchange risk, commodity price risk etc. The IASB is using this DP to seek feedback about how the approach could be applied to other risks (e.g. foreign currency risk, commodity price risk). Hence, other non-financial institutions that engage in dynamic risk management activities could also be affected.

STATUS
Discussion Paper

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
Relevant for financial institutions and other entities with dynamic risk management activities.

Background

Under a dynamic risk management strategy or 'macro-hedging' as it is commonly referred to, the amounts of both the hedging instrument and the hedged item change constantly (on a daily, hourly or a more frequent basis). Financial institutions such as banks often use a macro-hedging strategy to manage their interest rate risk exposure arising from a portfolio of financial assets and liabilities e.g. hedging the net position of fixed rate financial assets and fixed rate financial liabilities.

The IASB began its deliberations of macro-hedging in September 2010 as part of the project to replace IAS 39.

The existing requirements in IAS 39 incorporate fair value hedge accounting for a portfolio hedge of interest rates and assume a 'static' hedging relationship (i.e. no new exposures can be added or existing exposures can be removed). Banks have found the existing IAS 39 requirements difficult to apply as the IAS 39 model does not capture the 'dynamic' nature of macro-hedging activities.

This is because, in reality, banks' risk management of interest rate risk is usually performed dynamically and is based on open portfolios to accommodate the constant changes in risk exposures. An open portfolio is where the items in the portfolio change over time as new items are added and existing items are no longer included. To apply the requirements in IAS 39, banks often treat its open portfolios as a series of closed portfolios with very short lives which gives rise to operational complexities as hedge accounting relationships needs to be traced and hedge adjustments amortised.

The accounting results under IAS 39 also do not necessarily reflect the entity's risk management strategies and therefore do not provide users of financial statements with information that is consistent with risk management. In addition, the scope of the IAS 39 requirements is limited to interest rate risk.

The IASB noted that the development of a new macro-hedging model would take time and that this would conflict with the timeline for the completion of IFRS 9. Consequently, macro-hedging has been made a separate project and the final requirements will be issued as a separate standard.

The IASB decided to issue a DP as a mean to collect more information and seek feedback on a broader range of alternatives and variations.

The 'Portfolio Revaluation Approach' (PRA)

a) Overview

The DP discusses a PRA as a possible approach to better reflect dynamic risk management in an entity's financial statements. Under the PRA, the net open risk position(s) would only be revalued for the changes in the managed risk. Income and expense on the other types of risks of the managed exposures would be recognised based on the applicable IFRSs.

The following example extracted from the DP, illustrates the application of the PRA and compares it with the current hedge accounting requirements.

Example

Bank A has the following portfolio of assets and liabilities on 31 December 20X0:

Assets	*CU*	*Liabilities*	*CU*
Fixed interest rate loans	*150*	*Fixed interest rate liabilities*	*100*
Variable interest rate loans	*150*	*Variable interest rate liabilities*	*200*

Bank A has a net fixed interest rate loan position of CU50 (150-100), and a net variable interest rate liability position of CU50 (200-150). The net open risk position of Bank A is therefore CU50 receive fixed/pay variable.

Bank A hedges the resulting net open interest rate risk position (CU50) using an interest rate swap (IRS).

Under the PRA, Bank A would revalue the portfolio of assets and liabilities for changes in interest rate risk only, and the IRS would be measured at FVTPL. The net effect of the risk management activities would be reflected in profit or loss. The interest income or expense from the assets and liabilities would be measured at amortised cost in accordance with IFRS 9.

Banks usually seek to manage a particular risk (e.g. interest rate risk) within a portfolio. The other risks such as liquidity and credit risk are usually managed separately. Therefore, the IASB has decided not to pursue a full fair value approach because macro-hedging is typically not used to manage the risk of changes in the full fair value of the portfolio.

b) Scope

The DP discusses two possible scope alternatives for the application of the PRA.

- ***Focus on dynamic risk management*** – under this alternative the PRA would be applied to all managed portfolios. For example, if the bank manages the interest rate risk arising from the entire banking book dynamically, it would revalue all exposures (including all assets and liabilities) to reflect the effect of changes in interest rate risk irrespective of whether any derivative instruments have been taken out. Under this alternative, if a bank has decided not to hedge its net open interest rate positions with derivatives, volatility would arise in profit or loss
- ***Focus on risk mitigation*** – under this alternative, the PRA would only apply to those managed exposures where an entity has taken out derivatives to mitigate its net open interest rate positions as part of its dynamic risk management strategy.

c) *Presentation*

i) Statement of financial position

The DP discusses the following three presentation alternatives for the revaluation adjustments arising from the PRA:

- ***Line-by-line gross up*** – the carrying amount of the exposures (assets and liabilities) that are subject to the PRA would be adjusted to reflect the revaluation of 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 revaluation of exposures that are assets and those that are liabilities
- ***Single net line item*** – a single line item which represents the net revaluation adjustment for all exposures subject to the PRA.

The following table extracted from the DP, illustrates the three presentation alternatives in the statement of financial position:

DR/(CR)				Presentation alternatives in the statement of financial position		
	Amortised cost	**Revaluation adjustment**	**Fair value**	**Line-by-line gross up**	**Aggregate adjustment**	**Single net line item**
Assets						
Retail loans	1,000	11		1,011	1,000	1,000
Commercial loans	750	30		780	750	750
Debt securities	500	(20)		480	500	500
Dynamic risk management revaluation					21	
Derivatives			25	25	25	25
Liabilities						
Deposits	(400)	5		(395)	(400)	(400)
Issued debt securities	(1,500)	(40)		(1,540)	(1,500)	(1,500)
Firm commitments		(15)		(15)		
Dynamic risk management revaluation					(50)	(29)
		(29)	25			
Profit or loss from dynamic risk management activities		(4)				

Figure 1: Illustration of the presentation alternatives in the statement of financial position (extract from the DP)

ii) Net interest income presentation

The aim of macro hedging of banks is often to achieve a stable net interest margin. An objective of the PRA is for the presentation of net interest income to portray this perspective of dynamic risk management to users. The DP considers two presentation alternatives to reflect this dynamic risk management focus. Both alternatives would present net interest income adjusted by the effect of macro-hedging activities and the net revaluation effect under the PRA approach for the managed exposure and hedging instruments.

The two alternatives are as follows:

– ***Actual net interest income presentation*** – actual interest revenue and interest expense would be presented along with an additional interest line to present net interest income from hedging instruments. The revaluation effect from macro-hedging activities would also be presented in a separate line item.

– ***Stable net interest income presentation*** – net interest income would be reported based on the managed/hedged rate, irrespective of whether the bank has been able to achieve a stable profile through its macro hedging activities. The revaluation effect from macro-hedging activities would be presented in a separate line item.

The following table extracted from the DP, illustrates the actual net interest income presentation alternative.

Actual net interest income presentation

CU	30 Jun 20X1	31 Dec 20X1	30 Jun 20X2	31 Dec 20X2
Interest revenue	2.0	2.0	2.0	2.0
Interest expense	(1.49)	(1.37)	(1.24)	(1.61)
Net interest from dynamic risk management	(0.01)	(0.10)	(0.21)	0.09
Net interest income	**0.5**	**0.53**	**0.55**	**0.48**
Revaluation effect from dynamic risk management	0.25	0.21	(0.67)	(0.52)
Total profit or loss for the 6 month period	**0.75**	**0.74**	**(0.12)**	**(0.04)**

Figure 2: Illustration of the actual net interest income presentation alternative (extract from the DP)

The following table extracted from the DP, illustrates the stable net interest income presentation alternative.

Stable net interest income presentation

CU	30 Jun 20X1	31 Dec 20X1	30 Jun 20X2	31 Dec 20X2
Interest revenue	1.99	1.87	1.74	2.11
Interest expense	(1.49)	(1.37)	(1.24)	(1.61)
Net interest income	**0.5**	**0.5**	**0.5**	**0.5**
Revaluation effect from dynamic risk management	0.25	0.24	(0.62)	(0.54)
Total profit or loss for the 6 month period	**0.75**	**0.74**	**(0.12)**	**(0.04)**

Figure 3: Illustration of the stable net interest income presentation alternative (extract from the DP)

Under the stable net interest income presentation alternative, interest revenue is presented at the managed rate for both the hedged component and the unhedged component of the managed exposures.

d) Behaviouralisation

Entities that engage in macro-hedging activities, typically risk-manage based on expected cash flows rather than the exposure's contractual terms. Two typical examples for banks are demand deposits and prepayable instruments.

i) Demand deposits

For financial liabilities with a demand feature i.e. demand deposits (e.g. current account and savings account balances), under IFRS the fair value cannot be less than the present value of the amount that is payable on demand. Consequently, demand deposits are measured at the nominal or demand amount under IFRS and are assumed to have no fair value risk with regard to interest rate changes, because they can be withdrawn immediately.

Demand deposits generally pay a zero or low, stable interest rate, and are typically left as a deposit for a longer and generally predictable time. Banks typically determine a level of core demand deposits that they believe will be maintained for a particular time frame and treat it in a similar way to a fixed term interest rate exposure for interest rate risk management purposes.

The IASB's preliminary view is that to reflect macro-hedging activities, the PRA should capture the behavioursalisation of demand deposits if the bank's macro-hedging activities take such behavioursalisation into consideration. The IASB is using the DP to seek views from respondents.

ii) Prepayable instruments

It is also common for banks to risk-manage portfolios of prepayable instruments based on the expected/behavioural patterns of prepayment rather than the contractual lives of the instruments. Different banks manage prepayment risks differently using a combination of options, swaps and other derivatives. The DP is also seeking views on how the PRA should be applied to prepayable instruments.

e) Deemed exposures arising from pipeline transactions

In a bank's macro-hedging activities, there might be some instances where the managed exposure does not meet the definition of assets or liabilities in IFRS. An example of deemed exposures is pipeline transactions. For example a bank may consider that it expects fixed interest rate risk to arise from advertised offers of lending at fixed interest rates, and monitors and manages it in the same way as other fixed interest rate exposures for interest rate risk. However, such pipeline transactions are not recognised for accounting purposes. The IASB is seeking views on whether pipeline transactions should be included in the PRA.

f) Equity model book

Some banks manage interest rate risk exposure that arises from their own equity instruments by disaggregating its return into:

- A 'base return' that is similar to interest (to compensate equity holders for providing funding), and
- A residual return.

Some banks undertake macro-hedging activities to ensure that the net interest income earned at least meets the target 'base return' for equity holders. Essentially a part of the equity is viewed and managed by some banks as a deemed fixed interest rate exposure. The IASB is seeking views on whether the part of equity that is deemed a fixed interest rate exposure should be included in the PRA if it is managed as part of the bank's macro-hedging activities for interest rate risk.

g) Mandatory vs optional application

The IASB is also seeking views on whether the PRA should be made mandatory or optional. If the PRA is made mandatory, dynamic risk management would need to be precisely defined.

h) Application of PRA to other risks

The IASB's intention is to develop an accounting approach for macro-hedging activities that would accommodate the management of different type of risks, and not just interest rate risk or be a model which could be used only by banks. The IASB is aware that foreign currency risk and commodity price risk may also be managed in open portfolios. The DP is seeking feedback on the suitability of the PRA model for other dynamic risk management activities of other risks (other than interest rate risks).

i) Alternative approach PRA through other comprehensive income (OCI)

The DP also discusses an alternative approach for the accounting for macro-hedging activities, being the PRA through other comprehensive income (OCI) approach. Under the PRA through OCI approach, the net effect of the revaluation of the managed portfolios and the changes in the fair value of the risk management instruments would be recognised in OCI rather than in profit or loss. This approach would avoid the profit or loss volatility from revaluing open net risk positions that have not been hedged.

j) Effective date

At this early stage in the project, there is no suggested effective date.

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