

IFRS Developments

IASB issues a discussion paper on accounting for macro hedging

What you need to know

- ▶ The IASB has published for comment a new approach for the accounting for dynamic risk management: the portfolio revaluation approach (PRA, the approach) to macro hedging which aims to provide useful information on dynamic risk management activities.
- ▶ The PRA would revalue the risk managed exposures with respect to the dynamically managed risk.
- ▶ The PRA focuses on risk management techniques; it is not a form of hedge accounting and is not restricted by existing hedge accounting conventions.
- ▶ The PRA is most relevant for banks and their management of interest rate risk, but may apply to other industries and risks where dynamic risk management occurs.
- ▶ The DP considers whether the PRA would apply to all activities that are subject to dynamic risk management or only to those where the risks are actually mitigated. This will have a major impact on the extent to which the PRA would result in less or greater profit or loss volatility, and the complexity of its implementation.

The PRA is designed to accommodate accounting for open portfolios for which new exposures are frequently added, and risk management is undertaken, for the resulting portfolio risk position.

Introduction

The IASB has issued a discussion paper (DP) outlining a new approach to the accounting for dynamic risk management: the portfolio revaluation approach to macro hedging, which builds on some of the risk management techniques that banks use. Although the focus of the DP is banks, the approach is not restricted to their activities and risks.

The portfolio revaluation approach to macro hedging

Overview

The PRA does not change the accounting for financial instruments used for risk management purposes. Rather, it provides for the revaluation of items included in dynamically managed portfolios (e.g., loans), with respect to the managed risk of those items. This is similar to the revaluation of the hedged item in a fair value hedge. It is not a full fair value approach.

Under the approach, an accounting mismatch between derivatives, which are accounted for at fair value through profit or loss (FVTPL), and the risk managed exposures, which are accounted for on a different basis, would be avoided with regard to the particular dynamically managed risk. The changes in fair value of the derivatives and the gain or loss from revaluing the risk managed exposures are recognised together in profit or loss.

Consequently, reported profit or loss will be driven by economic mismatches between risk managed exposures to which the PRA is applied, and financial instruments used for risk management purposes.



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The DP considers which instruments the approach may be applied to and the basis for identifying the managed risk. The DP considers widening the eligibility of instruments and deemed risk within exposures when compared to hedge accounting, including the role of internal derivatives and the ability to model the behaviour of demand deposits on application of the PRA.

Dynamic risk management - open portfolios

The main characteristic of open portfolios is that new exposures are added and existing exposures are removed continuously, and risk managers focus on the resultant risk position. The PRA would result in revaluing all exposures in the managed portfolio for the relevant risk for which they are managed. This would mean that no linkage is necessary between the revaluation of managed exposures and offsetting fair value changes of risk management instruments, thereby avoiding the operational complexity involved in tracking and amortising hedge adjustments from general hedge accounting relationships.

The absence of linkage requirements also reflects that, typically, for those entities that engage in dynamic risk management, there is no direct link between external exposures and external derivatives. Instead, an asset and liability management function (ALM) often acts as a central interface between business units and trading functions. This involves the use of internal lending transactions at transfer prices to transfer risk in external exposures to be managed by ALM and internal derivatives with trading functions to reflect risk mitigation activity undertaken by ALM.

Calculation of the revaluation adjustment

The application of the PRA would not change the classification and measurement requirements of other IFRSs. It would require an overlay adjustment, reflecting the revaluation of the managed exposures within the managed portfolio for the managed risk. This adjustment is calculated using present value techniques, whereby the cash flows and the discount rates used would be identified with reference to the managed risk.

Internal transfer pricing deals between business units and ALM typically represent the transfer of risk in external exposures into ALM for risk management. For that reason, the DP suggests that the use of internal transfer pricing deals to calculate the revaluation adjustment may be a practical expedient to assist in the capture of the managed risk in external exposures for the purposes of the PRA.

The IASB is seeking views on the potential role of transfer pricing within the PRA, in particular, whether it would be operable and representative of risk management activity.

Cash flow estimates on a portfolio basis

In the case of portfolios, the cash flow profile of the portfolio as a whole is often more predictable than for an individual exposure. Prepayable loans are a good example. This effect is used in risk management when quantifying risk exposures, and the PRA also uses it when determining the exposure to be revalued for the relevant risk for which it is managed. This is referred to as using a 'behaviouralised' cash flow estimate. Consequently, the revaluation of prepayable loans would be based on their expected lives instead of their contractual lives.

Example

Risk mitigation of a CU500 million prepayable loan portfolio with a contractual maturity of five years would be undertaken after consideration of expected prepayments within the portfolio. As such, if there is an expectation that half the loans will prepay after three years, and the remainder in line with their contractual maturity, the risk profile included within risk management and the PRA would be CU250 million of three-year risk and CU250 million of five-year risk.

The IASB's preliminary view is that this behaviouralised cash flow profiling should also be applicable for portfolios of demand deposits. This would mean that the PRA could be applied on the basis of an expected cash flow profile for so-called 'core deposits' that are expected to remain outstanding for periods that significantly exceed their contractual maturity. Accordingly, the IASB considers it possible that core demand deposits could be included within the PRA with a maturity profile based on risk management expectations, (e.g., three years) that exceeds the contractual maturity (e.g., overnight). A bank's inability to designate core demand deposits in hedge accounting relationships in a manner consistent with their risk management activity is often cited as one of the major reasons why some banks are precluded from providing useful information on risk management activities in their financial statements.

Another of the uses of behaviouralisation discussed in the DP is the so-called 'equity model book'. This is a deemed interest rate risk associated with an entity's financing in the form of equity. The DP considers whether and how such an equity model book might be revalued for the associated deemed interest rate risk, in particular, if this would result in useful information for users of financial statements.

Presentation in the statement of financial position

The DP discusses three possible ways of presenting the revaluation adjustments in the statement of financial position:

- ▶ An adjustment to each line item that includes revalued exposures for the related revaluation amount
- ▶ Aggregating revaluation amounts separately for assets and liabilities and presenting those net amounts in one separate line item on each side of the statement of financial position
- ▶ Aggregating all revaluation amounts and presenting that net amount as a separate line item on either the asset or the liability side of the statement of financial position - depending on whether the amount is a debit or a credit

The presentation of risk management instruments in the statement of financial position would remain unchanged.

Presentation in the income statement

Two different income statement presentations are included in the DP, although each results in the same net profit or loss. The presentation alternatives both focus on reflecting the effects of dynamic risk management activity on net interest income and the net revaluation effect from those activities, but in slightly different ways:

- ▶ **Actual net interest income presentation** - no change to reported interest revenue and expense for managed exposures. In addition, a new interest line would reflect net interest income from risk management instruments. The revaluation effect from dynamic activities would be reported separately.
- ▶ **Stable net interest income presentation** - interest revenue and expense from managed exposures is presented on the assumption of perfect risk management. Any deviations from 'perfect risk management' of realised and future net interest income would be reported as the revaluation effect from dynamic risk management.

The Board believes that there are clear benefits to the presentation of actual net interest income. In particular, this would provide the net interest income both before and after the effects of dynamic risk management and because it would be easier to implement.

Role of internal derivatives

The DP suggests that, in order to faithfully present both risk management activity and trading strategies in the income statement, there is a need to gross up offsetting internal derivatives between ALM and trading functions in the income statement, reporting revenue as part of 'revaluation effect from dynamic in net revaluation' and 'trading activities', respectively. The net impact on profit or loss from internal derivatives would be nil.

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Scope of application of the PRA

The DP considers whether the PRA should be applied whenever risk management activity is undertaken or only when risk mitigation through hedging occurs.

The DP defines risk management activity as including any of dynamic risk identification, analysis and mitigation through hedging. So, if the scope of the PRA focuses on risk management activity, all exposures included within dynamic risk management analysis would be revalued with respect to the managed risk, irrespective of whether risk mitigation has been undertaken or not. This would result in volatility in the profit or loss from intentionally unhedged positions. This could provide useful information on dynamic risk management activities, including the decision not to hedge. However, the DP recognises that this scope alternative could result in applying the PRA to the majority of a bank's balance sheet, which would be a huge change.

Alternatively, the DP suggests that the PRA could be applied only where all aspects of dynamic risk management have been undertaken, including dynamic risk mitigation activities through hedging. This would be more complex to implement as the mitigated risk position will continually change over time, with a need to introduce processes for tracking and amortisation.

The DP also asks considers whether application of the PRA should be mandatory or optional.

Alternative solutions considered

The DP refers to a number of other solutions, for which the IASB's preliminary view is that they would not provide a faithful view of risk management activities. The DP also explores an alternative solution whereby the revaluation effect is recognised in other comprehensive income, rather than the income statement, but expresses some conceptual and operational concerns about this approach.

The DP poses a broad range of questions. These include whether the development of an approach that enhances the usefulness of information on macro hedging is really necessary and whether there is a need for a similar solution for non-banks and other risks.

Disclosures

The DP lists four disclosure themes which are intended to assist users of financial statements to understand an entity's dynamic risk management.

How we see it

For preparers, the ability to use internal derivatives without the need to identify related external trading derivatives and the inclusion of behaviouralised demand deposits on application of the PRA mitigate two of the most often cited difficulties with the existing hedge accounting solutions for dynamic risk management. However, if the scope of application of the PRA is linked to the risk management activity rather than risk mitigation activity, the perceived benefits from these changes could be outweighed by the reported volatility in profit or loss from intentionally unhedged positions.

Although simple in concept, the PRA represents a significant change from the existing accounting for dynamic risk management and the operational challenges in making that change should not be underestimated.

Next steps

The DP is open for comment until 17 October 2014. Depending on the feedback the IASB receives on the DP, we expect the next step to be the development of an exposure draft in 2015.