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Accounting for dynamic risk management activities

Aligning macro hedge accounting more closely with risk management

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IN THE HEADLINES

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> “This is the opportunity for everyone to say what they think a transparent, operational and decision-useful accounting solution should look like.”

– Enrique Tejerina,
KPMG’s global IFRS financial instruments deputy leader

‘**Dynamic risk management**’ is a continuous process that involves identifying, analysing and deciding on whether, and how, to mitigate one or more risks associated with an ‘open portfolio’ – i.e. a portfolio that is subject to regular additions (e.g. new business or replacements) or subtractions (e.g. sales or maturities). These activities need to reflect the frequent changes in an open portfolio’s value and risk position, and require estimation of the volume and timing of the items in the portfolio. In addition, the risks are often managed on a net basis.

Aligning macro hedge accounting with risk management

Although current IFRS[1] provides models for macro hedge accounting, these contain restrictions that limit their ability to reflect some common dynamic risk management activities.

Without an accounting model that reflects many dynamic risk management activities, it can be difficult to faithfully represent a company’s risk positions in its financial statements. Some companies are left with focusing on reducing volatility in profit or loss rather than truly reflecting their risk management activities.

In response to these issues, on 17 April 2014 the IASB published a discussion paper (DP) on a new approach for macro hedge accounting. Like the general hedge accounting model finalised in November 2013, the macro hedge accounting model aims to better reflect companies’ risk management activities while reducing the operational complexities of hedge accounting. The project involves fundamental accounting questions and is not simply a modification to existing hedge accounting models.

A wide range of industries affected

As a starting point, the IASB’s focus has been on developing a model for banks to use to account for dynamic risk management of interest rate risk. Macro hedge accounting for these dynamic risk management activities may have a pervasive impact on a bank’s financial position, performance, and operations – including the need for systems to capture and model the risk profiles of large groups of financial instruments.

However, dynamic risk management activities are not restricted to banks’ interest rate risk management. Companies across a number of industries engage in dynamic risk management activities, covering a broad range of strategies, techniques and approaches. These activities may manage risks such as interest rate risk, commodity price risk and foreign exchange risk.

1 Specifically, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*.

Problems with existing accounting requirements

Current IFRS may result in different measurement or recognition for items that have the same or similar risks. For example, banks often use interest rate derivatives to reduce the interest rate risk arising from loans and deposits. However, loans and deposits are generally accounted for on an amortised cost basis, whereas interest rate derivatives are accounted for at fair value through profit or loss (FVTPL). These different accounting requirements result in volatility in profit or loss.

To address such accounting mismatches, current IFRS allows companies to select either a fair value hedge model or a cash flow hedge model. However, these models do not necessarily portray dynamic risk management – in the example above, the bank’s main risk management objective may be to protect the net interest margin from the interest rate risk in its interest rate exposures. The current accounting requirements can also be operationally onerous, because one-to-one designation is usually required between the hedged item and the hedging instrument, and hedging relationships need to be tracked and frequently adjusted to match the dynamic nature of open portfolios.

As an exception, current IFRS contains special requirements for ‘fair value hedge accounting for a portfolio hedge of interest rate risk’. This allows some hedged items to be included on a ‘behaviouralised basis’ – e.g. prepayable fixed interest rate mortgages – rather than on a contractual cash flow basis, which accommodates some aspects of dynamic risk management. However, this model can only be applied for hedges of interest rate risk and cannot be used for other types of risk – e.g. commodity price risk and foreign exchange risk. In addition, a company cannot designate a *net* amount comprising both assets and liabilities. Banks have found these requirements difficult to apply in practice and have questioned whether they result in useful information in their financial statements.

Is a portfolio revaluation approach the solution?

To help stimulate debate, the DP puts forward an outline of one possible approach to macro hedge accounting, a 'portfolio revaluation approach' (PRA), which in some ways is similar to the fair value hedge model.

Accounting under the PRA

Managed exposures

Managed exposures would be identified and remeasured for changes in the managed risk, with the gain or loss recognised in profit or loss. The remeasurement would be based on a present value technique.

Hedging instruments

Risk management derivatives – i.e. hedging instruments – would continue to be measured at FVTPL.

Result of hedge accounting

The performance of a company's dynamic risk management activities would be captured by the net effect of the above measurements in profit or loss.

Other risks

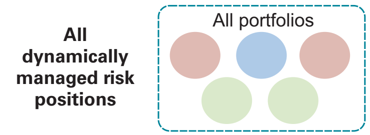
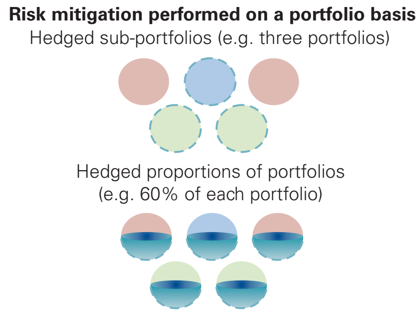
Risks that are not managed would not be included in this approach – i.e. this is not a full fair value model.

The IASB expects the PRA to be operationally easier to apply than the current hedge accounting models because:

- the accounting result would be consistent with risk management activities; and
- it would not require a specific linkage between managed exposures and risk management derivatives.

Two scope alternatives for the PRA

The DP presents two scope alternatives for the application of the PRA, which differ based on whether the PRA would capture all three elements of dynamic risk management – i.e. risk identification, analysis and mitigation through hedging.

Scope alternatives	Description	
'Focus on dynamic risk management' approach	The PRA would be applied if any one of the three elements of dynamic risk management are present – e.g. the PRA would apply to all net open risk positions regardless of whether they have been hedged.	
'Focus on risk mitigation' approach	The PRA would be applied only when all three elements of dynamic risk management are present – e.g. the PRA would only apply when the company has undertaken risk mitigation activities through hedging. The PRA could be limited to only dynamically managed sub-portfolios that have been hedged. Alternatively, the PRA could be applied to proportions of portfolios if hedged positions are determined as a proportion of a dynamically managed portfolio.	

How closely to align with risk management?

A key question is to what extent dynamic risk management activities should be reflected in the accounting. The DP discusses a number of items that would broaden the scope of the PRA as compared with the current hedge accounting models.

The DP asks whether the following items should be eligible for inclusion in the managed exposure for interest rate risk:

- pipeline transactions – i.e. forecast volumes of drawdowns of fixed interest rate products at advertised rates;
- equity model book – i.e. companies' own equity where it is managed to earn a minimum target return similar to interest; and
- behaviouralised expected cash flows related to core demand deposit liabilities and prepayment risk.

The DP also considers other aspects of dynamic risk management, including the use of risk limits, and the roles of transfer pricing and internal funding indexes.

There is a trade-off to consider: the more such items are incorporated into the PRA, the closer hedge accounting may be aligned with dynamic risk management activities. But the broader the scope, the less consistent it may be with conventional accounting concepts.

Mandatory or optional?

The DP asks whether application of the PRA should be mandatory or optional. Hedge accounting has historically been voluntary, so mandating the PRA for dynamic risk management activities would be a significant change.

Have your say …

The longer than usual comment period of six months is a welcome decision, reflecting the complexity of this issue, the broad range of risk management practices, and the potentially pervasive impact on banks' financial position and performance. Corporates will also need this additional time to get to grips with what is, for many, a new concept.

We strongly encourage constituents to participate in the development of a transparent, operational and decision-useful macro hedge accounting model. Comments are due to the IASB by 17 October 2014.

For more information on the issues, please go to the IASB announcement on the DP, or speak to your usual KPMG contact.

Basic facts

The IASB issued its DP on macro hedge accounting on 17 April 2014 as the first due process document for this project. As the project involves fundamental accounting questions, the IASB has not proceeded straight to issuing an exposure draft.

Interaction with IFRS 9

Since November 2008, the IASB has been working to replace its financial instruments standard (IAS 39) with an improved and simplified standard, IFRS 9 *Financial Instruments*. The IASB has split the hedge accounting phase of the project into two parts: general hedge accounting and macro hedge accounting. On 19 November 2013, the IASB issued a new general hedge accounting standard – part of IFRS 9 *Financial Instruments* (2013).

The IASB has tentatively decided that the effective date of IFRS 9 will be 1 January 2018. To avoid jeopardising this date, the macro hedge accounting project has been carved out from the development of IFRS 9.

Because of the close interaction between the general hedge accounting and macro hedge accounting models, the IASB permits a company to make an accounting policy choice to defer adoption of IFRS 9 (2013)'s general hedge accounting model until the standard resulting from the macro hedge accounting project is effective. In addition, the IASB carried forward the exception permitting fair value hedge accounting for a portfolio hedge of interest rate risk in paragraph 81A of IAS 39 to the general hedge accounting model of IFRS 9 (2013).

Timeline

17 April 2014:
Discussion paper published

17 October 2014:
Comment period ends

1 January 2018:
Effective date for IFRS 9

Not established:
Effective date for new macro hedge accounting model

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