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FINANCIAL INSTRUMENTS

Issue 22, March 2015

KPMG
cutting through complexity

“Now that the feedback on the DP has been considered, the IASB will need to decide on the direction of the project before the next phase can begin.”

**Chris Spall**
KPMG’s global IFRS financial instruments leader

# The future of IFRS financial instruments accounting

**This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB’s discussions in March 2015 on its financial instruments project.**

The macro hedging project was again the focus of the IASB’s March meeting, with the Board discussing the remaining feedback received on its April 2014 discussion paper (DP).

Towards the end of the meeting, Board members also expressed a range of ‘bigger picture’ views, and seemed to agree that the direction of the project would need to be decided before undertaking section-by-section redeliberations. We expect the overall direction to be determined in future Board meetings.

### Highlights

Feedback on the following sections of the DP was presented at the meeting.

- *Revaluing managed exposures:* Many respondents believed that the revaluation calculations would provide a faithful representation of dynamic risk management (DRM) activities.
- *Presentation:* Most respondents supported a ‘single net line item’ presentation in the statement of financial position and an ‘actual net interest income’ (NII) presentation in the statement of profit or loss and other comprehensive income (OCI). Wide-ranging concerns were raised on the gross presentation of internal derivatives.
- *Disclosures:* Many respondents believed that robust disclosures are critical to achieving transparency and comparability.
- *Other considerations:* Many respondents supported the proposals on when to include exposures in managed portfolios.
- *Applying the portfolio revaluation approach (PRA) to other risks:* There were mixed views on applying the PRA to other risks.

# THE IASB CONSIDERS RESPONSES TO MACRO HEDGING PROJECT

**The story so far …**

## Accounting for dynamic risk management

Although current IFRS – specifically, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* – provides models for macro hedge accounting, these contain restrictions that limit companies' ability to reflect some common dynamic risk management (DRM) activities; moreover, some of these models deal specifically with interest rate risk management rather than other types of risk. Without an accounting model that reflects the broader use of DRM activities, some have asserted that it can be difficult to faithfully represent these activities in financial statements.

In response to these issues, in April 2014 the IASB published its discussion paper *DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the DP) as the first due process document for the project. As the project involves fundamental accounting questions and is not simply a modification to current hedge accounting models, the IASB did not proceed straight to issuing an exposure draft. Our publication New on the Horizon: Accounting for dynamic risk management activities provides a detailed analysis of the proposals.

### Portfolio revaluation approach

The DP puts forward an outline of one possible approach to macro hedge accounting – the portfolio revaluation approach (PRA) – under which companies' managed exposures are identified and revalued for changes in the managed risk.

- *Managed exposures:* These 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 fair value through profit or loss (FVTPL).
- *Result of hedge accounting:* The performance of a company's DRM 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. PRA is not a full fair value model.

The IASB expects the PRA to be operationally easier to apply than the current hedge accounting models for open portfolios, because it would reduce the complexities associated with one-to-one designations required under current IFRS.

### Managed exposures

A key question in applying the PRA is the extent to which DRM activities should be reflected in the accounting. The DP discusses a number of areas that would broaden the scope of the PRA as compared with current IFRS. The DP considers whether, for example, the following items should be eligible for inclusion:

- pipeline transactions – i.e. forecast volumes of draw-downs of fixed interest rate products at advertised rates;
- the equity model book – i.e. companies managing own equity to earn a minimum target return similar to interest; and
- behaviouralised expected cash flows related to core demand deposit liabilities, prepayment risk and changes in expected customer behaviour.

### Two scope alternatives

The DP presents two possible ways of applying the PRA.

- *Focus on DRM:* Under this approach, the PRA would apply to all dynamically managed exposures regardless of whether they have been hedged.
- *Focus on risk mitigation:* The PRA would apply only when companies have undertaken risk mitigation activities through hedging.

# RESPONSES TO THE MACRO HEDGING DP

## What has happened since the DP was issued in April 2014?

The 180-day comment period for the DP closed on 17 October 2014, with 126 comment letters submitted to the IASB. The Board also conducted outreach meetings with interested parties including preparers, users of financial statements, regulators, accounting standard setters, accounting bodies and accounting firms. In addition, the Accounting Standards Advisory Forum discussed the topic on more than one occasion and provided members' views on the DP. A similar approach was also followed by the Global Preparers Forum.

In February 2015, the staff provided the Board with:

- a summary of the feedback received from users of financial statements; and
- a detailed analysis of feedback received from all respondents on a number of sections of the DP.

At its March meeting, the IASB completed its analysis of the feedback on the DP.

## Next steps for macro hedging

Towards the end of the March meeting, Board members expressed a range of 'bigger picture' views on the project. One member was concerned that the proposals contain too many "artificial accounting constructs"; some others, meanwhile, drew attention to the potential benefits of the proposals in increasing transparency of information to users of financial statements.

Overall, Board members seemed to agree that the direction of the project would need to be decided before undertaking section-by-section redeliberations. We expect the overall direction to be determined in future Board meetings.

## Detailed analysis of feedback from respondents

Feedback on the following sections of the DP was presented at the meeting.

| Sections of the DP | Section numbers | Page |
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Many respondents believed that the revaluation calculations would provide a faithful representation of DRM activities.

The use of transfer pricing transactions was preferred by many respondents.

## Revaluing managed exposures

| Issue | Summary of feedback |
|---|---|
| **Revaluation calculations**[1] | Many respondents believed that revaluation calculations based on a present value technique with respect to the 'managed risk' only – e.g. interest rate risk – would provide a faithful representation of DRM activities. These respondents did not believe that entity-specific elements – e.g. customer margin – should be included in the revaluation calculations.<br><br>Some respondents expressed concerns, stating that the PRA needs to address the issue of a basis risk arising from an imperfect hedging relationship – e.g. a foreign currency basis spread that is present in the valuation of a cross currency swap but that does not exist in the managed exposures.<br><br>Other concerns included the following.<br><br>• Revaluation calculations based on a present value technique would require remeasurement of the managed exposures, and may therefore:<br>– involve significant judgement that might take behaviouralisation into consideration, given the nature of the managed exposures;<br>– have practical challenges, such as a choice of discount rates; and<br>– be inconsistent with the objective of interest rate risk management by banks, if their aim is to protect net interest income from the risk of variability of future cash flows, rather than from the risk of the fair value changes on interest rate risk exposures.<br><br>• If a present value technique is used to present DRM activities, it needs to incorporate managed exposures that are not recognised in the statement of financial position. |
| **Transfer pricing**[2] | Many respondents preferred using transfer pricing transactions as an operational expedient in applying the PRA, if this faithfully represents the risks in the managed exposures.<br><br>However, some respondents did not support using transfer pricing transactions because they are entity-specific.<br><br>Many respondents noted that the PRA should only capture market interest risk. This is largely because such an approach would not lead to a day-one revaluation impact arising from other aspects such as a funding or liquidity spread. Accordingly, these respondents supported a revaluation approach that uses a market funding index – e.g. LIBOR – for both cash flows of the managed exposures and the discount rate. |

1. Under the PRA, net open risk positions would be revalued using present value techniques. The cash flows to be discounted and the discount rates would be identified with reference to the managed risk. For example, the revaluation of the managed exposures for interest rate risk would be calculated as the cash flows that represent the exposure to the interest rate risk that is being managed, discounted at the current rate for that risk.
2. It is common for banks to embed their funding rate as part of their internal transfer pricing arrangements, facilitating the transfer of interest rate risk from the business unit to the asset liability management (ALM) unit. ALM usually manages interest rate risk on exposures using transfer pricing transactions that are based on benchmark funding rates, without including any customer or product margins. This is because customer and product margin risk are generally the responsibility of the business unit.

| Issue | Summary of feedback |
|---|---|
| **Funding index** | Many respondents felt that it would be appropriate to use a funding rate as the managed risk for the PRA when the DRM objective is to manage net interest income (NII) on the bank's funding curve.<br><br>Many respondents also supported the use of different funding indexes within a company in applying the PRA, depending on currency, jurisdiction, product type, tenor etc. However, some respondents expressed concerns at a potential lack of comparability arising from different funding index choices. |

## Presentation

**Most respondents supported a 'single net line item' presentation in the statement of financial position and an 'actual NII' presentation in the statement of profit or loss and OCI.**

| Issue | Summary of feedback |
|---|---|
| **Presentation in the statement of financial position** | Most respondents supported a 'single net line item'[3] presentation in the statement of financial position, for the following reasons.<br>• It would be consistent with the DRM of net open risk exposures.<br>• It would be operationally easier, because it would not need to allocate the revaluation adjustment to different line items in assets and liabilities.<br>• A 'line-by-line gross up' presentation would present each line item neither at amortised cost nor at fair value. |
| **Presentation in the statement of profit or loss and OCI** | Most respondents supported an 'actual NII' presentation[4] for the following reasons.<br>• It would provide clear information for DRM activities using risk management derivatives – i.e. interest income and expense would be presented using the effective interest rate method, and the effects of the PRA would be presented separately.<br>• Presenting interest income and interest expense would be consistent with requirements for amortised cost measurement and the effective interest method under IFRS 9.<br>• A 'stable NII' presentation would not represent a true picture of DRM activities, because it presents NII as if it had been fully hedged. |

3. The DP describes three alternative approaches for presenting the revaluation adjustments in the statement of financial position: (a) line-by-line gross-up; (b) aggregate adjustment; and (c) single net line item. The single net line item approach requires that the net revaluation adjustment for the entire revalued portfolio would be presented in a single line item in the statement of financial position.

4. The DP describes two alternative approaches for presenting the outcome of the PRA in the statement of profit or loss and OCI: (a) stable net interest income approach; and (b) actual net interest income approach. The actual net interest income approach requires that actual interest income and expense on the managed exposures would be reported using the effective interest method.

Wide-ranging concerns were raised on the gross presentation of internal derivatives.

| Issue | Summary of feedback |
|---|---|
| **Presentation of internal derivatives** | There were mixed views on the gross presentation of internal derivatives. Wide-ranging concerns were raised, including the following.<br>• It would be inconsistent with the general concept of presenting consolidated financial statements, because:<br>– internal transactions should be eliminated in the consolidated financial statements; and<br>– the role of financial reporting should be to represent external transactions – i.e. internal derivatives are not binding contracts.<br>• It would reduce comparability, because the use of internal derivatives is entity-specific.<br>In addressing these concerns, some respondents noted that disclosures are better placed to represent the use of internal derivatives.<br>Views in support of the gross presentation of internal derivatives were as follows.<br>• It would be operationally easier, as it would not require matching external derivatives with internal derivatives that are used in applying the PRA.<br>• It would be a faithful representation of both the DRM activities within the asset liability management (ALM) unit, and the trading activities within the trading unit. |

## Disclosures

Many respondents believed that robust disclosures are critical to achieving transparency and comparability.

| Issue | Summary of feedback |
|---|---|
| **Disclosures** | Many respondents broadly supported the four disclosure themes[5] identified in the DP.<br>Many respondents believed that robust disclosures are critical to achieving transparency and comparability because DRM activities are entity-specific. Regulators in particular emphasised this point.<br>Some respondents suggested the following additional disclosures:<br>• sensitivity analysis of NII before and after DRM; and<br>• components of NII – i.e. showing a customer margin separately.<br>Respondents also noted the importance of considering the extent to which current IFRS requirements – e.g. IFRS 7 *Financial Instruments: Disclosures* and regulatory guidelines such as Basel requirements – represent DRM activities, before introducing new disclosure requirements. |

5. The DP identifies four possible disclosure themes that would need to be developed for the PRA: (a) qualitative information on the objectives for DRM; (b) qualitative and quantitative information on the net open risk position and its impact on applying the PRA; (c) applying the PRA; and (d) qualitative and quantitative information on the impact of DRM on the current and future performance of a company.

| Issue | Summary of feedback |
|---|---|
| **Scope of disclosures** | There were mixed views on the appropriate scope of disclosures.<br>• Many respondents agreed that the scope of disclosures should be identical to the scope of application of the PRA.<br>• Many others suggested that the scope of disclosures should be 'holistic', describing DRM activities as a whole – mainly because information on both hedged and unhedged exposures is useful to users of financial statements. |

## Other considerations

**Many respondents supported the proposals on when to include exposures in managed portfolios.**

| Issue | Summary of feedback |
|---|---|
| **Inclusion of exposures** | Many respondents agreed that the PRA should allow for including exposures in managed portfolios after a company first becomes party to a contract – e.g. when exposures that are not dynamically managed are subsequently included in DRM activities.<br>Those respondents also supported the amortisation of non-zero day one revaluations that arise from exposures that are subsequently included in DRM activities. |
| **Exclusion of exposures** | Many respondents agreed that the PRA should allow for excluding exposures from managed portfolios before derecognition – e.g. when exposures that are managed dynamically are subsequently removed from DRM activities.<br>Those respondents also supported the amortisation of revaluations from the point at which exposures are removed from DRM. |
| **Applying the PRA to foreign exchange risk together with interest rate risk** | Many respondents believed that the PRA should be applied to foreign exchange risk, as well as interest rate risk, when they are dynamically managed.<br>Some respondents suggested that the IFRS 9 general hedge accounting model for foreign currency basis spreads[6] would be a relevant consideration when applying the PRA to foreign exchange risk. |

6. IFRS 9 introduced the concept of a 'cost of hedging' that allows the foreign currency basis spread of a financial instrument to be separated and excluded from the designated hedging instrument.

## Applying the PRA to other risks

**There were mixed views on applying the PRA to other risks.**

| Issue | Summary of feedback |
| --- | --- |
| **Non-interest rate risks in non-banking industries** | Many respondents believed that applying the PRA to DRM activities for non-interest rate risk in non-banking industries should be considered. Some respondents identified that risk management activities in the utilities and energy sectors are similar to dynamic interest rate risk management by banks.<br><br>However, some respondents were not in favour of applying the PRA to non-interest rate risk in non-banking industries, mainly because applying the PRA to other types of risks or other industries would be difficult to enforce and audit. |

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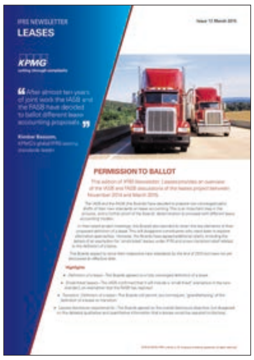


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