

Financial instruments

IFRS Newsletter



“We welcome the Board revisiting the important area of dynamic risk management. The project appears to have started from a fresh perspective so there’s a long way to go to finalise an accounting solution.”

- Chris Spall
KPMG’s global IFRS financial instruments leader

The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB’s discussions in May 2017.

The Board continued its discussions on its dynamic risk management (DRM) project by considering two of the focus areas for the project: DRM activities undertaken to stabilise net interest margin (NIM) and core deposit modelling.

Highlights

At the May 2017 meeting, the staff presented an education session to the Board. The staff:

- discussed using DRM activities to stabilise NIM;
- demonstrated how derivatives may be used to achieve the target portfolio in the context of stabilising NIM;
- discussed how NIM reconciliations could be used to measure the accuracy of the DRM function; and
- outlined the relevant information that could be considered for financial reporting.

The next steps will be to schedule discussions over the next few months on the following areas of focus:

- prepayment risk and the dynamic nature of portfolios;
- how DRM is currently reflected in financial statements; and
- how to evaluate a proposed accounting model.

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Dynamic risk management

The story so far...

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 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 April 2014 DP) as the first due process document for the project. This outlined one possible approach to macro hedge accounting – the portfolio revaluation approach (PRA) – under which companies' managed exposures would be identified and revalued for changes in the managed risk. As the project involves fundamental accounting questions and is not simply a modification of current hedge accounting models, the IASB did not proceed straight to issuing an exposure draft (ED). Our publication [New on the Horizon: Accounting for dynamic risk management activities](#) provides a detailed analysis of the proposals.

Respondents to the April 2014 DP broadly supported the macro hedging project, although several acknowledged that aligning financial reporting and DRM activities would be challenging. Despite this general support, the Board identified significant diversity in views on the project's objectives. Many respondents felt that the objectives were unclear, and different stakeholder groups seemed to have different views on what those objectives should be. Based on these comments and feedback, the Board decided to:

- consider the disclosure requirements first, followed by the recognition and measurement requirements;
- prioritise dynamic interest rate risk management; and
- form an 'expert advisory panel' at a later stage in the project.

The Board also decided that the project would remain as a research project, instead of being transferred to the Board's standards agenda, and that a second DP would be published before issuing an ED. Furthermore, the Board decided to keep open the possibility of moving directly to an ED if a solution emerges that addresses the disclosure, recognition and measurement issues.

In April 2016, the Board was provided with feedback from the 2015 agenda consultation, which noted that the key priorities are to enhance the reporting of interest rate risk management in open portfolios and to overcome the limitations in the current hedge accounting requirements. The Board directed the staff to consider the findings on customer behaviour and replication of portfolios of core demand deposits when further developing the alternative approaches for DRM.

By managing deposit-funded asset loan portfolios within a DRM framework, it is possible to manage changes in NIM.

Dynamic risk management

What's the issue?

Following further research carried out, the Board reopened its discussions on the project in March 2017. The staff presented an education session to the Board and outlined the project approach, project stages and next steps. In particular, the staff indicated that the focus areas for the project would include DRM activities undertaken to stabilise NIM and core deposit modelling.

At the May 2017 meeting, the staff presented an additional education session to the Board. The objectives of this session were:

- to outline why and how DRM activities are undertaken (including a discussion on NIM stabilisation);
- to demonstrate how derivatives are used to transform portfolios in the context of stabilising NIM;
- to discuss NIM reconciliations; and
- to discuss accounting model relevance.

Net interest margin stabilisation

The staff outlined that NIM is defined within a DRM framework as 'the difference between the yield earned on loan assets and the cost of funding those assets'.

'Cost of funding', in turn, comprises:

- term funding – i.e. interest-bearing debt with contractual maturities; and
- deposit funding.

For deposit funding, the staff observed that a significant portion was 'perpetual' with a cost of 'effectively zero' in the long run. These perpetual deposits are considered to be part of the core deposit base – i.e. 'core deposits' – and therefore evaluating customer behaviour for these types of deposits would not be relevant.

KPMG insight

An example of deposits that may be behaviourally modelled are non-interest bearing current account (NIBCA) deposits. The duration of such instruments can be estimated using sophisticated techniques, allowing risk managers to more accurately hedge their NIM. In addition, NIBCA deposits that are withdrawn may be continuously replaced with new NIBCA deposits. In order to conclude that deposits are in essence 'perpetual' in nature, an evaluation of customer behaviour will be necessary.

The staff noted that for deposit-funded asset loan portfolios, the NIM is largely driven by the asset yield and that NIM stabilisation was an issue related to loan assets. The staff provided some reasons for this, as follows.

- Fixed-rate perpetual life loan assets do not exist.
- Asset profiles change as they mature and are replaced by new loans.

The staff presented case studies to demonstrate how an entity may use derivatives to achieve the target portfolio.

- Loan pricing is a function of the interest rate environment at the time of origination.
- NIM changes as loans mature and are replaced by new loans.

On this basis, by managing deposit-funded asset loan portfolios within a DRM framework, it is possible to manage changes in NIM. More specifically, this entails identifying the actions required to align the original loan asset portfolio with the target profile, which is a function of how management would like deposit-funded asset loan portfolios to reprice. In other words, management's decision on NIM repricing defines the target profile.

Derivatives used to transform portfolios

The staff pointed out that it is not possible to force customers to originate loans that are perfectly aligned with the target profile. Instead, risk-mitigating actions using derivatives were required to achieve this. In this regard, the staff presented case studies to demonstrate how an entity may use derivatives to achieve the target portfolio.



Case study – Using derivatives to achieve the target portfolio

Consider an entity with a portfolio of five-year fixed-rate non-amortising loan assets with a yield of 6.5% that are funded by core deposits with a 0% yield. All of the assets, and therefore the NIM, are subject to repricing risk in five years (T5). However, management does not want 100% of the NIM to reprice at T5. Management's target profile is for 40% of the NIM to reprice at T5 and the remaining 60% to reprice in year 10 (T10) instead. Management therefore compares the target profile with the actual profile and identifies the transactions necessary to transform the actual portfolio.

In this case study, the following transactions are undertaken at inception (T0) and at T5.

- At T0, the entity first splits the actual portfolio for risk management purposes. Since the target profile is for 40% of NIM to reprice at T5 and 40% of the actual profile naturally reprices at that time, no further action is required for those assets. Management will therefore focus its risk management actions on the 60% of the NIM that it does not want to reprice at T5.
- At T0, the entity secures a 10-year yield for 60% of the NIM (for which management intends repricing to occur in T10) by transacting a 10-year receive-fixed, pay-floating interest rate swap (IRS) (this replicates a 10-year fixed-rate asset).
- Also at T0, the entity closes out the open risk position that has arisen as a result of the pay-floating leg of the IRS by transacting a five-year receive-floating, pay-fixed IRS. At this point, the actual profile matches the target profile and no further actions are required until T5.
- At T5, the loans mature and cash is received, which is then used to originate new five-year floating-rate loans. The floating-rate loans are offset by the pay-floating leg of the IRS swap that was executed at T0. The actual profile matches the target profile and no further actions are required.

NIM reconciliations could be used to measure the accuracy of the DRM function.

To provide a contrast with this approach of matching the asset profile to the target profile, the staff presented another case study in which the deposits that funded the assets are modelled instead. In this case study, the staff identified the risk-mitigating actions that a risk manager would take.



Case study – Risk-mitigating actions the risk manager would take

If five-year fixed-rate loans were funded by 10-year deposits, then an entity would manage the risk position by executing two derivative transactions at T0 as follows:

- a 10-year receive-fixed interest rate swap to match the asset and liability duration; and
- a five-year pay-fixed interest rate swap to offset the five-year fixed-rate loan duration.

In the case studies discussed, the staff illustrated that the risk management actions undertaken and the resulting NIM profile are identical irrespective of the choice to match the loan asset portfolio to the target profile or to hedge the core deposits funding the loan assets.

NIM reconciliations

The staff noted that to understand and manage changes in NIM from period to period, an entity needs a thorough understanding of NIM and the factors that could cause a change in NIM. On this point, the staff noted that this could involve preparing a NIM reconciliation by periodically reconciling the actual NIM to the expected NIM so that the accuracy of the DRM function can be measured. The expected NIM used in the reconciliation could be derived from the DRM target profile.

With reference to the case studies presented, the staff outlined that there were three groups of products that had an impact on cash flows – namely:

- the original loan asset;
- the fixed leg of interest rate swaps; and
- the floating leg of interest rate swaps.

The staff presented a NIM reconciliation that included the impact of these three groups of products and noted that examples of reconciling items included delays in derivative execution and changes in interest rates.

The staff also noted that an important outcome of preparing a NIM reconciliation is that errors in the DRM process could be identified – although the information that management may have to diagnose such errors is largely dependent on how disaggregated the expected NIM calculation is.

The staff outlined relevant information that could be considered for financial reporting.

Relevant information for financial reporting

The staff outlined that the relevant information that could be considered for financial reporting included:

- determining the DRM target profile chosen by management (and the reasons for the choices);
- assessing how successful an entity is in achieving its DRM target profile; and
- assessing the factors taken into account when determining core and non-core deposits.

Next steps

The following table summarises the next steps of the project.

Area of focus	Timeline
Prepayment risk and the dynamic nature of portfolios	Q2 or Q3 2017
How DRM is currently reflected in financial statements	Q2 or Q3 2017
How to evaluate a proposed accounting model	Q3 2017

What did the IASB decide?

The Board did not make any decisions, but generally agreed with the information described by the staff in the case studies presented. Some Board members commented on the importance of disclosures about an entity's DRM activities to users of financial statements. On this point, one member suggested that the staff investigate why the existing disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* have not provided sufficient information about an entity's DRM activities.

KPMG insight

When undertaking risk management activities to stabilise the NIM, risk managers have the flexibility of hedging either asset portfolios or liabilities including core deposits. The objective of any proposed accounting solution should therefore be to appropriately reflect these risk management activities in the financial statements. However, reflecting risk management activities relating to core deposits may prove challenging because core deposits with a demand feature have a fair value that is not less than the amount payable on demand under existing IFRS requirements.

NIM reconciliations are an interesting concept. They would allow users of financial statements to evaluate the appropriateness of management's DRM decisions and provide further insight into an entity's DRM activities. The Board could consider including disclosures pertaining to NIM reconciliations as part of any proposed accounting solution.

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