Issue 43, November 2017

Financial instruments

IFRS Newsletter

"We support the IASB's plan to explore a model for dynamic risk management along the lines of cash flow hedge accounting."

– 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 November 2017.

Highlights

Dynamic risk management

The Board agreed that the accounting model for dynamic risk management (DRM) should improve transparency, address the capacity issue and provide a simple and reliable performance metric while reflecting the fluid nature of DRM.

The staff presented two accounting approaches where derivatives are used to align the asset profile with the target profile and recommended the approach based on cash flow hedge mechanics.

The Board did not make any decisions, but directed the staff to concentrate their effort on further developing the model based on cash flow hedge mechanics and begin involving preparers and users of financial statements in their discussions at an early stage. The next steps would be for the staff to formulate a detailed project plan before the IASB proceed to technical discussions.

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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 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). The April 2014 DP 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, many respondents felt that the objectives were unclear, and different stakeholder groups disagreed on what those objectives should be.

The Board decided that the project would remain as a research project, instead of being transferred to the IASB'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 March 2017, following further research carried out, the Board reopened its discussions on the project with the first of a series of education sessions.

	Key points covered by education session
March 2017	– Project approach, stages and next steps. – Indication by the staff that the focus areas for the project would include DRM activities undertaken to stabilise the net interest margin (NIM) and core deposit modelling.
May 2017	– Why and how DRM activities are undertaken to stabilise NIM. – How derivatives are used to transform portfolios when stabilising NIM. – NIM reconciliations.
June 2017	– Events that result in changes to the DRM portfolio, including: - how new originations impact management's target profile for the re-pricing of loan portfolios; - how DRM reacts to changes in the DRM portfolio; and - information relevant to financial reporting.
September 2017	– Prepayment risk and ways to manage it. – Hedge accounting and capacity.

The model should improve transparency, address the capacity issue, reflect the fluid nature of DRM and provide a useful performance metric.

Dynamic risk management

What's the issue?

In November 2017, the staff:

- explained the objectives of the proposed accounting model for DRM;
- identified two approaches to the accounting for fair value changes of derivatives that are successful in aligning the asset profile with the target profile, based on current accounting for cash flow hedges and fair value hedges, and recommended the approach based on cash flow hedge mechanics; and
- highlighted the key considerations required to develop the proposed model.

Objectives of the proposed model

The objectives of developing a new model are to improve information provided about risk management and, more specifically, to faithfully represent the impact of a bank's DRM activities on its financial statements. To achieve this aim, the staff believe that the model should focus on the following areas.

- **Transparency:** Conveying how DRM actions will affect the bank's economic resources is relevant to economic decision making. Financial statement users understand that the difference between cash inflows (interest income) and cash outflows (interest expense) is a key value driver for banks but also recognise the different re-pricing sensitivities of cash inflows and outflows. Transparency on the bank's approach to managing re-pricing of those cash flows will help users assess the key value driver and enhance comparability among its peer group and over time.
- **Capacity:** Under current IFRS, an entity could only apply hedge accounting if certain criteria are met. Entities that are funded by demand deposits could not designate those deposits as hedged items because they are not exposed to variability in cash flows or changes in fair value arising from market interest rate changes. This results in banks not having sufficient gross cash inflows and outflows against which derivatives may be designated. The proposed model should address this capacity issue.
- **Fluid nature:** As new exposures are originated and existing exposures mature, the composition of a bank's assets changes and DRM actions may be required to stabilise net interest margin (NIM). These actions result in frequent changes in the designation of hedging relationships – because current IFRS requires one-to-one designation between eligible hedged items and hedging instruments – and often require the amortisation of the associated cash flow or fair value hedge accounting adjustments. The processes required are complex, costly and prone to error, and the proposed model should address these operational challenges.
- **Performance measurement:** Current performance measures provide some information about effectiveness, but they are designed to reflect the performance of one-to-one relationships and are coloured by the fact that certain instruments – e.g. demand deposits – are not eligible hedged items under current IFRS. Therefore, the proposed model should provide a simple and reliable performance metric that shows whether management succeed in transforming the asset profile as desired.

The staff made the case for a model based on cash flow hedge mechanics.

KPMG insight

Capacity issue

In practice, many entities try to address the capacity issue using 'proxy hedges', which do not exactly represent but are 'directionally consistent' with the actual risk management approach. Expanding the scope of qualifying hedged items would allow risk management activities to be better reflected in the financial statements in such cases.

In Europe, companies that follow the EU carve-out version of IAS 39 may already be treating demand deposits as hedged items in macro fair value hedge relationships and may want to continue to do so.

Proposed approaches

Following the Board's decision in May 2015, the staff have prioritised the DRM of interest rate risk in developing the outline of the model. The proposed model also assumes that the entity uses derivatives (DRM derivative instruments) to transform its asset profile to its target profile. The staff have considered the following two accounting approaches, based on the alternatives for designating an interest rate hedging relationship under current IFRS.

- **Cash flow hedge mechanics:** for the cash flow variability arising from eligible floating-rate assets and liabilities that re-price based on market interest rates.
- **Fair value hedge mechanics:** for eligible fixed-rate assets and liabilities.

The following terms used in the proposed DRM model are analogous to those in the IFRS 9 hedge accounting model.

Proposed DRM model	IFRS 9 hedge accounting
Asset profile – i.e. all existing financial assets measured at amortised cost plus highly probable forecast transactions (e.g. reinvestments of maturing assets that result in future financial assets that will also be measured at amortised cost).	Hedged item
Target profile – i.e. the desired profile of cash flows arising from the items above as determined by management to stabilise NIM.	Risk management objective
DRM derivative instrument	Hedging instrument
Performance assessment	Effectiveness requirements

The two approaches presented are summarised below.

Approach 1: Cash flow hedge mechanics

If the DRM derivative instruments are successful in aligning the asset profile with the target profile, then changes in the fair value of the effective portion of the DRM derivative instruments would be deferred in other comprehensive income (OCI). The amount deferred would be reclassified to profit or loss in the period(s) during which the hedged cash flows arising from the asset profile affect profit or loss, so that the interest income recognised in profit or loss would be aligned with the target profile.

Advantages	Challenges
– A model that leverages cash flow hedge mechanics has a strong conceptual basis, considering that DRM entails understanding and managing how and when a change in market factors will affect cash inflows (interest income) and outflows (interest expense). Comment letters on the April 2014 DP also indicate that banks usually manage interest rate risk on a cash flow basis rather than a fair value basis. – This model prevents the revaluation of forecast transactions for the hedged risk from being recognised in the statement of financial position. This is also the reason for having the 'lower of' test in current IFRS – i.e. adjusting the cash flow hedge reserve to the lower of the cumulative gain or loss on the hedging instrument or the cumulative gain or loss on the hedged item.	– While the staff recognised the rationale behind the 'lower of' test, they acknowledged that it would pose a challenge to provide a complete picture of performance and would require further consideration when determining the performance objective of the model. – The staff recognised two concerns about the balance recognised in OCI, namely what information it purports to represent and how it should be reclassified to profit or loss. This is exacerbated by the fluid nature of DRM activities. The staff acknowledged that specific guidance would be required in this regard.

Approach 2: Fair value hedge mechanics

Under a fair value hedge model, the hedged item is remeasured for fair value changes attributable to the hedged risk. If the hedge is fully effective, then these changes are offset by fair value changes of the hedging instrument, resulting in no net effect on the statement of profit or loss and OCI.

Unlike a fair value hedge, the objective of DRM is not to eliminate the fair value risk from the asset profile but to transform the asset profile using DRM derivative instruments in order to attain the fair value risk inherent in the target profile. In other words, the DRM derivative instruments are successful in aligning the asset profile with the target profile if the fair value changes of the asset profile (A) plus the fair value changes of the DRM derivative instruments (B) equal the fair value changes of the target profile (C).

As in a fair value hedge, an entity recognises in profit or loss any fair value changes of the asset profile (A) as well as any fair value changes of the DRM derivative instruments (B). To faithfully represent that DRM activities are successful, it also recognises in profit or loss an offsetting amount that represents any changes in the fair value of the target profile attributable to the hedged risk (C), resulting in no net effect on profit or loss (i.e. $A + B – C = 0$). To achieve this, the entity also recognises the cumulative fair value changes of the asset profile (B) and the target profile (C) in the statement of financial position and amortise them to profit or loss in a manner that aligns interest income with the target profile.

Advantages	Challenges
– The entity would eliminate any measurement mismatch from the statement of financial position as well as the statement of profit or loss and also not have volatility in OCI compared to Approach 1. – There is a clear link between performance and the DRM objective because any residual fair value risk arising from misaligned asset and target profiles would be automatically recognised in profit or loss.	– The entity would recognise changes in the fair value of the target profile attributable to the hedged risk in the statement of financial position, even though it would not meet the definition of an asset or a liability in the Conceptual Framework. – Similarly, fair value changes of any highly probable forecast transactions in the asset profile would not meet the definition of an asset or a liability. It would be inappropriate to account for a hedge of forecast transactions as a fair value hedge because the entity would recognise an asset or a liability before it becomes a party to the contract and treat transactions in which there is no fair value exposure as if there were one. – As in Approach 1, if a DRM derivative instrument is settled to maintain alignment, then the entity would have to establish how to amortise the related cumulative fair value changes of the asset and target profiles to profit or loss.

Staff recommendation

The staff supported Approach 1 because a model based on cash flow hedge mechanics would better reflect the nature of DRM activities – i.e. to transform the asset profile such that the entity's cash inflows would react to changes in market factors based on the target profile. Furthermore, while the staff acknowledged the challenge to provide a complete picture of performance given the requirements of the 'lower of' test, it would be conceptually questionable to recognise the fair value changes of the target profile as well as forecast transactions under the alternative approach.

Board comments

In light of the arguments set out by the staff, the Board preferred Approach 1 – on the basis that it would be less complex and easier to explain than the alternative approach as well as broadly consistent with the principles in IFRS 9 and the Conceptual Framework. Accordingly, the Board directed the staff to develop an accounting model by taking Approach 1 as a starting point, instead of developing two competing models concurrently. Furthermore, the Board asked the staff to focus their initial efforts on identifying and tackling issues that are both difficult to address and fundamental to developing the model.

The Board noted that many preparers might be concerned about operational complexities and unwarranted volatility in OCI under Approach 1. The Board therefore suggested that the staff start involving preparers and users of financial statements around the world early to understand their expectations and concerns. One Board member also suggested that the staff consider seeking comments from prudential regulators as they develop the model.

The staff identified key areas that require further consideration.

Key considerations

The staff identified the following critical areas that need to be considered further in developing the proposed model.

Key considerations	Board comments
Asset profile	
– **Definition and eligibility criteria:** Leveraging existing concepts and definitions in IFRS 9 will ensure consistency. – **Initial designation of eligible items.** – **De-designation of items:** For example, it may be appropriate to remove from the asset profile assets that have become credit-impaired – i.e. the effect of credit risk dominates changes in its fair value – and forecast transactions that are no longer highly probable. Additional consideration is required about how these de-designations interact with performance, recycling or amortisation of accumulated changes in fair value.	The Board agreed that the 'scope' of the asset profile would require further consideration.

Key considerations	Board comments
Target profile	
– **Definition and eligibility criteria:** To determine an achievable target profile, entities should consider funding characteristics – e.g. whether financial liabilities are interest-bearing and have a specific repayment schedule, whether demand deposits are rate-sensitive, and the entity's approach and strategy regarding deposits that are non-sensitive with an indefinite life. – **How the target profile is consistent with risk management:** The target profile should not reflect trading strategies. The staff will consider restrictions that can exclude trading strategies from the target profile – e.g. establishing a relationship between the sizes of the asset and target profiles, and setting a ceiling on the size of the DRM derivative instruments. – **How performance is affected by changes in the target profile** – e.g. as a result of changes in regulation. – **Interaction between equity and the target profile** where banks treat equity as a source of funding.	Several Board members were concerned that limiting how a specific entity would define its target profile – e.g. delineating DRM activities by a threshold – might be arbitrary and might not reflect the nature of the entity's DRM activities. One Board member also noted that, while current IFRS generally dealt with accounting for individual assets and liabilities, under the proposed model the target profile – i.e. a desired profile of cash flows that is not an asset or a liability – would dictate how and when amounts recognised in OCI would be reclassified to profit or loss. The staff should justify this deviation from existing accounting principles.
Performance assessment and disclosures	
– **When the asset and target profiles are misaligned, what information should be portrayed through recognition and measurement and what would be better captured by disclosure:** As DRM activities are focused on using DRM derivative instruments to align the asset profile with the target profile, any event that results in the target profile not being achieved should in general be reflected in performance. Some events may require an adjustment to profit or loss while others may trigger specific disclosures in addition to recognition and measurement.	Several Board members noted that the proposed model assumed perfect alignment between the asset and target profiles, but did not consider cases where the DRM objective is not to fully align but to bring the asset profile closer to the target profile. Specifying how to measure performance in such cases – i.e. determining the extent to which the DRM objective is achieved – would be critical. The Board also believed that banks might be reluctant to provide extensive disclosures about the target profile because they might contain proprietary information.

Key considerations	Board comments
Criteria for designating a relationship	
– **Designation criteria** that ensure consistent application and allow entities to clearly identify which derivatives have been used for DRM and are therefore subject to the proposed model, which may include: - the asset profile consisting of eligible items and the target profile meeting the qualifying criteria; - formal designation and documentation of the relationship and the DRM objective and strategy at inception of the relationship; and - the relationship meeting the performance assessment criteria. – **Whether applying the model is optional or mandatory.** – **When discontinuation is permitted or required and how it interacts with performance, recycling or amortisation.**	The Board agreed that further consideration would be needed to determine what should be included in the formal documentation, given that the relationships under the proposed model would be designated on an open portfolio basis rather than one-to-one.

The Board supported a model based on cash flow hedge mechanics.

What did the IASB decide?

The Board did not make any decisions, but directed the staff to concentrate their efforts on further developing the model based on cash flow hedge mechanics. The staff should also begin involving preparers and users of financial statements in their discussions at an early stage.

Next steps

The staff will present a detailed project plan to the Board at a future meeting to enable it to proceed to technical discussions.

KPMG insight

Target profile

Under the proposed model, amounts recognised in OCI would be reclassified to profit or loss in a manner that aligns interest income with the target profile. In other words, the interest income recognised in profit or loss would be primarily based on the desired profile of cash flows as determined by management from time to time.

Because the target profile is chosen by management, it may be important for an entity to provide disclosures not only to explain what the target profile is but also to enable users to identify the key drivers of any changes to the target profile and the entity's risk management strategies. The IASB will have to consider how much disclosure is necessary to achieve the transparency objective of the proposed model and whether there are commercial concerns that would be a justifiable barrier to disclosing information about DRM.

Fair value changes in OCI and ineffectiveness

Although the proposed model would lead to volatility in OCI, volatility in OCI is already present for entities that currently use 'proxy hedges' by identifying alternative eligible hedged items – e.g. re-pricing assets – to which cash flow hedge accounting is applied.

A crucial decision in developing the model will be to determine to what extent fair value changes of the DRM derivative instruments should be deferred in OCI. Under current IFRS, for cash flow hedges ineffectiveness is recognised in profit or loss only when the cumulative fair value changes of the hedging instrument exceed the cumulative changes in the present value of the expected cash flows from the hedged item attributable to the hedged risk. Applying this to the proposed model, if the DRM derivative instruments bring closer, but do not fully align, the asset profile to the target profile, then the entity would always recognise all fair value changes of the DRM derivative instruments in OCI, regardless of whether the DRM objective has been achieved. An alternative method to measure ineffectiveness might be to represent how successful management are in meeting their DRM objective.

Another issue concerns reclassifying amounts recognised in OCI to profit or loss, which will be complex because of the continuous changes in DRM relationships. For example, how amounts in OCI should be reclassified to profit or loss when a DRM derivative instrument is no longer required for alignment and how changes in the target profile should affect recycling will need to be addressed.

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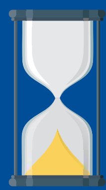

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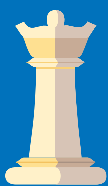

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