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The IASB´s DP on Accounting for Dynamic Risk Management

A solid basis to reflect Bank´s Risk Management Practice in Financial Statements?

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AGENDA

- Introduction, Research Question and Project
- Overview – Accounting for Dynamic Risk Management
- Approach to Comment Letter Evaluation
- Evaluation of Comment Letters
- Main Findings and further Research Necessity

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INTRODUCTION,
RESEARCH QUESTION AND PROJECT

INTRODUCTION, RESEARCH QUESTION AND PROJECT

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DISCUSSION PAPER (DP) ON ACCOUNTING FOR DYNAMIC RISK MANAGEMENT – A PORTFOLIO REVALUATION APPROACH TO MACRO HEDGING

- Until May 2012
  - Part of IFRS 9 Phase 3 Hedge Accounting
  - Separation from IFRS 9
    - New approach for dynamic risk management takes more time than initially expected
    - Macro Hedge Accounting not only relevant for Financial Instruments
- April 2014
  - Publication of DP on Accounting for Dynamic Risk Management
- October 2014
  - End of Comment Period
- New Approach
  - Dynamically managed positions to be revalued for changes in managed risks through p/l
  - Risk managment instruments (often derivatives) to be measured at fair value through profit or loss statement (general treatment under IAS 39/IFRS 9 anyway)
  - Net effect on p/l capture the overall success of an entity´s dynamic risk managment

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IS THE IASB´S DP A SOLID BASIS TO REFLECT BANK´S RISK MANAGMENT PRACTICE IN FINANCIAL STATEMENTS?

- Starting point
  - Submission of Comment Letters from publication on April 14th until October 17th 2014
  - 26 questions posted by the IASB
  - Submission of 123 Comment Letters (CL)
    - Publicly available at the IASB´s website
  - First research phase
    - CL provided jointly by a group of authors where counted once, despite being uploaded as separate CL on the IASB´s website
  - On the one hand – Conduction quantitatively by stating clearly the outcome of these questions
    - Thereby carving out respondents´predominant views
  - On the other hand – Comprehensive discussion of major arguments
    - Especially where views differ

Overview – Accounting for Dynamic Risk Management

OVERVIEW – ACCOUNTING FOR DYNAMIC RISK MANAGEMENT

CHARACTERISTICS OF DYNAMIC RISK MANAGEMENT

- „Risk management is undertaken for *open portfolio(s)*, to which new exposures are frequently added and existing exposures mature“ (DP, page 24)
- „As the risk profile of the open portfolio(s) changes, risk management is updated on a timely basis in reaction to the changed net position“ (DP, page 24)
- Main pillars of dynamic risk management
  - Frequent changes in risk exposures
  - Adequate reactions to those changes
  - Focus on net positions

PORTFOLIO REVALUATION APPROACH

- Exposures´ of cash flows included in the portfolio revaluation approach to be *revalued only for changes in the risk being managed* (for example interest rate risk) using the present value technique
- Immediate recognition of the revaluation adjustments in p/l
- Changes in unmanaged risks (for example credit risk) not to be revalued over time (application of the relevant accounting rules including impairments)
  - Hence, no Full Fair Value Model
- Risk management instruments (for example interest rate swaps) to be revalued at fair value through p/l (anyway)
- If the two effects do not offset either intentionally or unintentionally
  - Effect to be shown in p/l (IASB also considers to show it in OCI)

Approach to Comment Letter Evaluation

APPROACH TO COMMENT LETTER EVALUATION

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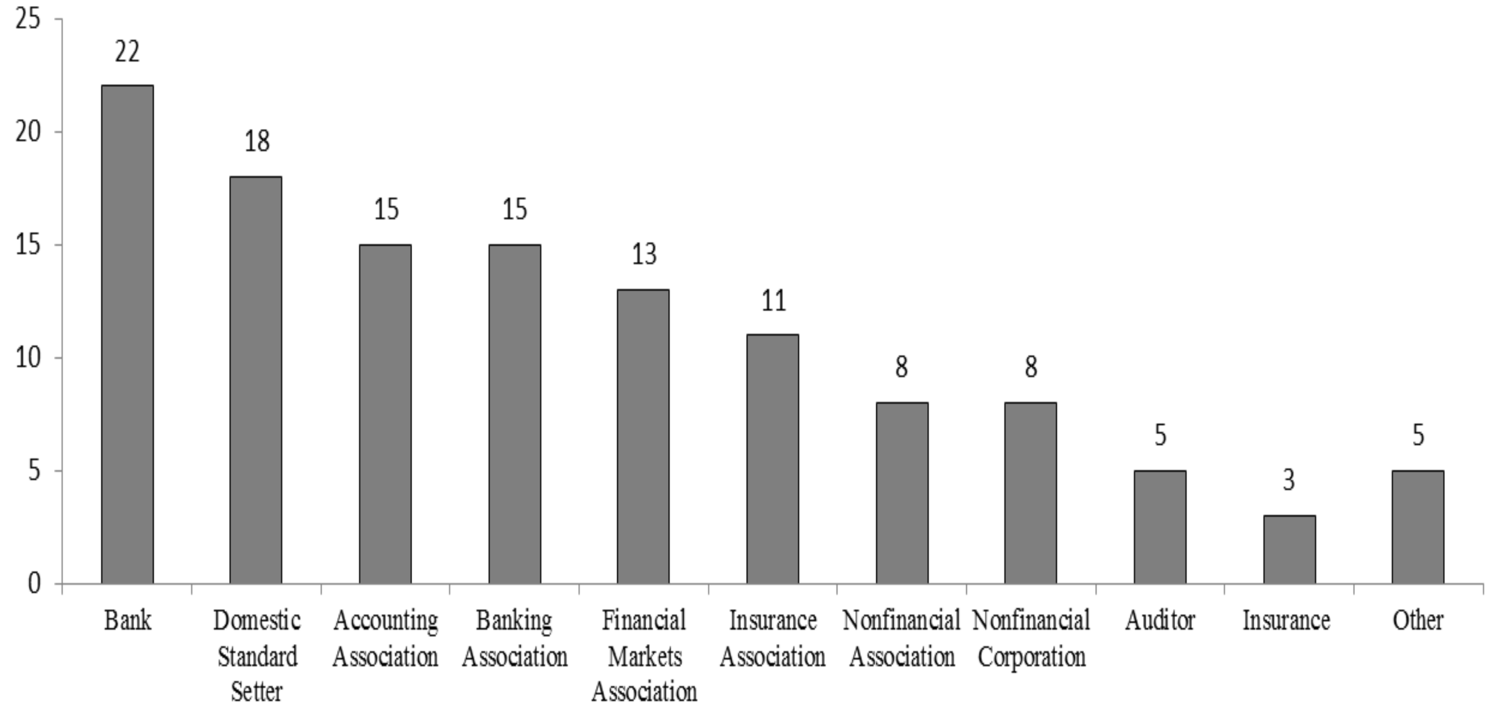
ELEVEN COMMENTATOR GROUPS FORMED TO ALLOW AN EXPLICIT ANALYSIS OF THE SIGNIFICANT STAKEHOLDERS´VIEW



Source – Own representation
Financial market associations include ECB and Basel Committee as well as explicit analysts

APPROACH TO COMMENT LETTER EVALUATION

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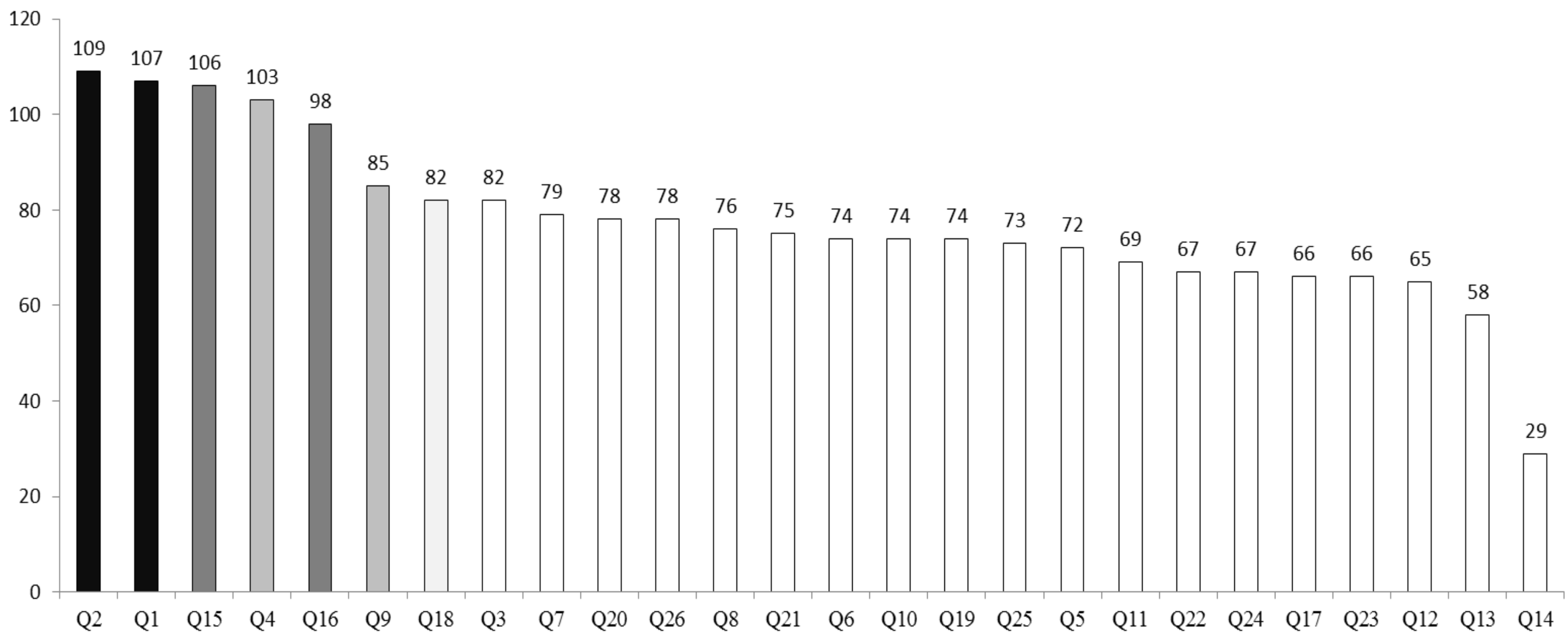
QUESTIONS ANSWERED BY FREQUENCY



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APPROACH TO COMMENT LETTER EVALUATION

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FIVE DISTINCT AREAS/MAIN TOPICS IDENTIFIABLE (THIS PRESENTATION FOCUSSES JUST ON TWO OF THEM)

- Difficulties with current standards in a dynamic risk management
  - Question 1 – Need for an accounting approach for dynamic risk management
  - Question 2a – Current difficulties in representing dynamic risk management in entities´financial statements
- *Scope alternatives and mandatory or optional application*
  - *Question 15 – Scope*
  - *Question 16 – Mandatory or optional application of portfolio revaluation approach*
- *Possible elements of behaviouralisation*
  - *Question 4 – Pipeline transactions, EMB and behaviouralisation*
  - *Question 9 – Core demand deposits*
- Alternatives for presentation within financial statements
  - Question 18 – Presentation alternatives
- Commentator´s view with regard to the concept in general
  - Question 2b – Do you think the PRA would address the issues identified?

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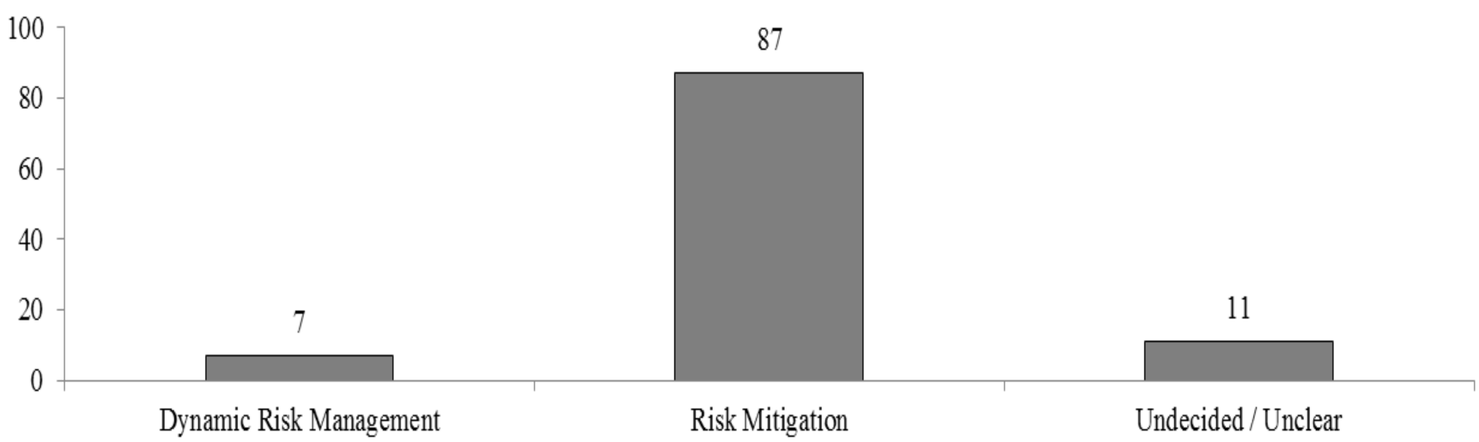
Evaluation of Comment Letters

EVALUATION OF COMMENT LETTERS

SCOPE ALTERNATIVES AND MANDATORY OR OPTIONAL APPLICATION (1)

- Question 15 – Do you think that the PRA should be applied to all managed portfolios included in an entity´s dynamic risk management (i.e. a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (i.e. scope focused on risk mitigation)?



Source – Own representation

EVALUATION OF COMMENT LETTERS

SCOPE ALTERNATIVES AND MANDATORY OR OPTIONAL APPLICATION (2)

- 82,6% of all answers prefer a scope limited to risk mitigation, only 6,7% prefer a scope focused on dynamic risk management while 10,5% are undecided or do not state a clear statement
- Whereas within the group of financial markets associations at least 9% would welcome a scope focused on dynamic risk management, no single commentator in the aggregate banking industry would prefer this broader scope
- Could this be explained by the initial presumption that banks have a strong focus on low earnings volatility which is rather given by a focus on risk mitigation?
- The group supporting the dynamic risk scope most often claims that only this alternative provides a complete picture of an entity´s economic position
- It is also argued that the chance for arbitrary manipulation of profit and loss could be reduced (it should be noted that this concern would be most relevant if the application of the PRA were optional)
- Finally it is argued that only a dynamic risk management scope would increase comparability of financial statements

SCOPE ALTERNATIVES AND MANDATORY OR OPTIONAL APPLICATION (3)

- Supporters of a risk mitigation scope can be divided into negative and positive reasoning
- Negative (why the dynamic risk management scope is not supported)
  - Scope on dynamic risk management would in effect challenge or even override classifications of IFRS 9 Phase 1 (especially measurement at amortised cost)
  - Scope on dynamic risk management would lead to undue volatility in p/l (as banks do not manage risk in such precission that the full risk exposure is constantly eliminated)
- Positive (why the risk mitigation scope is preferred)
  - Portfolio revaluation approach should (only) address accounting mismatches (the original objective of hedge accounting was to address different measurement of assets and liabilities on the one hand and derivatives on the other hand)
  - Scope focused on risk mitigation would be better suited as it includes only exposures subject to hedging activities (it reflects the appropriate level about risks that the entity has chosen to mitigate)

EVALUATION OF COMMENT LETTERS

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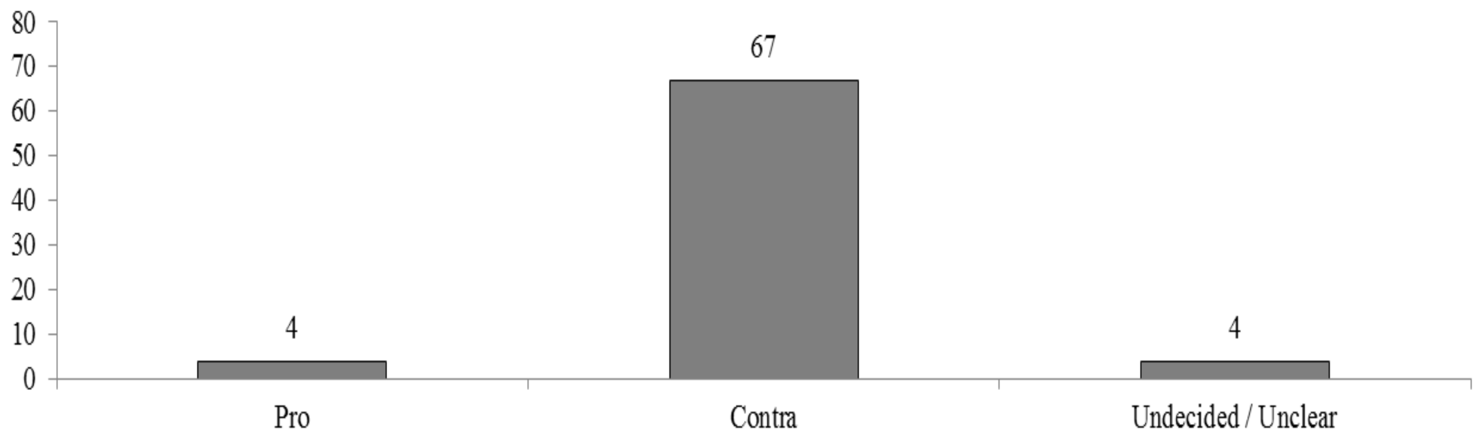
SCOPE ALTERNATIVES AND MANDATORY OR OPTIONAL APPLICATION (4)

- Question 16 – Do you think that the application of the PRA should be mandatory if the scope of application of the PRA were focused on
  - (a) dynamic risk management? Why or why not?
  - (b) risk mitigation? Why or why not?
- Question 16a



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EVALUATION OF COMMENT LETTERS

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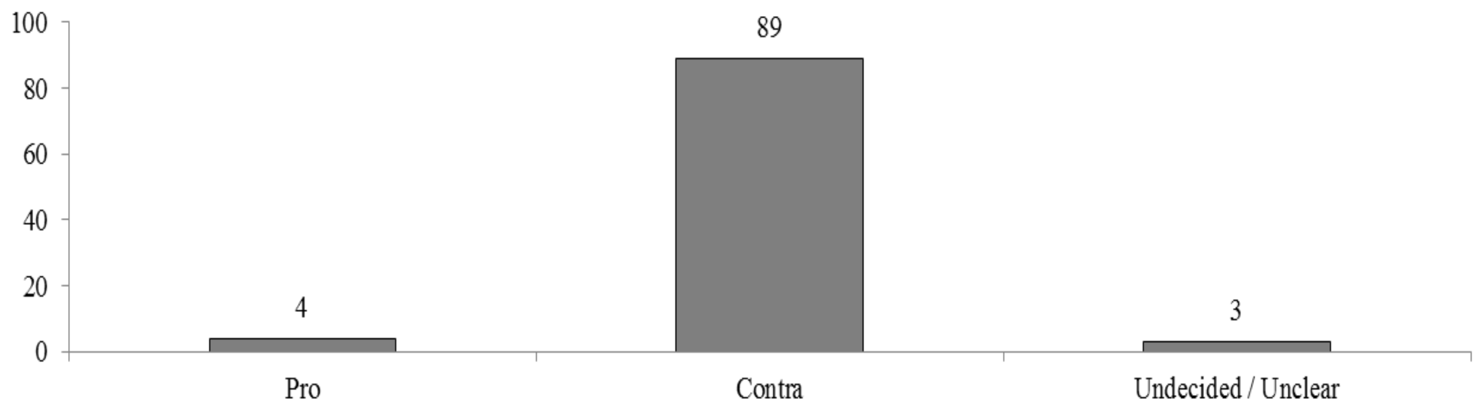
SCOPE ALTERNATIVES AND MANDATORY OR OPTIONAL APPLICATION (5)

- Question 16b



- 92,7% object a mandatory application within a risk mitigation approach (89,3% in case of a scope focused on dynamic risk management)
- 4,2% support a mandatory application within a risk mitigation approach (5.3% in case of a scope focused on dynamic risk management)

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EVALUATION OF COMMENT LETTERS

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SCOPE ALTERNATIVES AND MANDATORY OR OPTIONAL APPLICATION (6)

- Supporters of a mandatory application
  - Mandatory application would increase comparability
  - Optional application would fail to reach a closer alignment beween dynamic risk management and accounting (especially because entities would be able to choose between applying IFRS 9 and the PRA for dynamically managed portfolios)
- Supporters of an optional application
  - Optional application would be consistent with optional application of hedge accounting of IAS 39/IFRS 9
  - With a mandatory application mismatches between the two concepts would arise (which might be difficult to follow for users of financial statements)
  - Risk management strategies differ among banks which requires flexibility in the choice of the fitting accounting alternative

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POSSIBLE ELEMENTS OF BEHAVIOURALISATION (1)

- Behaviouralisation within the portfolio revaluation approach
  - Pipeline transactions
  - Equity Model Book (EMB)
  - Behaviouralisation of certain elements like expected prepayments of certain assets (for example mortgages)
  - Core demand deposits
- Inclusion of these items would broaden the scope compared to current hedge accounting requirements of IAS 39/IFRS 9

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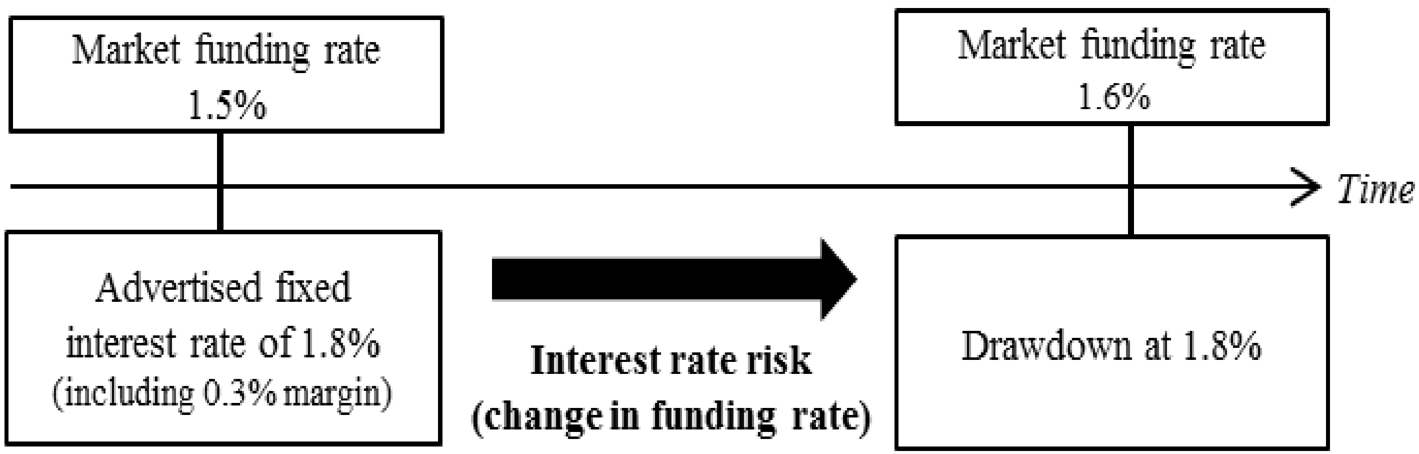
POSSIBLE ELEMENTS OF BEHAVIOURALISATION (2)

- Pipeline transactions
  - Forecast volumes of drawdowns on fixed interest rate products at advertised rates
  - In contrast to forecast transactions the criterion *highly probable* is not a necessary precondition for pipeline transactions



Source – Adapted from Spall/Tejerina/Harding, New on the horizon – Accounting for dynamic risk management activities, publication number 131894, London 2014, page 18

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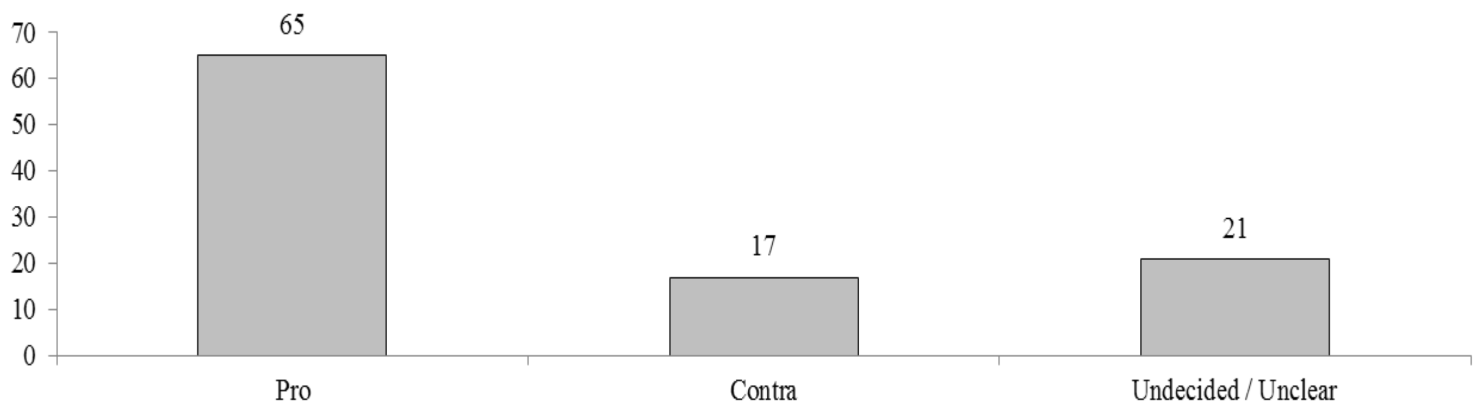
POSSIBLE ELEMENTS OF BEHAVIOURALISATION (3)

- Question 4a – Do you think that pipeline transactions should be included in the PRA if they are considered by an entity as part of its dynamic risk management? Why or why not? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework



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POSSIBLE ELEMENTS OF BEHAVIOURALISATION (4)

- Pipeline transactions
  - 63,1% support the inclusion while 16,5% oppose, 20,4% are undecided or do not state a clear statement
  - The aggregate banking industry supports it with an approval rate of 71%
  - In contrast, only 42% of the financial markets associations would welcome the inclusion while 50% would reject it
  - Opponents mainly foreground the conflict with the Conceptual Framework
  - In many cases pipeline transactions would represent forecast transactions with a higher degree of uncertainty where recognizing the asset would be inconsistent with basic accounting principles such as the definition of assets and liabilities
  - Several respondents fear that an inclusion grants significant discretion to management which might be leading to earnings management
  - Supporters to a large extent note that today pipeline transactions play an important role in dynamic risk management of banks
  - Many proponents acknowledge the conflict with the Conceptual Framework but concede that this has a lower priority as they seek for a pragmatic solution

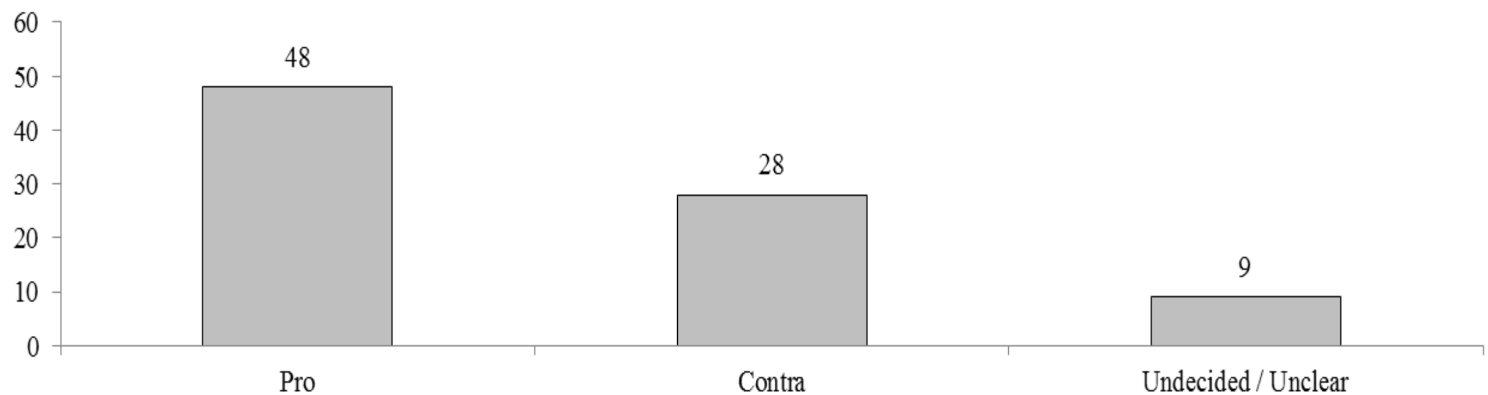
POSSIBLE ELEMENTS OF BEHAVIOURALISATION (5)

- Equity Model Book (EMB)
  - Return rate required by equity holders
  - Seen as a combination of a fixed rate base return similar to interest and a variable residual return resulting from total net income
  - Fixed rate base return provides a continous compensation to equity holders for providing funding
  - Banks include fixed rate base return on equity into their ALM (and treat it along with other exposures – called replication portfolio)
  - Inclusion means that a new exposure (a replication portfolio representing the fixed rate base return on equity) is added to existing liablities (demand deposits, term deposits as well as bonds)
  - Inclusion seems appropriate from a practical point of view as this would further align risk management with accounting
  - However – conceptual difficulties as equity is a residual parameter according to the Conceptual Framework (it does not satisfy the definition of liabilities)

EVALUATION OF COMMENT LETTERS

POSSIBLE ELEMENTS OF BEHAVIOURALISATION (6)

- Question 4b – Do you think that EMB should be included in the PRA if they are considered by an entity as part of its dynamic risk management? Why or why not? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework



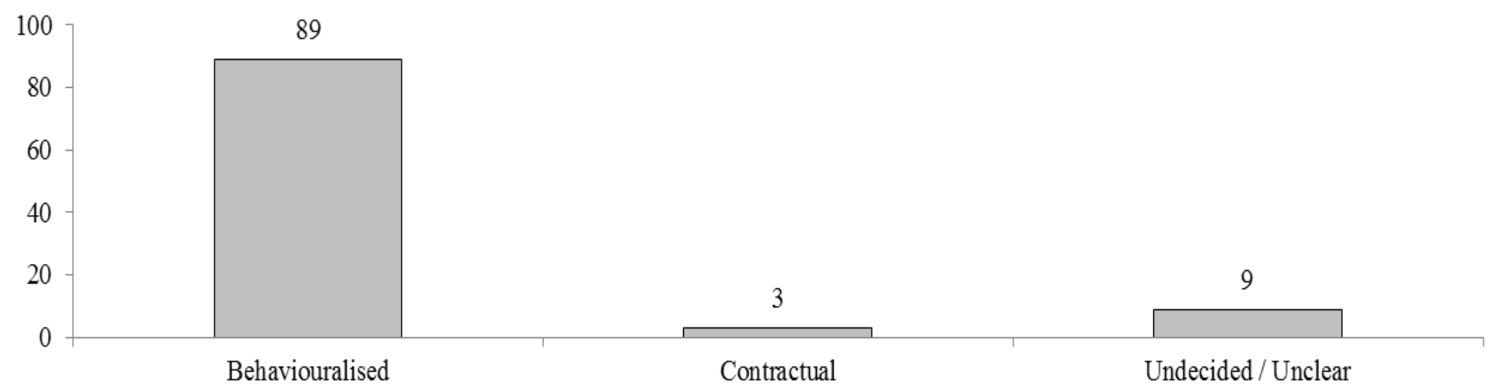
Source – Own representation

POSSIBLE ELEMENTS OF BEHAVIOURALISATION (7)

- EMB
  - 56,5% support the inclusion whereas 32,9% reject
  - The aggregate banking industry supports it with an approval rate of 84%
  - Only 25% of the financial markets associations are supportive, 67% reject the inclusion
  - Opponents again mainly foreground the conflict with the Conceptual Framework
  - „Equity is the residual interest in the assets of the entity after deducting all its liabilities. (…) In other words, they are claims against the entity that do not meet the definition of a liability.“ (ED for a Revised Conceptual Framework for Financial Reporting, page 46)
  - Respondents fear subjectivity of the assumptions made which might be leading to earnings management
  - Some respondents note that the cash flow hedge of IAS 39/IFRS 9 already allows for an indirect way to depict the effects of the interest rate risk
  - Supporters largely mention that hedges in context with the EMB play a crucial part in dynamic risk management and need to be included for the sake of a faithful representation
  - Some proponents see an even stronger need for a solution as equity is becoming a more significant source of funding due to changes in banking regulation

POSSIBLE ELEMENTS OF BEHAVIOURALISATION (8)

- Question 4c – For the purpose of applying the PRA, should the cash flows be based on a behaviouralised rather than on a contractual basis, when the risk is managed on a behaviouralised basis? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework



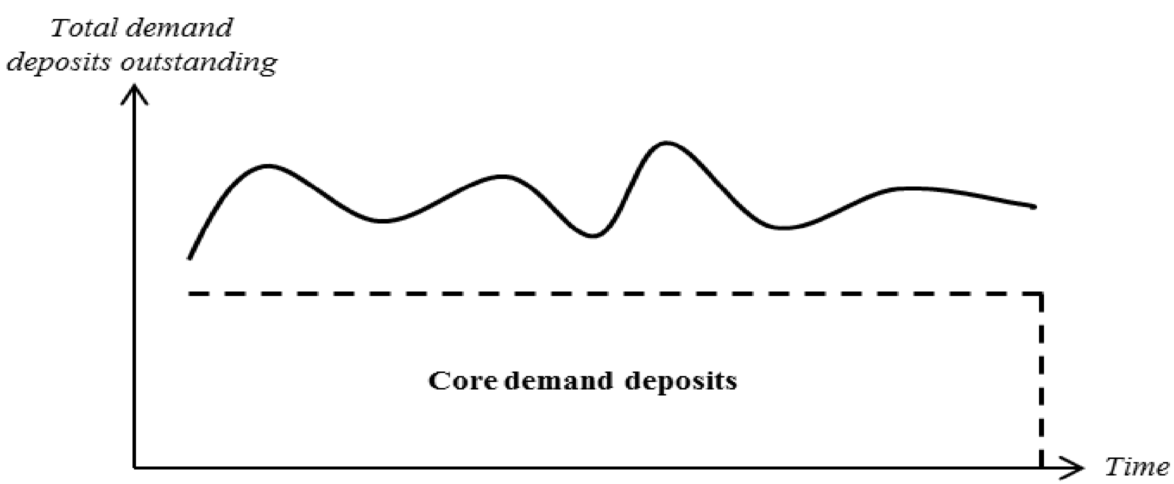
Source – Own representation

POSSIBLE ELEMENTS OF BEHAVIOURALISATION (9)

- Cash flows on a behaviouralised basis
  - 88,1% think that cash flows should be formed on a behaviouralised basis while only 3,0% would prefer cash flows on a contractual basis
  - The aggregate banking industry and the financial markets associations have only one supporter each for cash flows on a contractual basis
  - Opponents against an inclusion argue with concerns that a behaviouralised portfolio affecting profit and loss is very dependent on management´s assumptions and projections, which are arbitrary and difficult to verify – danger of earnings management
  - Some doubt the predictive value of the models used for behaviouralisation and assume that they are subject to modeling pitfalls
    (loan prepayments for mortgages might be driven by other factors than interest rates, for example the property market, and thus difficult to forecast)
  - Supporters mainly find this feature crucial to a new model that has the aim to align dynamic risk management and accounting
  - Some argue that the concept is already applied to the portfolio fair value hedge of interest rate risks in accordance with IAS 39, where cash flows are rather modeled on a behaviouralised basis than on a contractual basis
    (another example is the assessment of impairment for revolving facilities in IFRS 9)

POSSIBLE ELEMENTS OF BEHAVIOURALISATION (10)

- Core demand deposits (1)
  - Demand deposits bear a variable interest rate and can be withdrawn any time at the customer´s discretion
  - A certain amount is typically left as a deposit for a long and predictible time
  - ALM treats core demand deposits often as term fixed interest rate exposure



Source – Adapted from IFRS Foundation, Snapshot – Accounting for dynamic risk management activities, a portfolio revaluation approach to macro hedge, London 2014, page 9

POSSIBLE ELEMENTS OF BEHAVIOURALISATION (11)

- Core demand deposits (2)
  - Current hedge accounting requirements (IAS 39/IFRS 9) do not allow for a fair value hedge as (by definition) demand deposits do not contain fair value risk (contractually they bear variable interest)
  - If demand deposits are non-interest bearing (often the case in the current low interest environment) they do also not qualify for cash flow hedge as there is no volatility in cash flows
  - Inclusion seems appropriate from a practical point of view as this would further align risk management with accounting
  - However – conceptual difficulties arise as IFRS are usually based on contractual arrangements (inclusion would introduce considerable judgement about future events flowing into accounting figures)

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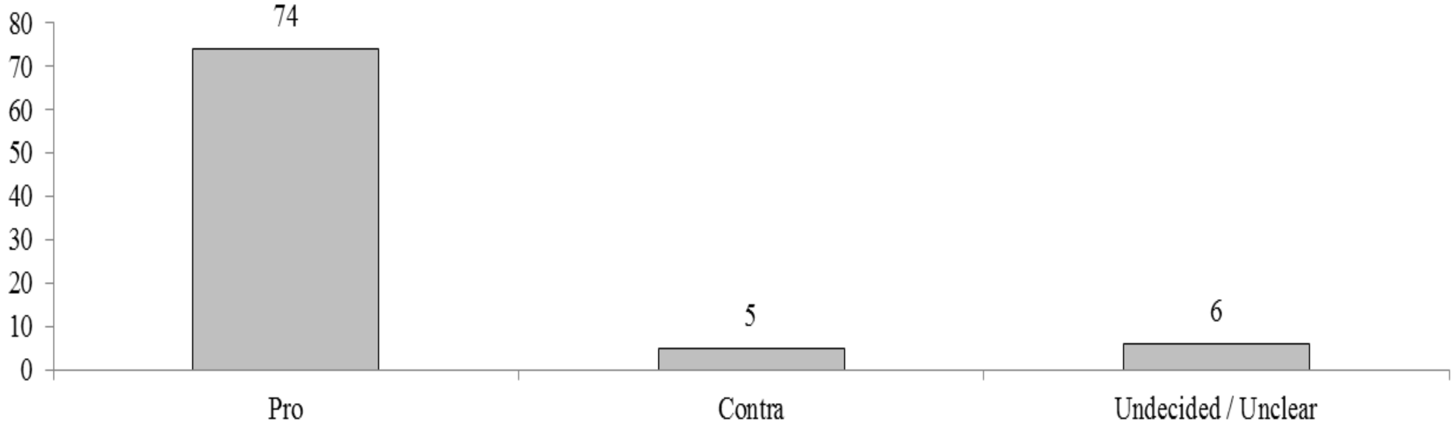
POSSIBLE ELEMENTS OF BEHAVIOURALISATION (12)

- Question 9a – Do you think that core deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA if that is how an entity would consider them for dynamic risk purposes? Why or why not?



Source – Own representation

POSSIBLE ELEMENTS OF BEHAVIOURALISATION (13)

- Core demand deposits (3)
  - 87,1% support the inclusion of core demand deposits while only 5,9% reject this
  - Approval rates between the aggregate banking industry and the financial markets associations are 90% and above and thus relatively equal
  - Opponents against an inclusion refer to the IASB´s statement in the DP, stating that the inclusion would raise significant issues concerning the recognition of revaluation gains and losses
  - The IASB notes that it is in some cases difficult to assess whether changes in core demand deposits are the result of customers´behavior, the reflection of bank´s actions responding to its assessment of interest rate risk or other factors (differentiation could be necessary as varying causes might have a distinct impact on p/l)
  - It is claimed that the inherent uncertainty about estimates for core demand deposits is so high that the principle of relevance outweighs the expected faithful representation
  - Supporters argue that core demand deposits form a base pillar of the strategy of a retail banking institution (without inclusion there would be no proper representation of risk management since the reported interest rate risk position would be distorted)

Main Findings and further Research Necessity

MAIN FINDINGS (1)

- Roughly 70% of the aggregated banking industry and the financial market associations sees a need for a specific accounting approach for dynamic risk management
- More than 80% of the respondents prefer a scope limited to risk mitigation
  - Within the group of financial markets associations at least 9% would welcome a scope focused on dynamic risk management
  - No commentator of the banking industry would support a broader approach
  - From a normative research perspective further consideration of the argumentation necessary (as they differ and partly seem to be politically based)
- More than 90% object a mandatory application within a risk mitigation approach (around 90% in case of a scope focused on dynamic risk management)
  - From a normative research perspective further consideration of the argumentation necessary (as they differ and partly seem to be politically based)

MAIN FINDINGS (2)

- More than 70% of the aggregate banking industry support the inclusion of pipeline transactions
- The aggregate banking industry supports the inclusion of the Equity Model Book with an approval rate of about 85%
- Approximately 90% think that cash flows should be formed on a behaviouralised basis (the aggregate banking industry and the financial markets associations have only one supporter each for cash flows on a contractual basis)
- Roughly 90% support the inclusion of core demand deposits (approval rates between the aggregate banking industry and the financial markets associations 90% and above and thus relatively equal)

MAIN FINDINGS AND FURTHER RESEARCH NECESSITY

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CONCEPTUAL REMARKS (1)

- Need for a specific accounting approach for dynamic risk management generally accepted
- Different views about the extension (dynamic risk management or risk mitigation)
- Different views about mandatory or optional application (predominant view optional)
- However
  - Portfolio approach always exception from single asset and liability measurement principle
  - Aim and sense of accounting to reflect business – not reducing volatility in p/l per se
  - Derivatives in trading or for speculation to be measured at full fair value (anyway)
  - Derivatives in hedge relationships to be included in dynamic risk management approach
  - Derivatives neither in trading nor in hedge relationships not in existence
  - If portfolio approach to be allowed then to reflect business (actual risk management)
  - If risk management activity to be reflected in accounting then mandatory
  - Voluntary approach for risk mitigation purposes contradicts measurement rules for derivatives (recognition and fair value measurement of derivatives absurd)

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CONCEPTUAL REMARKS (2)

- Possible Elements of Behaviouralisation
  - Always difficult to include as those elements usually don´t qualify as an assset or a liabiliy
  - To avoid earnings management
    - Restrictive treatment necessary
    - Avoidance of discretion for manipulation crucial
  - Example – Cash flow hedge of anticipated transactions (criterion of being highly probable)
  - Maybe possible for
    - Core demand deposits – as there is a contract and a history of withdrawing (however – to be adjusted for current market circumstances)
    - Prepayment risk – as there is a loan contract and a history of prepayments (however – to be adjusted for current market circumstances
    - Irrevocable loan committments – if there is a contract and common practice of inclusion into ALM

CONCEPTUAL REMARKS (3)

- Impossible Elements of Behaviouralisation
  - Pipeline transactions – in the definition of the DP
    (maybe possible if the probability of occurance is high, but very hard to prove)
  - Equity Model Book – as Equity in any accounting regime is a residual
    (fundamental and unchangeable principle of accounting out of its nature)

MAIN FINDINGS AND FURTHER RESEARCH NECESSITY

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FURTHER RESEARCH

- Comparison of different risk management appoaches in practice
  - Interviews in major banks Europe-wide (as an additional research method)
  - Different risk strategies, details of managed issues and instruments used
  - Clear description of main managements practices in the direction of possible accounting adaption needed
- Measurement of the importance of different elements of behaviouralisation
  - Percentage of managed portfolio(s)
  - Possible p/l effects (possible mismatches to managed figures)
  - Possibility of additional disclosure for excluded but managed parts
- Conclusion
  - DP a solid basis to reflect bank´s risk management practice in financial statements
  - However
    - Only a starting point for further development and investigtion
    - Many questions still to be solved

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THANK YOU VERY MUCH FOR YOUR ATTENTION

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