

IFRS

New on the Horizon: Accounting for dynamic risk management activities

July 2014

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Introducing the portfolio revaluation approach

On 17 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 its project on macro hedge accounting. The DP explores one possible approach to accounting for dynamic risk management – a continuous process that involves risk identification and analysis, and the mitigation of net open risk positions arising from managed portfolios. The project involves fundamental accounting questions and is not simply a modification to current hedge accounting models – so the IASB has not proceeded straight to issuing an exposure draft.

Although current IFRS provides models for macro hedge accounting, these contain restrictions that limit the ability to reflect some common dynamic risk management activities. Without an accounting model that reflects many dynamic risk management activities, some argue that it may be difficult to faithfully represent a company's risk positions in its financial statements, and that companies are left with focusing on reducing volatility in profit or loss rather than truly reflecting their risk management activities.

The IASB published its DP in response to these issues. Like the general hedge accounting model finalised in November 2013, the DP's macro hedge accounting model aims to better reflect companies' risk management activities while reducing the operational complexities of the current accounting requirements.

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 accounting model. Under the PRA:

- 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;
- risk management derivatives – i.e. hedging instruments – would continue to be measured at fair value through profit or loss;
- 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; and
- risks that are not managed would not be included in the PRA – i.e. this is not a full fair value model.

The new approach could have a much broader scope and impact than the current hedge accounting requirements, depending on the scope alternatives described in the DP.

The PRA would be likely to have a significant impact on banks, but it could also affect companies in other industries that employ 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.

We strongly encourage constituents to provide comments to the IASB on the DP, and to participate in the development of a transparent, operational and decision-useful macro hedge accounting model. We hope that this publication will help you to understand the DP and formulate your own response.

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KPMG International Standards Group

1 Key facts

- **The IASB has published a discussion paper (DP) on accounting for dynamic risk management for public comment, with comments due by 17 October 2014.**
- **A new approach would potentially affect a wide range of companies in different industries that engage in dynamic risk management activities covering risks such as interest rate risk, commodity price risk and foreign exchange risk.**
- **Consistent with the general hedging model in IFRS 9 *Financial Instruments*, the IASB is attempting to align accounting more closely with risk management. The aim of the DP is to stimulate debate on a potential new approach to macro hedge accounting – the portfolio revaluation approach (PRA). Under this approach:**
 - 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;
 - risk management derivatives – i.e. hedging instruments – would continue to be measured at fair value through profit or loss (FVTPL);
 - 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; and
 - risks that are not managed would not be included in the PRA – i.e. this is not a full fair value model.
- **The DP discusses two overall scope alternatives:**
 - the dynamic risk management approach; and
 - the risk mitigation approach.
- **The DP also discusses a number of items that could be included within the PRA in order to more faithfully represent dynamic risk management activities in the financial statements. These involve fundamental accounting questions and are not simply a modification to current hedge accounting models.**
- **The DP describes three alternative approaches for presenting the revaluation adjustments from exposures that are included in the revalued portfolio in the statement of financial position:**
 - line-by-line gross-up;
 - aggregate adjustment; and
 - single net line item.
- **The DP describes two alternatives for presenting the outcome of the PRA in the statement of profit or loss and other comprehensive income:**
 - stable net interest income approach; and
 - actual interest income approach.
- **The DP provides four broad disclosure themes and also seeks input on the scope of the disclosures.**
- **The macro hedge accounting project has been carved out from the development of IFRS 9 and would be effective at a later date, once finalised.**

2 How this could impact you

You may see greater transparency and a better reflection of dynamic risk management activities

- The macro hedge accounting model aims to better reflect companies' risk management activities while reducing the operational complexities of current hedge accounting requirements.
- The impact would be limited to those companies that undertake dynamic risk management activities – but it could be very significant for those companies.

A new model would potentially be less complex to apply for open portfolios

- The current accounting requirements are operationally onerous, because hedging relationships need to be tracked and frequently adjusted to match the dynamic nature of open portfolios. Some companies have therefore sought alternative hedge accounting solutions. However, it is often impractical to apply hedge accounting, given the frequency with which hedge portfolios are updated – e.g. daily.
- A feature of the PRA is that all items in the portfolio would be revalued, so there may be less need to track individual items.
- Depending on the scope alternative that is selected, a hedge effectiveness assessment may no longer be required. For example, if the macro hedge accounting model were mandatory and the scope of the model were a focus on dynamic risk management, then it is possible that no effectiveness assessment would be required, because the revaluation would automatically capture the ineffectiveness arising from a remaining open risk position.
- Furthermore, the PRA may provide a greater opportunity to use data that is already used for risk management.



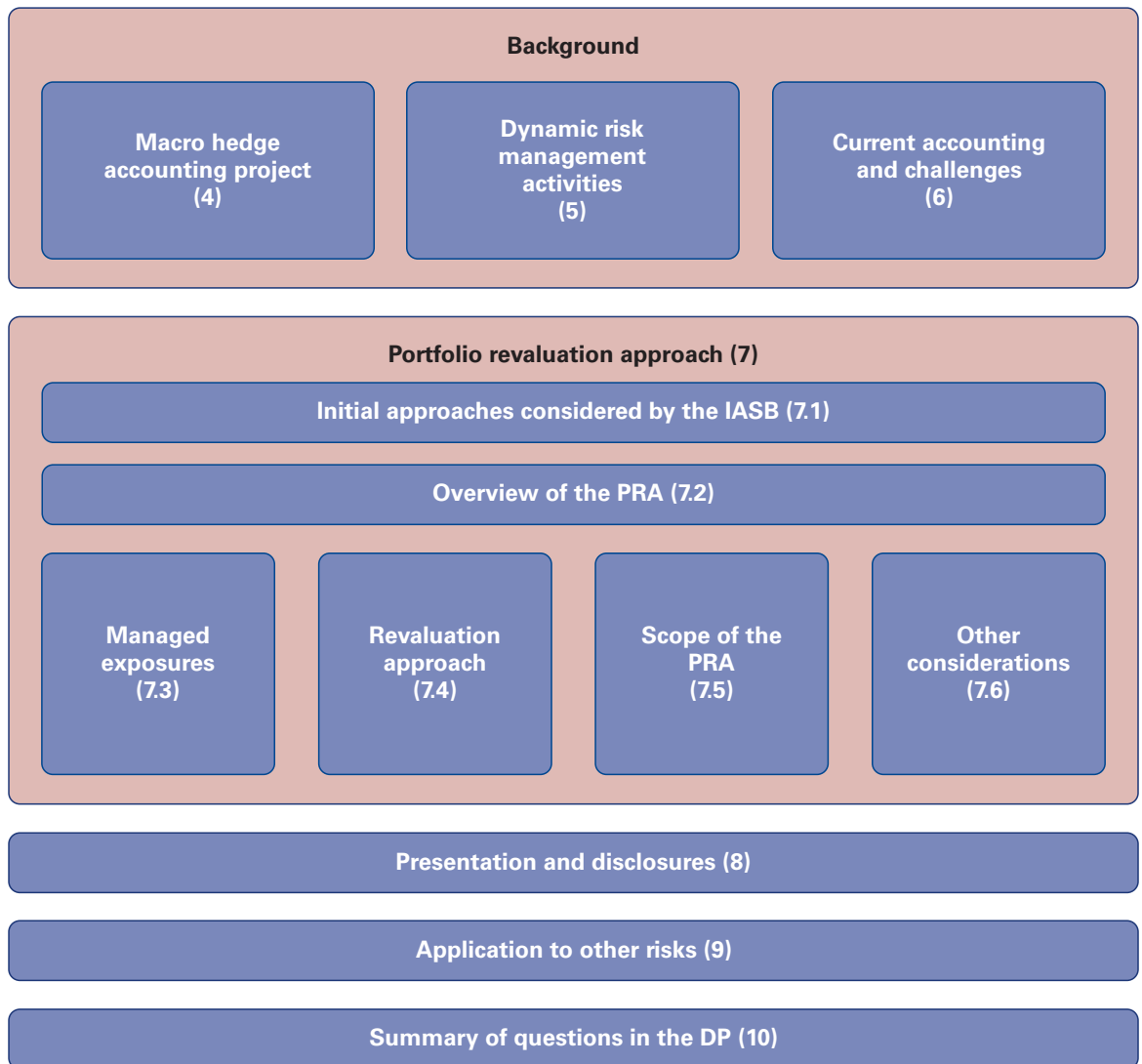
The wider impacts would depend on the scope alternative chosen by the IASB – i.e. which portfolios should be revalued – and whether application should be mandatory

- The DP presents two overall scope alternatives – the dynamic risk management approach and the risk mitigation approach. The dynamic risk management approach could result in significant new volatility in profit or loss, because items with risks that are managed dynamically but which are not hedged – i.e. open positions – would be revalued for the managed risk.
- The DP also discusses a number of items that would broaden the scope of items included in the managed risk exposures as compared with the current hedge accounting models. For example, the DP considers whether pipeline transactions¹, companies' own equity where it is managed to earn a minimum target return similar to interest, behaviouralised core demand deposit liabilities, and estimated cash flows related to prepayments should be eligible for inclusion in the managed exposure for interest rate 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 items that are incorporated into the PRA, the closer hedge accounting may be aligned with dynamic risk management activities. But the broader the scope of the PRA, the less consistent it may be with conventional accounting concepts.
- The less the PRA is aligned with dynamic risk management, the more changes to systems may be required to accommodate the new model – e.g. to track revaluation adjustments.
- The DP also considers whether application of the PRA should be mandatory, which would extend the impact to all companies that engage in dynamic risk management, regardless of whether they would otherwise choose to apply the PRA.

¹ Forecast volumes of draw-downs of fixed interest rate products at advertised rates.

3 Overview

The following diagram illustrates how key elements of the DP are explained throughout this publication.



Throughout this publication, we use 'Question' boxes to highlight questions raised in the DP, and to present items you may consider in formulating your response to the IASB.

4 Macro hedge accounting project

4.1 History of the project

DP IN8, 10

Between September 2010 and October 2013, the IASB held a series of public meetings and an educational session on accounting for dynamic risk management. Although current IFRS² provides models for macro hedge accounting, these contain restrictions that limit companies' ability to reflect some common dynamic risk management 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 dynamic risk management activities, it can be difficult to faithfully represent these activities in financial statements.

DP IN2, 10

In response to these issues, the IASB published 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 has not proceeded straight to issuing an exposure draft.

4.2 Interaction with IFRS 9

DP IN11

Since November 2008, the IASB has been working to replace its financial instruments standard (IAS 39 *Financial Instruments: Recognition and Measurement*) with an improved and simplified standard, IFRS 9.

The hedge accounting phase of the project was split into two parts: general hedge accounting and macro hedge accounting. On 19 November 2013, the IASB issued a new general hedge accounting standard as part of IFRS 9 (2013); the final version of IFRS 9, which contains revised classification and measurement and new impairment requirements, and which establishes an effective date of 1 January 2018, is expected in the third quarter of 2014.

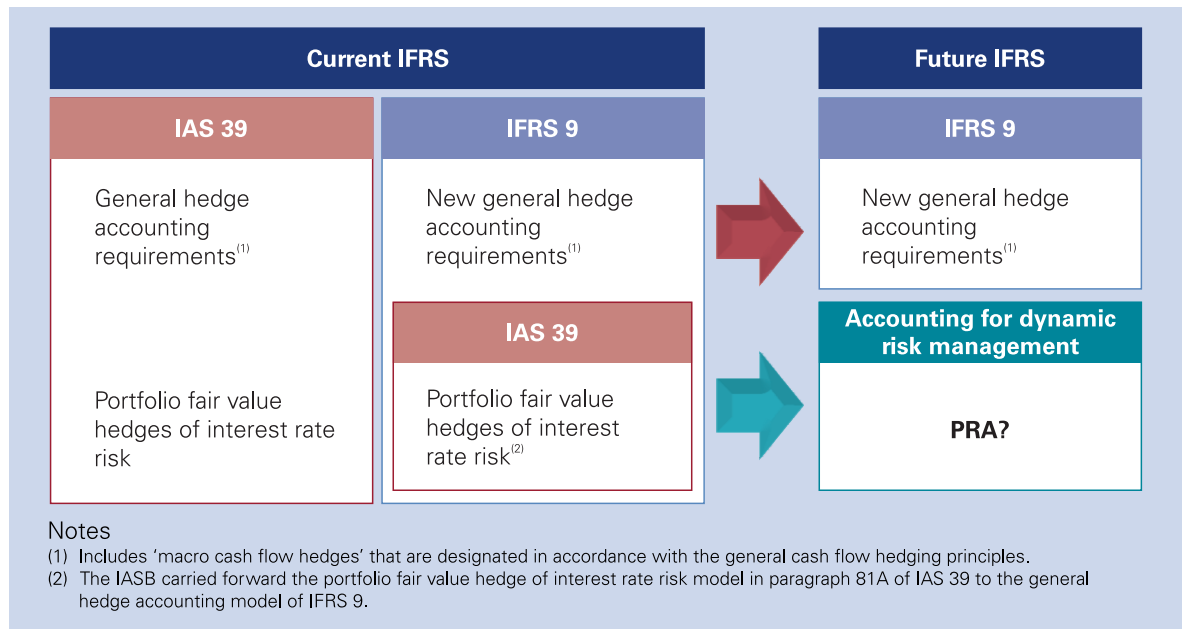
To avoid further delays to the mandatory effective date of IFRS 9, the macro hedge accounting project was carved out from the development of IFRS 9 as a separate project.

Observations – Interaction with current IFRS

DP IN13

Because of the potential interaction between the general hedge accounting model in IFRS 9 and any new macro hedge accounting model, the IASB has permitted a company to make an accounting policy choice to defer adoption of IFRS 9's general hedge accounting model until the standard resulting from the macro hedge accounting project is effective. In addition, the IASB carried forward the guidance permitting portfolio fair value hedges of interest rate risk in paragraph 81A of IAS 39 to the general hedge accounting model of IFRS 9. The DP states that the outcome of this project would replace the current portfolio fair value hedge of interest rate risk model (see 6.1.2), and therefore companies using those accounting requirements would be impacted if the preliminary views in the DP became a final standard.

2 Specifically, IAS 39 and IFRS 9.



4.3 Next steps in the project

DP IN5, IN14, 1.54

The IASB decided to focus on the way in which banks dynamically manage their interest rate risk as a starting point for the DP, because this provides a common example of a risk for which dynamic risk management is undertaken. However, the IASB's objective is to develop an approach to accounting for dynamic risk management that would apply to companies across all industries that engage in dynamic risk management activities. These activities may be undertaken to manage risks such as interest rate risk, commodity price risk or foreign exchange risk.

DP IN17–IN18

As the IASB has not reached a preliminary view on all of the issues discussed in the DP, the Board will consider the comments it receives to determine the appropriate next steps in this project.

Question 1 – Need for an accounting approach for dynamic risk management

The DP asks whether there is a need for a specific accounting approach to represent dynamic risk management in companies' financial statements.

Considerations for comment letter responses

Possible reasons why a company might believe that a specific accounting approach is needed for dynamic risk management

- The company currently applies the general hedge accounting model and/or the model for portfolio fair value hedges of interest rate risk, but desires an improved model that better reflects dynamic risk management activities in the financial statements – for example, one that:
 - better reflects how management hedges exposures, in a way that is unaffected by accounting concepts such as the distinction between a cash flow hedge and a fair value hedge, and the 'highly probable' criterion for future transactions; and
 - uses existing systems and infrastructure as much as possible to make applying the model operationally simpler.

	<ul style="list-style-type: none"> • The company believes that reflecting dynamic risk management using the current hedge accounting models is operationally challenging. • The company believes that key aspects of its dynamic risk management activities are ineligible for hedge accounting, or lead to financial reporting that does not faithfully represent the economics of its business. • The company believes that these problems cannot be solved more efficiently by making incremental changes to the current general hedge accounting model. • The users of its financial statements believe that the current hedge accounting models do not provide information that is consistent with dynamic risk management activities.
<p>Possible reasons why a company might not believe that a specific accounting approach is needed for dynamic risk management</p>	<ul style="list-style-type: none"> • The company believes that it is able to faithfully represent the economics of its dynamic risk management activities in its financial statements using the current hedge accounting models without undue cost or effort. • The general hedge accounting model in IFRS 9 is new, and the company believes that it would be premature to make additional changes to hedge accounting without first seeing how practice develops under IFRS 9. • The company believes that further improvements can be made to the general hedge accounting model to better accommodate macro hedge accounting, and that a separate model on accounting for dynamic risk management activities would be unworkable and not necessary. • The users of its financial statements believe that further improvements can be made to the current disclosure requirements, to better reflect dynamic risk management activities.

5 Dynamic risk management activities

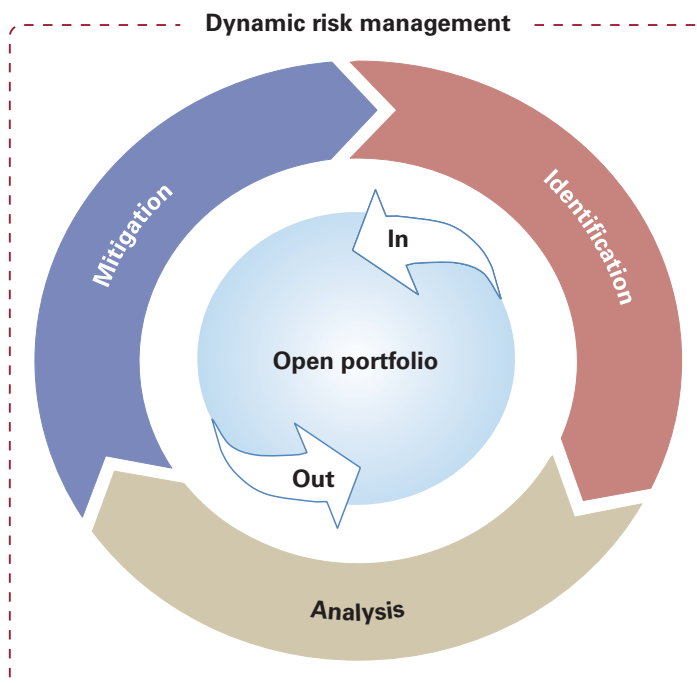
Many companies manage risks dynamically on a portfolio basis rather than on an individual basis. Managing these risks on a continuous and dynamic basis is a critical component of many companies' risk management activities. For example, net interest income is a significant – often the most significant – contributor to a bank's profitability. However, net interest income is exposed to changes in interest rates. The effectiveness with which a bank manages this risk affects its profitability.

However, dynamic risk management activities are not restricted to banks' interest rate risk management. Companies in other 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.

5.1 Characteristics of dynamic risk management

DP 1.1

The DP describes 'dynamic risk management' as a continuous process that involves identifying, analysing, and deciding whether, and how, to mitigate one or more risks associated with an 'open portfolio' – i.e. a portfolio that is made up of managed exposures that change over time because of additions and removals of managed exposures (for example, a loan portfolio with new loans being added and existing loans maturing or being prepaid over time).



DP 2.1.1

The DP describes the main characteristics of dynamic risk management as follows.

- Risk management is undertaken for open portfolios, to which new exposures are frequently added and existing exposures mature.
- As the risk profile of the open portfolios changes, risk management is updated on a timely basis in response to the changed net risk position.

DP 2.1.2

In addition, dynamic risk management may exhibit some of the following characteristics.

- In the context of interest rate risk management, the objective may be to keep the net interest income from the open portfolios within a targeted sensitivity to changes in market interest rates.
- Risk management may be based on open portfolios that include exposures based on estimates of the volume and/or timing of the cash flows – e.g. behaviouralised exposures.
- Only risk arising from external exposures is included within the managed portfolio.

Illustration – Interest rate risk management undertaken by banks

In managing their interest rate risk, banks focus on maintaining a fixed interest margin on a portfolio of their assets and liabilities. A bank’s net interest income comprises:

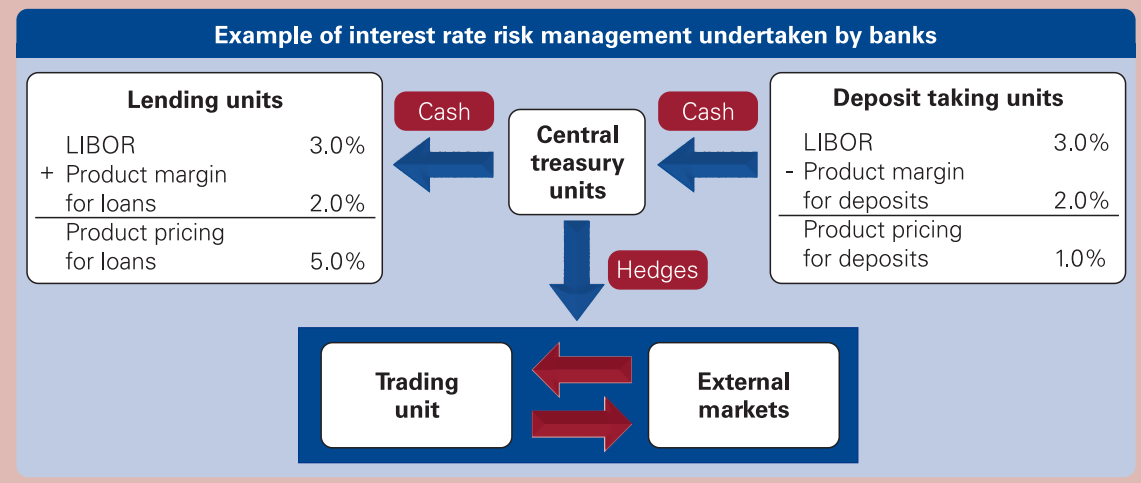
- the product margins of the assets and liabilities – i.e. the spreads between the contractual interest rates and the relevant benchmark interest rates that are charged by business units to compensate for credit risk and other expenses, and to generate profits; and
- any mismatches in the benchmark interest rates underlying the pricing of the instruments in the portfolio.

Such mismatches may arise from mismatches in interest rates such as: fixed interest rates vs floating interest rates; different maturities; different repricings; different amounts; and differences in the benchmark interest rates used – including bid-offer spreads and different indexes. These lead to volatility in banks’ net interest income, and so the objective of banks’ interest rate risk management activities is to address those mismatches arising from the benchmark interest rates.

Banks monitor and manage their interest rate risk on a portfolio basis through a central treasury unit or market risk management function responsible for asset liability management (ALM), by:

- combining fixed-rate assets and liabilities as well as floating-rate assets and liabilities in a portfolio; and
- analysing them by their repricing dates (time buckets) to determine the amount of the mismatch between assets and liabilities with the same repricing dates.

Banks often enter into hedging instruments in order to manage these risks to the extent of their risk appetite – i.e. their risk-taking policies. Banks can have different approaches to risk-taking policies – some may adopt relatively narrow risk limits, while others may have a greater tolerance for unhedged exposures that are within relatively wide risk limits. These activities can be depicted as follows.



All of these activities take place on a dynamic basis. For example:

- new loans are constantly being underwritten while existing loans mature or are prepaid;
- new deposits are made by some customers while they are withdrawn by other customers; and
- the resultant net interest rate risk exposure is constantly changing, and the ALM group undertakes risk management activities based on the changed net risk position.

Question 3 – Description of dynamic risk management

The DP asks whether the description of dynamic risk management in the DP is accurate and complete.

Considerations for comment letter responses

A variety of dynamic risk management approaches exist in practice, so it may be difficult to define dynamic risk management activities without using significant judgement to distinguish between risk management activities that are 'dynamic' and other risk management activities.

Some companies may view the active process of collating, analysing and monitoring the risks as dynamic risk management, while others may consider that the additional step of engaging in risk mitigation activities through hedging is also part of dynamic risk management. If the objective of developing a macro hedge accounting model is to align the accounting with the way risks are dynamically managed, then the definition of dynamic risk management becomes key, because that definition can significantly affect what is reflected in the financial statements (see also 7.2).

The description of dynamic risk management may be accurate from the perspective of a typical bank, but other industries – e.g. insurance – may have different perspectives.

6 Current accounting and challenges

6.1 Current hedge accounting

6.1.1 General hedge accounting model

DP 1.7–1.8

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 FVTPL. These different accounting requirements result in volatility in profit or loss.

DP 1.3

To address such accounting mismatches, current IFRS allows companies to select either a fair value hedge accounting model or a cash flow hedge accounting model. However, these models do not necessarily portray dynamic risk management – in the example in section 5.1, 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 on a portfolio basis.

6.1.2 Portfolio fair value hedges of interest rate risk

DP 1.9

As an exception, current IFRS contains special requirements for portfolio fair value hedges of interest rate risk.³ These allow 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.

6.1.3 Macro cash flow hedge accounting

The implementation guidance in IAS 39⁴ contains illustrative examples for applying cash flow hedge accounting when a financial institution manages interest rate risk on a net basis. Some financial institutions have implemented hedge accounting programmes based on that guidance as an alternative to designating portfolio fair value hedges of interest rate risk. Sometimes, those strategies are referred to as 'macro cash flow hedges' under IAS 39. That implementation guidance is based on the general principles of IAS 39, and the strategies may rely on the de-designation and re-designation of hedges of closed portfolios. Therefore, the strategies may add complexity to hedge accounting by requiring the amortisation of amounts from accumulated other comprehensive income (OCI) to profit or loss.

6.1.4 EU carve-out version of IAS 39

The EU endorsed a carve-out version of IAS 39 in 2004, which deleted certain paragraphs relating to hedge accounting. The carve-out version of IAS 39 allows companies to apply the following in respect of a portfolio fair value hedge of interest rate risk:

- demand deposits may be designated as hedged items (see 7.3.4);
- a bottom layer approach may be used where changes in prepayment expectations do not necessarily result in ineffectiveness (see 7.3.5); and
- 'sub-benchmark' items may be designated as hedged items (see 7.3.6).

³ See paragraphs 81A and AG114–AG132 of IAS 39.

⁴ See paragraphs IG.F.6.1–F.6.3 of IAS 39; although that implementation guidance was not carried forward to IFRS 9, the IASB clarified that not carrying forward the implementation guidance did not mean that it had rejected that guidance.

6.1.5 Fair value option

As an alternative to hedge accounting, current IFRS permits a company to designate as at FVTPL a financial instrument that would otherwise be measured at amortised cost, if doing so eliminates or significantly reduces an accounting mismatch (the 'fair value option'). This election is available only at initial recognition and is irrevocable. Moreover, the financial instrument is required to be designated in its entirety – e.g. the full nominal amount of a loan.

6.2 Challenges with current hedge accounting

DP 1.20–21

The limitations of the current hedge accounting requirements have led to some companies, especially banks, being unable to reflect the outcome of their dynamic risk management activities in their financial statements, as the following table illustrates.

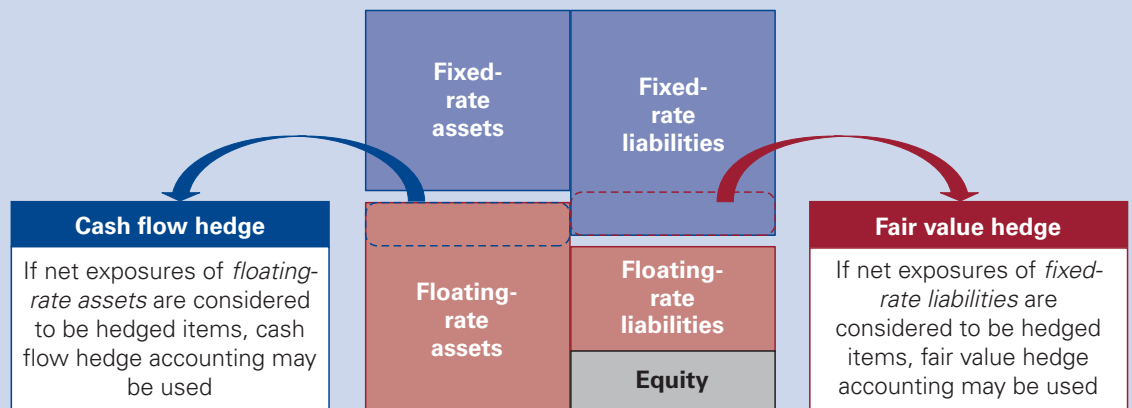
Risk management activities	Current hedge accounting requirements
There is no distinction between hedged items and hedging instruments.	There is a distinction between hedged items and hedging instruments, in order to determine the effectiveness of the hedging relationship and to measure the ineffectiveness. Current hedge accounting generally relies on a one-to-one designation of the hedged items to the hedging instruments, which, in effect, forces open portfolios into closed portfolios for hedge accounting purposes.
The replacement of items within portfolios does not necessarily change risk management decisions, as long as the overall net risk exposure remains the same or is within acceptable limits.	Changes in the portfolio may have to be treated as hedge discontinuations, even when they have no impact on the overall risk exposures. Hedging relationships may need to be tracked and frequently adjusted to match the dynamic nature of open portfolios.
Risk management decisions are updated on a timely basis in response to the change in net risk position.	Under IAS 39, a net risk position is not eligible as a hedged item. However, certain net risk positions for closed portfolios may be designated as the hedged item under IFRS 9. The portfolio fair value hedge of interest rate risk model does not allow designation of a net amount comprising both assets and liabilities.
There is no distinction between different types of hedged items that are managed for a common risk.	There is a distinction between different types of hedged items that might or might not qualify for hedge accounting. For example, hedge accounting is prohibited for items that do not qualify for hedge accounting – e.g. core demand deposits – even though they may give rise to risk exposures that are managed economically.
Different goals and risk limits are used to manage the dynamic nature of the portfolio.	There are no risk limit concepts – the objective of hedge accounting is to hedge either fair value changes or cash flow changes.

As a result, some companies do not apply hedge accounting, while others apply hedge accounting selectively, with a focus on reducing volatility in profit or loss. Consequently, despite the fact that dynamic risk management activities are usually implemented in a comprehensive manner, current accounting requirements result in a 'patchwork' presentation that some argue does not portray the effect of risk management in companies' financial statements in the most transparent way.

Observations – Cash flow hedges and fair value hedges – Two different ways of accounting for the same risk management activity

In many situations, current IFRS allows multiple alternative hedge accounting designations to be used for a particular dynamic risk management activity. For example, a bank may hedge its net interest margin against interest rate changes that affect net floating rate assets that are funded by net fixed-rate liabilities, using pay-floating, receive-fixed interest rate swaps. The bank could elect to designate the swaps as either cash flow hedges of the floating-rate assets or as fair value hedges of the fixed-rate liabilities.

These decisions are often driven by accounting, operational and regulatory capital considerations, rather than by the objective of depicting the bank's risk management.



Question 2 – Current difficulties in representing dynamic risk management in companies' financial statements

The DP asks:

- whether it has correctly identified the main issues that companies currently face when applying the current hedge accounting requirements to dynamic risk management; and
- whether the PRA would address the issues identified.

Considerations for comment letter responses

Applying current hedge accounting to dynamic risk management may cause difficulties.

- Current hedge accounting requires companies to treat open portfolios as a series of closed portfolios that may not faithfully represent the economics of the business.
- Treating open portfolios as a series of closed portfolios involving frequent changes in hedge designations – i.e. de-designations and re-designations – may be operationally challenging.
- The existence of a variety of current hedge accounting models may reduce comparability between companies that engage in dynamic risk management activities.

- The restrictions in the current hedge accounting requirements on eligible exposures – e.g. demand deposits, sub-benchmark instruments and designations of net positions – may not allow a company to present the exposures it economically hedges in its financial statements.

It is important to note that the IASB's objective in developing a new accounting model is not simply to adopt the treatment used for risk management in all circumstances, but instead to facilitate a risk management view, to the extent that it can be accommodated within the accounting framework.

Applying the PRA would reflect in profit or loss the offsetting effects of the revaluation adjustments of managed exposures and the fair value changes of risk management instruments, to the extent that an economic offset exists. By contrast, the current cash flow hedge accounting model requires the effective portion of the gains or losses on risk management instruments to be recognised in OCI.

7 Portfolio revaluation approach

7.1 Initial approaches considered by the IASB

DP 1.22

In the DP, the IASB explains that it considered whether assets and liabilities that are dynamically managed should be treated as another business model for the purposes of the classification and measurement requirements under IFRS 9. However, given that these requirements are applicable to all companies, the IASB believes that it is more appropriate to consider a specific approach to accounting for dynamic risk management rather than making pervasive changes to the classification and measurement requirements in IFRS 9.

DP 1.24–27

Current IFRS may result in different measurement or recognition for hedged items and hedging instruments – e.g. if a loan is measured at amortised cost and a derivative is measured at fair value.

	Hedged items	Hedging instruments
Current IFRS general measurement requirements	Amortised cost	Fair value

The IASB initially considered two approaches to address these mismatches:

- account for the hedging instruments on an accrual basis, consistent with the hedged items (accrual accounting concept); or
- measure all dynamically risk managed exposures at FVTPL (full fair value accounting).

	Hedged items	Hedging instruments
Alternative 1 Accrual accounting	Amortised cost	Accrual basis
Alternative 2 Full fair value accounting	Fair value	Fair value

The IASB believes that a shortcoming of the accrual accounting concept is that it would portray perfect risk management – even if it was not achieved – because any mismatches would not be reflected in the financial statements. The Board also believes that a shortcoming of the full fair value approach is that it would require the measurement of the hedged risk and the unhedged risk elements, which would result in mismatches with the measurement of the hedging instrument. This would not properly reflect a company's risk management activities.

Therefore, the IASB’s preliminary view is that neither accrual accounting for the hedging instruments nor fair value accounting for the hedged items or managed exposures would provide a faithful representation of actual risk management activities in the financial statements.

7.2 Overview of the PRA

DP 1.28–29

To help stimulate debate, the DP puts forward an outline of one possible approach to macro hedge accounting – the PRA – under which companies’ managed exposures are identified and revalued for changes in the managed risk. The purpose of the PRA is to provide a faithful representation of a company’s dynamic risk management activities in its financial statements by enabling users of financial statements to understand the company’s performance, and the corresponding risks, by profit source.

Consideration	Accounting treatment
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 it would reduce the complexities associated with one-to-one designations required under current hedge accounting and would provide a greater opportunity to use existing dynamic risk management data for accounting purposes.

DP 1.33

The PRA is not a full fair value model, because the managed exposures are not remeasured at fair value; they are only revalued for the risk that is being managed.

	Managed exposures	Hedging instruments
PRA	Remeasurement for changes in managed risk	Fair value

Like the general hedge accounting model finalised in IFRS 9 (2013), the macro hedge accounting model aims to better reflect companies’ risk management activities while reducing the operational complexities of current accounting.

Current issues	Potential benefits of a new approach
One-to-one linkage between what is being hedged and the hedging derivative does not accommodate the dynamic nature of risk management	Enhanced information from companies on their dynamic risk management activities
Open portfolios can only be accommodated by treating them as a series of closed portfolios with short lives – which is operationally challenging	Closer alignment with the company's risk management perspective and risk management systems, thereby reducing operational complexities such as amortisation and tracking
Risk management can only be accommodated indirectly – on a net basis through gross designation	Better reflection of the dynamic nature of risk management on a net basis
Behaviouralisation of exposures – e.g. prepayable mortgages – is currently possible, but only to a limited extent	Improved accommodation of behavioural factors affecting the risk arising from exposures rather than purely contractual features
Limitations make it difficult to align with a risk management focus or risk management systems	Improved accommodation of different types of risks managed in open portfolios

7.3 Managed exposures

A key question in applying the PRA is the extent to which 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 considers whether the following items should be eligible for inclusion in the managed exposure for interest rate risk:

- pipeline transactions – i.e. forecast volumes of draw-downs of fixed interest rate products at advertised rates (see 7.3.1);
- the equity model book (EMB) – i.e. companies' own equity where it is managed to earn a minimum target return, similar to interest (see 7.3.2);
- risk limits (see 7.3.3);
- behaviouralised expected cash flows related to core demand deposit liabilities, prepayment risk and changes in expected customer behaviour (see 7.3.4);
- bottom layers and hedging proportions of managed exposures (see 7.3.5); and
- sub-benchmark rate managed risk instruments (see 7.3.6).

7.3.1 Pipeline transactions

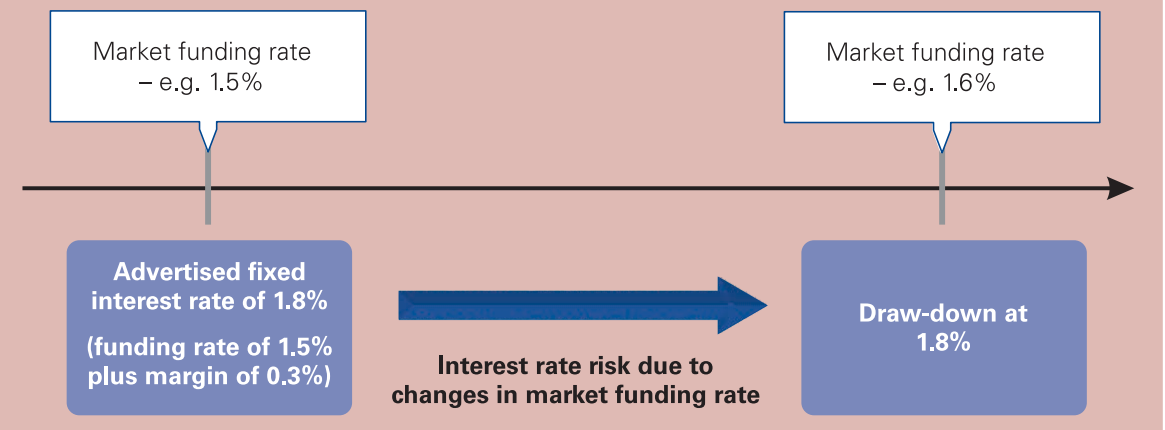
DP 3.2.1–3.2.2

Some banks may consider forecast volumes of draw-downs of fixed interest rate products at advertised rates – i.e. pipeline transactions – when they are managing interest rate risk. These transactions may or may not be considered to be 'highly probable', as that term is used in IFRS 9. Typically, neither the bank nor its customer has a contractual commitment for a pipeline transaction.

Illustration – Pipeline transactions

DP 3.2.2

Bank X advertises a fixed interest rate mortgage product to its current and future customers, and considers the offer to be binding for reputational reasons. As part of its dynamic risk management activities, X estimates the likely volume of customer balances to be drawn down on a behaviouralised basis and manages the resultant fixed interest rate risk.



DP 3.2.3

There are conceptual difficulties with revaluing pipeline transactions for interest rate risk, because the PRA would result in the recognition of an asset or a liability before a bank becomes a party to a transaction. It would also presume the existence of fair value risk for exposures that have not been recognised for accounting purposes.

Observations – Pipeline transactions vs loan commitments

DP 3.2.2

Economically, a bank may view the interest rate risk profile from pipeline transactions to be the same as writing a short-term, free option to customers to enter into a fixed interest rate product at a predetermined interest rate. For example, a mortgage loan pipeline transaction may have a similar risk profile to a loan commitment under which the lender is contractually obliged to grant a loan, but the borrower is not required to draw down the loan – i.e. a lender's written option.

The key difference between pipeline transactions and loan commitments is that pipeline transactions are anticipated future contracts – like a forecast transaction – whereas loan commitments are existing contracts, even though they are often unrecognised in the financial statements.

Including loan commitments in the managed exposure for interest rate risk would be less controversial than including pipeline transactions, because loan commitments are existing contracts.

Forecast transactions that are not pipeline transactions

DP A3.1–A3.2

In addition to pipeline transactions, banks may also forecast likely levels of fixed and floating interest rate exposures. However, these exposures do not contain a revaluation risk with respect to changes in interest rate, because there is no contractual or other basis to transact at a fixed rate. When certainty is required to manage changes in the interest rate attached to forecast transactions, risk managers may lock in a forward interest rate using derivatives. The risk management objective is to lock in a fixed interest cash flow; consequently, a cash flow hedge accounting approach would be more suitable if hedge accounting were desired.

DP A3.3

Current hedge accounting provides a solution for hedges of highly probable forecast transactions, even though they are anticipated, rather than existing, items. The cash flow hedge mechanics result in the gain or loss on the hedging instrument (to the extent that it is an effective hedge) being recognised in OCI instead of profit or loss. These mechanics avoid recognising the hedged item in the statement of financial position and hence avoid the conflict with the IASB's *Conceptual Framework for Financial Reporting* and other IFRSs that would otherwise arise from recognising an item that does not (yet) exist through a contractual arrangement. Accordingly, the DP suggests that forecast transactions that are not pipeline transactions should not be included in the PRA.

Question 4(a) – Pipeline transactions

The DP asks whether pipeline transactions should be included in the PRA if a company considers them to be part of its dynamic risk management.

Considerations for comment letter responses

It would be difficult to achieve complete alignment with risk management, given the different purposes of financial reporting and risk management, the variety of risk management practices and ongoing developments in this area. However, some may believe that focusing only on accounting solutions would be too narrow a basis for the deliberations on accounting for dynamic risk management. There is a trade-off to consider: the more the PRA incorporates such items, the more closely hedge accounting may be aligned with dynamic risk management; however, the PRA may then be less consistent with conventional accounting concepts.

Some companies may have conceptual difficulties with revaluing a pipeline transaction – i.e. the recognition of an asset or a liability before the company becomes a party to the transaction.

The DP suggests that the PRA should not include forecast transactions that are not pipeline transactions. However, further consideration might be required in applying the PRA for risks other than interest rate risk, because many companies dynamically manage foreign currency risks for forecast transactions.

Some may view pipeline transactions as being similar to constructive obligations.⁵ The IASB's discussion paper on its conceptual framework⁶ lays out a preliminary view that the definition of a liability should not be limited to legal obligations, but should also include constructive obligations. The IASB is also seeking to provide more guidance to help distinguish a constructive obligation from a broader notion of economic compulsion. Companies may want to consider the nature of their pipeline transactions and provide feedback to the IASB on the possible reasons for including or not including such transactions in the managed exposure.

The identification of pipeline transactions may require significant judgement. Additional disclosures may also be necessary for users to understand the nature of pipeline transaction exposures and how they have been hedged.

Companies may want to consider the extent to which they find the current cash flow hedge accounting model to be adequate.

⁵ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines a constructive obligation as an obligation that derives from a company's past actions where: by an established pattern of past practice, published policies or a sufficiently specific current statement, the company has indicated to other parties that it will accept certain responsibilities; and as a result, the company has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

⁶ DP/2013/1 *A Review of the Conceptual Framework for Financial Reporting*.

7.3.2 Equity model book

DP 3.3.1

Some companies, particularly banks, include equity as a source of funding as part of their interest rate risk management model. The idea behind the EMB is that the return required by equity investors can be viewed as a combination of:

- a fixed-rate base return that is similar to interest, which provides a base level of compensation to equity holders for providing funding; and
- a variable residual return that results from the total net income (less the base return) that accrues to equity holders; this is the gain or loss that equity holders receive because they provide loss absorption.

DP 3.3.1, 3.3.2

Banks that use the EMB use their dynamic interest rate risk management to help attain the targeted fixed-rate base return. This is done by modelling the target base return using the targeted interest rate profile for the return on equity, as if this were an interest rate exposure. This is sometimes referred to as a replication portfolio. Banks that use the EMB as part of their dynamic risk management activities could include the replication portfolio as part of their open portfolio to be revalued for interest rate risk under the PRA.

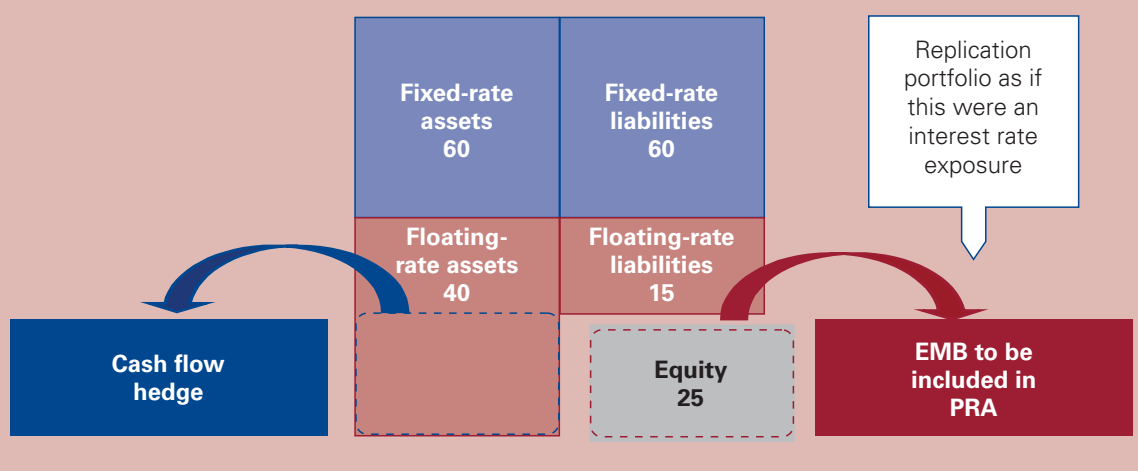
Example – Equity model book

DPA1.2–A1.13

Bank Y has fixed-rate assets of 60, fixed-rate liabilities of 60, floating-rate assets of 40, floating-rate liabilities of 15 and equity of 25. Y also enters into swaps to pay floating interest and receive fixed interest with a notional amount of 25.

If the EMB were allowed to be included in the managed portfolio, then 25 of the EMB would be revalued for changes in the managed interest rate.

Alternatively, current hedge accounting allows an indirect way to represent the actual risk management activities, by applying cash flow hedge accounting for the cash flow risk on the floating interest rate assets.



DP 3.3.3

This approach assumes that users of financial statements find information on a bank's ability to achieve its targeted base return on equity to be useful. Conversely, some users of financial statements may find it strange that an accounting solution for the risk management of open portfolios would include a revaluation of the targeted base return on equity with respect to interest rate risk.

Question 4(b) – Equity model book

The DP asks whether the EMB should be included in the PRA if a company considers it part of its dynamic risk management.

Considerations for comment letter responses

Possible benefits to including the EMB in the PRA

- There may be less duplication of effort – e.g. having one set of numbers for risk management purposes, and another set for accounting purposes.
- Developing a new model may only make sense if it reflects the way a bank manages its risk. If a bank already includes the EMB in its dynamic risk management, then it should be included in the PRA. If a bank is required to develop a whole new approach to reflect dynamic risk management in its accounting, then it may be simpler to apply alternative approaches that are already permitted in the general hedge accounting model in IFRS 9.
- The financial statements may better reflect the economics of management's actual risk management activities.
- Users of financial statements may be better able to evaluate the success or failure of management's risk management strategies.

Possible concerns about including the EMB in the PRA

- Remeasuring the managed exposures to reflect interest rate risk may involve remeasuring items that do not meet the definitions of an asset or a liability under the IASB's conceptual framework.
- Including the EMB as part of managed exposures would depend on how the risk management function decides what is being managed. It may be difficult to justify using the EMB for the amount, the target rate of return and the duration of the EMB because there is normally little external evidence to support those variables; this is different from estimates for pipeline transactions and core demand deposits that involve customer behaviours that can be supported with historical data.
- Some users of financial statements may not view the return on equity as comprising a fixed-rate base return and a residual return.
- Companies that do use the EMB may also want to consider the assumptions they use for risk management purposes – e.g. the term, the interest rate used etc – and how often they make changes to those assumptions. This is because under the PRA, any changes to those assumptions may have an immediate impact on profit or loss, similar to changes in expected customer behaviour (see 7.3.4).
- Companies may want to consider the extent to which they find the current cash flow hedge accounting model to be adequate.
- If the PRA included the EMB as part of the managed exposures, then comparability might decrease between companies that use current cash flow hedge accounting and companies that use the PRA.

7.3.3 Risk limits

The DP considers whether the common risk management practice of using risk limits should be incorporated into the PRA.

DP 3.8.2

Companies establish risk limits to set thresholds for risk levels that they are willing to tolerate. As long as a risk position remains within the risk limit, a company does not have to take any action to reduce the risk – e.g. the company does not have to engage in hedging activities. In general, the company would consider its dynamic risk management strategies to be effective as long as the expected risk exposure stays within its pre-defined risk limits.

Example – Risk limits

Bank Z uses sensitivity analysis as a risk management technique that measures the valuation change of risk exposures, thereby allowing management to judge Z's net interest risk exposure. Z uses sensitivity analysis to measure value changes in assets (loans and securities), liabilities (deposits) and derivatives that would materialise if the benchmark interest rate yield curve were to shift by 10 basis points – i.e. 0.1%. This is sometimes referred to as the economic value of shareholders' equity.

Under its board-approved risk management policy, Z establishes the risk limits to set thresholds for risk levels that can be accepted without seeking risk mitigation. If the impact of such interest rate changes on the economic value of shareholders' equity is within the board-approved limits, then Z does not need to undertake further risk mitigation activity.

DP 3.8.3

In accounting terms, the concept of risk limits could imply that there should be no volatility in profit or loss, as long as the net open risk position is within the limits set by management. Although this would align the accounting with the dynamic risk management perspective, it could lead to arguably counter-intuitive results. For example, a company that tolerated greater risk, and had correspondingly wide risk limits, would show less volatility in profit or loss than a company that maintained narrow risk limits.

Question 8 – Risk limits

The DP asks whether risk limits should be reflected when applying the PRA.

Considerations for comment letter responses

As the DP observes, some may argue that introducing risk limits could lead to counter-intuitive results, because a company that tolerates greater risk, and has correspondingly wide risk limits, would show less volatility in profit or loss than a company that maintains narrower risk limits.

If the scope of the PRA were a focus on dynamic risk management (see 7.5), then some companies may argue that risk limits should be incorporated into the PRA, to avoid greater volatility in profit or loss. For example, take two banks – Bank A has a higher risk tolerance, while Bank B has a lower risk tolerance. Bank A may only partially hedge its total exposure, while Bank B may fully hedge its total exposure. If the scope of the PRA were a focus on dynamic risk management, Bank A would show significantly higher profit or loss volatility if risk limits were not incorporated into the PRA, whereas Bank B would show lower profit or loss volatility; this would be the case even if Bank A is either more or equally as effective and efficient in executing its hedging programme in comparison to Bank B. Conversely, if the scope of the PRA were a focus on risk mitigation with a proportion approach (see 7.3.5), some companies may not view the incorporation of risk limits into the PRA as being especially relevant, because only the actual proportion of the portfolio hedged would be revalued.

If the risk limits concept were introduced, it might also be considered a bright line concept, similar to the 80–125 percent bright line effectiveness range under IAS 39. However, introducing a similar bright line concept would contradict general risk management principles, as well as the general hedge accounting requirements under IFRS 9, which remove the 80–125 percent bright line test.

As an alternative to explicitly considering a company's risk limits in the PRA, users may be able to achieve an understanding of the role of risk limits in a company's dynamic risk management through disclosures.

7.3.4 Behaviouralised expected cash flows

DP 3.4.1

Dynamic risk management is usually based on the expected cash flow profile, rather than on the contractual lives of the exposures. For example, a bank may model its demand deposits on a behavioural basis rather than based on their contractual terms. As another example, a bank may model the expected prepayments within a prepayable fixed interest rate mortgage exposure and use those expected cash flows as the basis for its dynamic risk management activities.

Core demand deposit liabilities

Banks frequently collect deposits with zero or low interest rates from customers, but the deposits can be withdrawn without any notice or penalty. The interest rates paid on these deposits are generally insensitive to changes in market interest rates. These deposits are known as demand deposits, but typically they are left as a deposit for a long and generally predictable time, despite the low interest paid.

DP 3.4.2

When managing interest rate risk, banks often identify a core element of the demand deposit portfolio and treat that element as having a longer-term interest rate profile, taking into consideration behavioural and other information. This behaviouralisation is based on expectations for the demand deposit portfolio as a whole, and not on each individual exposure. These core demand deposits are viewed as creating interest rate risk and are modelled as fixed-rate liabilities for dynamic risk management purposes.

Demand deposits cannot qualify for fair value hedge accounting under current hedge accounting requirements, because the contractual maturity (on demand) does not give rise to fair value risk.⁷ Also, they cannot qualify for cash flow hedge accounting if they are non-interest bearing, because there is no volatility in cash flows.

Questions 4(c) and 9 – Behaviouralisation and core demand deposits

Behaviouralisation

The DP asks whether cash flows should be on a behaviouralised basis rather than on a contractual basis – e.g. after considering prepayment expectations – when the risk is managed on a behaviouralised basis.

Core demand deposits

The DP asks whether core demand deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA if that is how a company would treat them for dynamic risk management purposes.

The DP also asks what guidance would be necessary for companies to determine the behaviouralised profile of core demand deposits.

⁷ Paragraph AG118(b) of IAS 39 and paragraph 47 of IFRS 13 *Fair Value Measurement* specify that the fair value of a financial liability with a demand feature – e.g. a demand deposit – is not less than the amount payable on demand, discounted from the first date on which the amount could be required to be paid.

Considerations for comment letter responses

Introducing the concept of behaviouralisation when applying the PRA may have the following benefits.

- The concept could be consistent with the way exposures are managed for risk management purposes.
- It would also be consistent with the accounting treatment under current IFRS for portfolio fair value hedges of interest rate risk on fixed-rate prepayable assets and liabilities that are modelled on a behaviouralised expected cash flow basis, rather than on a contractual basis.

Some companies may identify inconsistencies between the guidance in IFRS on:

- measuring liabilities with a demand feature at the amount payable on demand, discounted from the earliest repayment date; and
- scheduling those demand liabilities for hedging purposes using a behaviouralised approach, and therefore recognising a revaluation adjustment against the deposits for movements in interest rates.

Some may argue that scheduling deposits using a behaviouralised approach reflects the way risk is managed, and therefore that if the purpose of the PRA is to reflect the results of dynamic risk management, then such revaluation adjustments should be accepted for accounting purposes.

Some companies may argue that there is no real fair value risk with respect to demand deposits, but just an expectation that the company will be able to continue to borrow at low interest rates.

Companies following the EU carve-out version of IAS 39 may already be treating core demand deposits as managed exposures, and may want to continue to do so.

Identifying core demand deposits may require significant judgement. Additional disclosures may be necessary for users to understand the nature of core demand deposit exposures and how they have been hedged.

Prepayment risk

DP 3.5.1

Demand deposits are not the only item where the PRA could make greater use of behaviouralisation. For example, mortgage borrowers may prepay existing fixed interest rate mortgages if market interest rates decrease, so that they can refinance at lower rates.

DP 3.5.2

Changes in the economic value of inherent prepayment options would affect the revaluation adjustment. This impact could be determined differently depending on how the prepayment risk is managed. For example, the impact could be determined by modifying the cash flows that incorporate the behaviouralisation if prepayment risk is managed based on behaviouralised cash flows, or alternatively by revaluing the inherent prepayment option if it is managed using options.

Example – Prepayment risk

Bank C has a portfolio of fixed-rate mortgages that are prepayable – i.e. C has sold a call option to the borrowers. If interest rates decline, the borrowers may prepay the mortgages and refinance at a lower rate. To hedge this exposure, C purchases ‘fixed receiver swaptions’ – i.e. options to enter into a receive-fixed, pay-floating interest rate swap. If interest rates subsequently go down and prepayments occur, C can exercise its swaption and offset the impact of prepayments by receiving the higher fixed interest rate on exercise of the swaption.

DP 3.5.3

Alternatively, C may incorporate prepayment assumptions that are determined based on an historical analysis of its customers' prepayment behaviour into the expected cash flows of its mortgage portfolio by different time buckets – e.g. monthly expected cash flows. The expected cash flow profile, analysed by time buckets, is then used as the basis for the bank to enter into an appropriate amount of hedging instruments – e.g. interest rate swaps – to hedge its interest rate risk.

Question 5 – Prepayment risk

The DP asks how the PRA should consider cases where risk management instruments with optionality are used to manage prepayment risk as part of dynamic risk management.

Considerations for comment letter responses

In our experience, managing interest rate risk on items that are prepayable is normally based on behaviouralised cash flows, because the cost of entering into options to hedge prepayment risk could be prohibitive.

If companies are entering into options to manage the prepayment risk, an issue also arises as to how to treat the time value component of the option. In these situations, it might be possible to revalue the managed portfolio's contractual cash flows inclusive of the contractual prepayment options for the purposes of the PRA, in order to reflect the economic offset. Alternatively, similar to the IFRS 9 general hedging requirements, if the time value of an option is excluded from the hedging relationship, then it could be considered to be a cost of the hedge and accounted for separately.

Recognition of changes in expected customer behaviour

DP 3.6.1–2

The PRA would require changes in the behaviouralisation of cash flows that are included within managed portfolios to be reflected when determining the revaluation adjustment arising from those portfolios. The PRA would recognise the impact of changes from past assumptions through profit or loss.

Example – Recognition of changes in expected customer behaviour

DP 3.6.3

Bank D initially behaviouralises an exposure as a four-year fixed interest rate exposure based on its prepayment assumptions. D transacts a four-year derivative to eliminate the four-year interest rate risk. If after one year the exposure is expected to be prepaid in four years' time – i.e. one year later than originally thought – then the revaluation adjustment for the managed portfolio will reflect the current value of the exposure with respect to the managed risk. That is, there will be a catch-up adjustment recorded in profit or loss as if the exposure had always been a five-year exposure; however, the fair value of the derivative is based on its remaining life of three years. The net impact of those two remeasurements on profit or loss reflects the outcome that is currently expected, which is different to D's original prepayment assumptions.

Question 6 – Recognition of changes in customer behaviour

The DP asks whether the impact of changes in past assumptions of customer behaviour captured in the cash flow profile of behaviouralised portfolios should be recognised in profit or loss by applying the PRA when, and to the extent that, they occur.

Considerations for comment letter responses

Applying the PRA would involve making a number of assumptions about customer behaviour – e.g. in modelling the profile of the core demand deposits, or in estimating expected prepayments to determine the expected cash flows in a portfolio of prepayable assets or liabilities. Some may argue that any changes in these estimates should immediately be recognised in profit or loss. However, others may argue that such changes in estimates are simply part of the dynamic risk management process and that they would react to such changes in the assumptions by adjusting the quantity of risk management instruments. Furthermore, all of these actions may be taken within the risk tolerance levels and/or limits approved by the company's board. They may make the following arguments.

- If the quantity of risk management instruments is adjusted immediately to deal with the change in the expected cash flow profile of the underlying exposure because of changes in customer behaviour, then no profit or loss impact should arise. That is, in the example above, the original four-year exposure should not be modelled retrospectively as if it had always been a five-year exposure.
- If the quantity of risk management instruments is *not* adjusted immediately to deal with the change in the underlying exposure, then again no profit or loss impact should arise – as long as the company made a conscious decision not to adjust the quantity of risk management instruments, in accordance with its risk policies and limits. That is, in the example above, the fifth year of fixed-rate exposure would simply be viewed as being unhedged, which should not lead to a profit or loss impact. This issue is linked to the issue on risk limits (see 7.3.3).

If changes in customer behaviour are not recognised in profit or loss immediately, then amortisation may be needed, raising operational issues as to when and how to recognise that effect.

Recognising the changes in customer behaviour immediately in profit or loss under the PRA might be justified as follows.

- It would be consistent with the way changes in estimates are generally recognised under IFRS.
- It would be consistent with the accounting treatment under current IFRS for portfolio fair value hedges of interest rate risk on fixed-rate prepayable assets or liabilities that are modelled on a behaviouralised expected cash flow basis rather than on a contractual basis.

7.3.5

DP 3.71

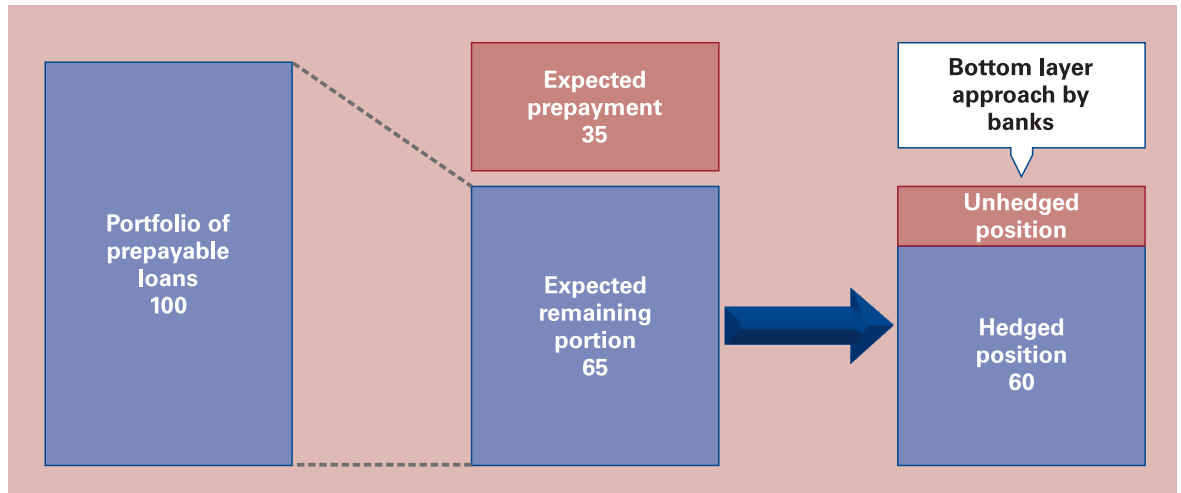
Bottom layers and hedging proportions of managed exposures

Many banks undertake dynamic risk management activities for prepayable exposures by using a bottom layer approach.

Example – Bottom layer approach

DP 3.71

Bank E has a portfolio of prepayable loans of 100, with a five-year contractual maturity. Considering the portfolio as a whole, E expects that loans with a total principal of 35 will be prepaid before the end of the contractual term. Therefore, loans of 65 are estimated to be in existence for the full five years. E may choose to transact a five-year pay-fixed, receive-floating swap for 60 – i.e. the bottom 60 layer of the expected five-year exposure of 65. As long as loans of 60 remain outstanding for the full contractual term, E considers its dynamic risk management activities to be a success.



DP 3.72–3.75

The DP identifies several difficulties that would arise if a bottom layer approach were possible under the PRA. In particular, the inclusion of a bottom layer approach within a revaluation approach would ignore the prepayment risk within the portfolio, unless the bottom layer was breached. This appears to contradict the fact that the bottom layer approach is applied taking into account the prepayment risk. In addition, applying the PRA to a bottom layer would require tracking and amortisation when changes to the level of the bottom layer occur. When considering a bottom layer, a bank cannot determine which exposures within the portfolio make up the bottom layer and which do not. Therefore, unless all exposures making up the portfolio were homogeneous, difficulties would arise when determining the revaluation adjustment for the bottom layer. However, open portfolios are unlikely to be homogeneous, as new exposures are added with terms based on different market conditions.

DP 3.76

Similar issues would occur if the revaluation of a managed portfolio were based on a proportion approach – i.e. a proportion of the exposures within that portfolio and the hedged proportion changed accordingly (for example, from 80 percent to 90 percent). In that case, the additional 10 percent to be revalued for the first time would require amortisation and tracking, and would increase operational complexity.

Question 7 – Bottom layers and proportions of managed exposures

The DP asks whether the PRA should permit or require a bottom layer or a proportion approach, if it is used for dynamic risk management purposes.

Considerations for comment letter responses

The risk management function may view the bottom layer approach as being similar to a cash flow hedge that uses the 'first payments received/paid' technique – e.g. hedging the interest receipts on the first 100 of loan principal expected in certain specified periods in the future. Certain loans may prepay, while new loans may be added to the portfolio – but as long as at least 100 of principal is outstanding (i.e. the bottom layer), the hedge would be considered effective. Some may argue that if the portfolio is modelled in this way for risk management purposes, then the accounting should reflect that view.

Some companies may also argue that if the scope of the PRA were a focus on risk mitigation (see 7.5.1), then they could create sub-portfolios of prepayable exposures that are 'similar' in nature – for example, prepayable mortgages originated within a certain time period (e.g. a month) for a given term (e.g. a five-year term) and having coupons that are close to each other. They may choose to hedge the bottom layer of this portfolio using an interest rate swap. If no new mortgages are added to this sub-portfolio, then it can be considered to be homogeneous, without any complications in attributing the PRA to the bottom layer. In other words, if risk management is based on defining a series of closed sub-portfolios in this way, then some of the complexities identified in the DP may not arise.

Companies following the EU carve-out version of IAS 39 may already be following the bottom layer approach and may want to continue to do so.

7.3.6 Sub-benchmark rate managed risk instruments

DP 3.10.1

Some financial instruments are priced at an interest rate based on a benchmark index less a margin. These are often referred to as 'sub-benchmark instruments' – e.g. sub-LIBOR instruments. It is common for only the benchmark interest rate risk from these financial instruments to be included within dynamic risk management.

DP 3.10.2, 3.10.4

When sub-benchmark financial instruments pay a floating interest rate that is linked to the benchmark, they generally include an embedded floor so that the coupon cannot be negative. Typically, risk managers do not include the interest rate risk from the embedded floor within their managed portfolio. However, the embedded floor has an economic effect on the bank's interest rate risk profile.

Example – Embedded floor

DP 3.10.4

Bank F funds its fixed interest rate asset portfolio with a portfolio of floating-rate sub-LIBOR deposits, and wishes to achieve a stable net interest income. F may choose to transact a pay-fixed, receive-LIBOR swap. Such a strategy would lock in a stable net interest income, unless LIBOR fell below the level of the (negative) margin. In that case, if the portfolio had a floor, then the stable net interest income would no longer be achieved. Therefore, when accounting for recognised floating-rate sub-benchmark financial instruments as part of the managed portfolio, F would need to consider the effect of the embedded floor.

DP 3.10.7

If the interest rate on external exposures includes a negative margin – i.e. if the interest rate is the benchmark index less a margin – there is an expectation that the negative margin should be presented in the statement of profit or loss and OCI in a similar way to a positive margin – i.e. the interest rate is the benchmark index *plus* a margin. As a result, the margin should be accrued in net interest income separately from the dynamic risk management activity. This is because the margin is a feature of the bank's underlying business, and is not created by the dynamic risk management of interest rate risk – regardless of whether the margin is negative or positive. Dynamic risk management will, however, influence net interest income, because it attempts to stabilise a company's net interest income by managing mismatches between fixed and floating interest rate exposures.

DP 3.10.9

Some believe that it would not be appropriate for any accounting approach for dynamic risk management of sub-benchmark instruments to ignore the effect that the embedded floor has on a strategy to stabilise the net interest income. However, others believe that if the purpose of the accounting approach is to represent dynamic risk management, then the embedded floor is not relevant if it is not included within dynamic risk management.

DP 3.10.11

Current IFRS does not generally allow companies to designate a full LIBOR component in a financial instrument that yields LIBOR less a spread. If LIBOR falls below the absolute value of that negative spread and the instrument has a floor – e.g. zero – then it would result in interest that is inconsistent with the movement of market interest rates. Consequently, in contrast to exposures with full LIBOR

variability, hedging sub-LIBOR exposures means that the company remains exposed to cash flow variability in some situations. The IASB noted that allowing a designation that ignores this fact would not faithfully represent the economic phenomenon.⁸

DP 3.10.13

However, the PRA is not a modification to current hedge accounting, but rather a new approach intended to better align the accounting with dynamic risk management. In view of the PRA's differing objectives, the IASB considered it appropriate for the DP to include a discussion on how the dynamic risk management of sub-benchmark interest rates could be reflected in the PRA.

DP 3.10.15

Potential approaches presented in the DP to deal with sub-benchmark issues within the PRA are as follows.

	Approach 1	Approach 2	Approach 3
	Full contractual cash flows discounted at benchmark index	Full contractual cash flows discounted at benchmark index with static margin	Risk included in ALM (transfer pricing – see 7.4.2)
Cash flows (numerator)	Customer contractual cash flows – e.g. LIBOR - 0.2%	Customer contractual cash flows – e.g. LIBOR - 0.2%	Benchmark pricing cash flows – e.g. LIBOR
Initial discount rate (denominator)	Initial benchmark index – e.g. LIBOR	Initial customer deposit rate – e.g. LIBOR - 0.2%	Initial benchmark index – e.g. LIBOR
Subsequent discount rate (denominator)	Current benchmark index – e.g. LIBOR	Adjusted for benchmark changes but margin kept static – e.g. LIBOR - 0.2%	Current benchmark index – e.g. LIBOR - 0.2%
Day one revaluation difference	Day one revaluation effect may arise	Zero	Zero
Interest recognition (based on actual net interest income presentation – see 8.2)	Actual coupon including the effect of the negative margin (and any embedded floor) – e.g. LIBOR - 0.2%	Actual coupon including the effect of the negative margin (and any embedded floor) – e.g. LIBOR - 0.2%	Actual coupon including the effect of the negative margin (and any embedded floor) – e.g. LIBOR - 0.2%
Revaluation effect from dynamic risk management	Clean ⁹ revaluation of contractual cash flows with respect to changes in benchmark index plus amortisation/accretion of day one revaluation difference	Clean revaluation of contractual cash flows with respect to changes in benchmark index (discount rate includes static negative margin)	Clean revaluation of benchmark cash flows with respect to changes in benchmark index

DP 3.10.16

All three approaches would present the same interest profile in profit or loss – i.e. the actual coupon payable on the contractual cash flows (customer deposits). The differences arise when determining the revaluation adjustment. Under Approaches 1 and 2, the cash flows included within the revaluation would be based on the actual deposit rate, whereas Approach 3 would only revalue the benchmark cash flows, consistent with the dynamic risk management approach. Consequently, the revaluation adjustments from Approaches 1 and 2 would include changes in the discounting effect both on the benchmark cash

⁸ See paragraphs BC6.26–BC6.27 and BC6.226–BC6.229 of IFRS 9.

⁹ Clean changes in fair value are fair value changes in derivatives and/or the managed exposures after excluding accrued interest.

flows and on the negative margin. In addition, the revaluation effect from Approach 1 would include the unwinding of the day one revaluation effect. However, this would be offset by the amortisation of the day one revaluation difference over time.

Embedded derivatives

DP 3.10.17

None of the above approaches recognises the effect of the embedded floor on future interest cash flows for floating interest rate financial instruments. In order for the risks from the embedded floor to be reflected in the accounting for dynamic risk management, the value of the embedded floor in sub-benchmark floating interest rate financial instruments should be included in the revaluation adjustment. This could be achieved by introducing an internal floor transaction as well as the usual internal benchmark deposit through transfer pricing.

DP 3.10.19

Such an approach overcomes some of the difficulties of applying sub-benchmark instruments with the embedded floor, and builds on existing transfer pricing transactions. However, the introduction of an internal floor could represent a change to dynamic risk management practices.

Question 10 – Sub-benchmark rate managed risk instruments

The DP asks whether sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if this treatment would be consistent with a company's dynamic risk management approach, or whether the alternative approaches for calculating the revaluation adjustment for sub-benchmark instruments would provide an appropriate reflection of the risk attached to sub-benchmark instruments.

The DP also asks whether it is appropriate not to reflect an embedded floor within the managed portfolio, if sub-benchmark floating interest rate financial instruments have an embedded floor that is not included in dynamic risk management because it remains with the business unit.

Considerations for comment letter responses

Including sub-benchmark instruments in the managed exposures would be consistent with the way exposures are managed for risk management purposes.

If core demand deposits were allowed to be included in the managed exposures, then some may argue that it would be consistent to include sub-benchmark instruments in the managed exposures as well. This is because the demand deposits typically either pay no interest or pay nominal interest at a rate below the benchmark rate.

When there is no embedded floor in the sub-benchmark instruments, the revaluation amount would be fully offset by changes in the benchmark rate, even if the benchmark rate is below the absolute value of the negative spreads.

Companies following the EU carve-out version of IAS 39 may already be treating sub-benchmark instruments as benchmark instruments, and may want to continue to do so.

7.4 Revaluation approach

7.4.1 Revaluation of managed exposures

DP 4.1.1

Under the PRA, net open risk positions would be determined based on managed exposures that are included in managed portfolios. 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. Consistent with dynamic risk management, which is typically undertaken on a 'by risk' basis, the revaluation would be determined by managed risk, and so the managed exposures

would be remeasured for changes in fair value with respect to the managed risk but not for other risks – i.e. this is not a full fair value remeasurement. The identification of the managed exposures making up the managed portfolio and the revaluation for accounting purposes would need to reflect the dynamic risk management objective. Under this model, the resulting profit or loss volatility would represent remaining open interest rate risk positions after considering the hedging instruments.

DP 4.1.2

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. Changes in the components of the interest rates that do not form part of the managed risk – e.g. those relating to credit risk and instrument liquidity – would not be part of the revaluation adjustment. Consequently, identifying the managed risk would be critical when applying the PRA.

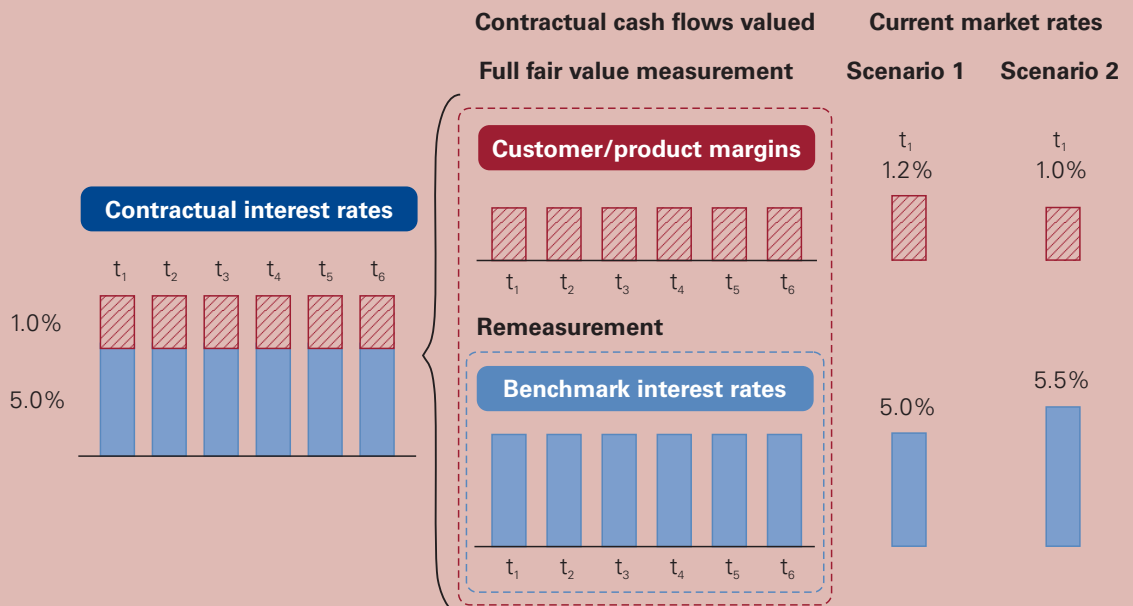
Example – Difference between a full fair value measurement and the PRA

Bank G has a portfolio of fixed-rate loans of 100 with a maturity of six years and an average contractual interest rate of 6.0% (being the initial benchmark rate of 5.0% plus the customer/product margin of 1.0%). The loans are measured at amortised cost. G has a receive-six-month-LIBOR-floating leg and a pay-5.0%-fixed leg interest rate swap. The managed risk is six-month LIBOR.

Consider the following two scenarios.

1. Only the customer/product margin is changed at t_1 .
2. Only the benchmark interest rate is changed at t_1 .

(The notation t_1, t_2 etc indicates the points in time at which the loans are measured.)



Under the full fair value measurement approach, both scenarios affect the measurement – i.e. even if the benchmark interest rates are stable, changes in customer/product margin (Scenario 1) affect the fair value.

Under the PRA, however, the managed exposures would only be revalued for the risk that is being managed, and therefore the remeasurement would be based on the changes in the benchmark interest rate. Any other aspects of the loans – e.g. changes in the customer/product margins – would be recognised as interest income or expense on an accrual basis.

	Periods		
	t ₀	t ₁	
		Scenario 1	Scenario 2
Contractual interest rate	6.0%	6.0%	6.0%
Benchmark interest rate	5.0%	5.0%	5.5%
Customer/product margin	1.0%	1.2%	1.0%
Full fair value measurement	100 ^(a)	99.16 ^(b)	97.92 ^(c)
PRA	100	100 ^(d)	97.86 ^(e)

Notes

(a) $6 \times (1.06)^{-1} + 6 \times (1.06)^{-2} + 6 \times (1.06)^{-3} + 6 \times (1.06)^{-4} + 6 \times (1.06)^{-5} + 106 \times (1.06)^{-6} = 100$

(b) $6 \times (1.062)^{-1} + 6 \times (1.062)^{-2} + 6 \times (1.062)^{-3} + 6 \times (1.062)^{-4} + 106 \times (1.062)^{-5} = 99.16$

(c) $6 \times (1.065)^{-1} + 6 \times (1.065)^{-2} + 6 \times (1.065)^{-3} + 6 \times (1.065)^{-4} + 106 \times (1.065)^{-5} = 97.92$

(d) $5 \times (1.05)^{-1} + 5 \times (1.05)^{-2} + 5 \times (1.05)^{-3} + 5 \times (1.05)^{-4} + 105 \times (1.05)^{-5} = 100$

(e) $5 \times (1.055)^{-1} + 5 \times (1.055)^{-2} + 5 \times (1.055)^{-3} + 5 \times (1.055)^{-4} + 105 \times (1.055)^{-5} = 97.86$

Question 11(a) – Revaluation of the managed exposures

The DP asks whether the revaluation calculations outlined in the DP provide a faithful representation of dynamic risk management.

Considerations for comment letter responses

Companies that favour the fair value hedge accounting approach may prefer the approach outlined in the DP. This is because:

- the net effect of the PRA would be reflected in profit or loss; whereas
- under a cash flow hedge approach, only the hedging derivatives' gain or loss is presented in OCI, without the offsetting impact of the revaluation effect of the managed exposures, which leads to volatility in shareholders' equity.

By contrast, companies that prefer volatility in OCI, rather than in profit or loss, may not support the PRA approach.

Some companies may manage their interest rate risk profiles on a cash flow basis rather than on a revaluation basis. It is debatable whether the PRA would provide a faithful representation of dynamic risk management for those companies, particularly for their hedges of floating interest rate exposures.

Given the nature of dynamic risk management, managed exposures and risk management instruments are constantly changing, and therefore revaluation calculations may be burdensome in practice – e.g. revaluations may require a variety of benchmark rates to be used for different types of managed exposures – unless existing risk management data and systems can facilitate such calculations.

7.4.2 Transfer pricing and internal funding indexes

DP 4.2.1

The PRA seeks to reflect dynamic risk management by revaluing risk positions consistently with the way in which they are managed. If the dynamic risk management objective is to manage net interest income for interest rate risk, then it is possible that the best representation of the managed risk is the internal funding index used by the bank.

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 ALM unit. ALM usually manages interest rate risk on exposures using transfer pricing transactions that are based on the 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.

DP 4.2.2

Consequently, one practical expedient would be to use the transfer pricing processes that are already in place at banks to capture the managed risk in managed portfolios when applying the PRA.

DP 4.2.8, 4.2.16–17

However, the extent to which a mechanism like transfer pricing could be used would depend on whether existing transfer pricing transactions adequately represent the managed risk in the managed portfolio for the purpose of applying the PRA. Although many banks base the transfer price on benchmark interest rates, they may adjust the rates by additional margins to reflect other internal or external pricing factors – e.g. to provide incentives or disincentives to the business units for originating particular products.

Question 11(b) – Revaluation of the managed exposures

The DP asks whether it would be appropriate for the managed risk to be the funding rate, if the dynamic risk management objective is to manage net interest income with respect to the funding curve of a bank.

Considerations for comment letter responses

Market participants are currently facing difficult issues regarding the use of funding valuation adjustments in measuring the fair value of derivatives.¹⁰ Permitting the managed risk to be a company's own funding rate would increase the tensions between:

- a company's own funding rate, which is by its nature a company-specific variable; and
- the funding rate (or view of interest rate risk) of market participants.

There may also be tensions between the way a company manages its risks and the way other market participants view those risks.

Furthermore, if companies are allowed to use their own funding curves as the managed risk, comparability among companies may be difficult to achieve – unless their transfer pricing mechanisms treat the benchmark interest rate as the managed risk.

However, using own funding rates for the managed risk may result in a model that is most aligned with a company's dynamic risk management, and may provide operational efficiencies in applying the PRA.

DP 4.2.18–4.2.20

The DP describes three approaches that could be taken if transfer prices:

- are at a rate other than the benchmark rate; and
- are accepted as a practical expedient for calculating the basis for the revaluation under the PRA.

¹⁰ See KPMG's publication [Funding valuation adjustment in the valuation of derivatives](#).

Approach	Description
Approach 1	Permit the use of a transfer pricing rate that reflects only the market funding index – e.g. the three-month LIBOR curve – in determining the cash flows that are used both for revaluation purposes <i>and</i> for determining the discount rates.
Approach 2	Permit the use of transfer prices without restriction – i.e. including any spreads – to identify the cash flows that are used for revaluation purposes, but require that the discount rates be derived only from the relevant (unadjusted) market funding index.
Approach 3	Permit the use of full transfer prices (without restriction) to identify the cash flows that are used to determine the revaluation adjustment, but ‘fix’ all spreads over the market funding index within the transfer price for the discount rate at the original spread that was used in pricing the transfer pricing transaction.

Question 12 – Transfer pricing transactions

The DP asks:

- whether transfer pricing transactions would provide a good representation of the managed risk in the managed portfolio for the purpose of applying the PRA;
- which of the approaches discussed above would provide the most faithful representation of dynamic risk management, if the managed risk is a funding rate and is represented through transfer pricing transactions at a rate other than the benchmark rate;
- whether restrictions are required on the eligibility of the indexes and spreads that can be used in transfer pricing as a basis for applying the PRA; and
- how the issues about the ongoing linkage – i.e. whether the transfer pricing transactions would continue to be a good proxy for the managed risk in the managed portfolio over time – should be resolved if transfer pricing were to be used as a practical expedient.

Considerations for comment letter responses

Are transfer prices a good representation?

In managing interest rate risk, some banks may want to focus specifically on the impact of benchmark interest rate changes on the managed exposures, so that:

- changes in funding rates due to companies’ own credit risk, liquidity risk etc are excluded from the PRA; and
- the PRA only reflects the economics of pure interest rate risk management.

Furthermore, certain company-specific factors – e.g. taxes and incentive plans – may have a bearing on the transfer pricing mechanism. These items may further complicate the revaluation effect of the managed exposures if the desire is to focus solely on the impact of the interest rate risk.

Additional disclosures may be necessary for users to understand: the process a company uses to establish its transfer prices; the extent to which transfer prices are based on observable market factors vs unobservable company-specific factors; and how they are used for dynamic risk management.

Some smaller banks may not yet have a robust transfer pricing mechanism, and may therefore be unable to use it as an operational expedient as suggested in the DP.

If internal transfer prices are used, then this may result in commercially sensitive information being disclosed in the financial statements.

Which approach would provide the most faithful representation?

Any approach that results in a need to amortise adjustments arising from non-zero day one revaluations may lead to operational complexities that the PRA model seeks to avoid.

If transfer pricing is used as an operational expedient, then it may be desirable not to have any day one revaluation difference – e.g. Approach 2 in 7.4.2, above. This may imply that the cash flows used for revaluation should be based on the full transfer prices (without restriction), whereas for the purposes of the discount rate, the original spread used in pricing the transfer pricing transaction should be fixed for ongoing valuation. If different business transactions that originated at different times have different transfer pricing spreads, then operational complexity may arise from tracking all of the transfer pricing spreads to ensure that appropriate spreads are used to value appropriate transactions that are part of the managed portfolio.

Are restrictions necessary?

It is also important to consider the need for restrictions on selecting a transfer price when applying the PRA. One possible approach would be to allow companies to choose transfer prices in line with their risk management activities. The advantage of this approach is that the financial statements would represent the way interest rate risk is actually managed. In addition, the operational burden would be low, as the actual data used for risk management could be used for financial reporting purposes as well. However, there is a risk that the comparability of financial statements would be reduced. To mitigate this risk, detailed disclosures on the assumptions and settings for transfer prices would be required, which may be commercially sensitive.

Another approach would be to stipulate the transfer prices that should be used in the PRA as a minimum requirement – i.e. which risk elements need, as a minimum, be included (for example, benchmark rates such as LIBOR, credit risk, customer/product margins and liquidity elements). This approach would increase the comparability of companies' revaluation approaches, as similar types of transfer prices could be used; however, the information might no longer accurately reflect their actual risk management activities.

If multiple approaches were permitted, then this may result in a lack of comparability between companies – e.g. if one company uses its funding cost, while another company uses a benchmark rate.

How should issues over ongoing linkage be resolved?

Using transfer pricing transactions to represent the managed risk in the managed portfolios would probably have significant operational advantages. However, it is important to consider whether some or all transfer pricing transactions appropriately represent the managed risk when applying the PRA.

DP 4.3.4

7.4.3

Selection of funding index

DP 4.4.4

The PRA could accommodate more than one funding index, assuming that the revaluation adjustments can be derived from different benchmark index curves depending on the different managed portfolios. Although the exact funding source cannot usually be identified, incorporating a funding index within the PRA that does not faithfully represent the actual funding index to which a bank is subject and that it dynamically manages would not provide useful information on the bank's dynamic risk management processes.

DP 4.4.5

The DP assumes that, in the case of managed liabilities, the appropriate funding index would be the benchmark interest rate that a bank used for pricing those liabilities.

Question 13 – Selection of funding index

The DP asks whether it would be acceptable to identify a single funding index for all managed portfolios if funding is based on more than one funding index.

The DP also asks whether criteria for selecting a suitable funding index or indexes are necessary.

Considerations for comment letter responses

Companies may consider describing how many funding indexes they use as part of their dynamic risk management activities.

Those companies that dynamically manage risks other than interest rate risk may consider describing:

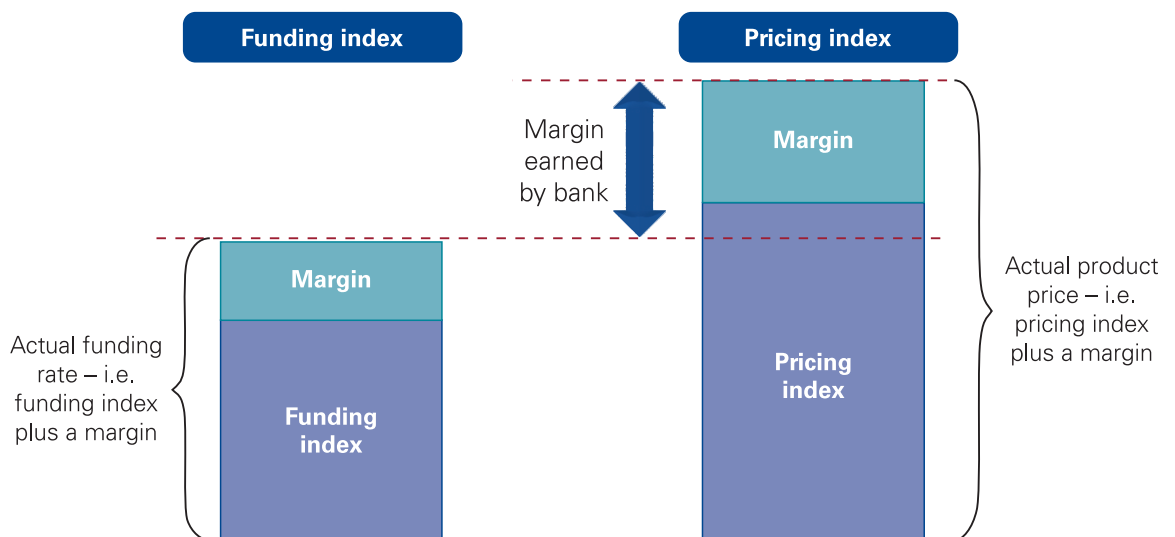
- the indexes they use for risk management purposes that are the equivalent of funding indexes in the context of managing interest rate risk; and
- their perception of the difficulties of using these indexes in applying the PRA.

7.4.4

Pricing index

DP 4.5.1–3

Another alternative to a funding index would be to use a pricing index as the basis for revaluation under the PRA. This would be appropriate if the dynamic risk management objective is to hedge the pricing index. When there is a clear pricing benchmark for a product, it could be used for the initial pricing of the product, and could therefore form the basis for the managed risk and hence the PRA.



Question 14 – Pricing index

The DP seeks examples of dynamic risk management undertaken for portfolios using a pricing index, and asks whether the pricing index would be an appropriate basis for applying the PRA if the pricing index is used in dynamic risk management.

The DP also asks whether applying the PRA would provide useful information about dynamic risk management activities that use the pricing index.

Considerations for comment letter responses

In our experience, a funding index is commonly used for interest rate risk management purposes. Therefore, using a pricing index may require companies to consider more carefully whether the index appropriately reflects the managed risk.

Companies that dynamically manage risks other than interest rate risk may consider whether there is a similar distinction between relevant funding indexes and pricing indexes with respect to those other managed risks – e.g. commodity price risk.

7.5 Scope of the PRA

7.5.1 Two scope alternatives

DP 5.1.1–3

The DP presents two scope alternatives for applying the PRA, which differ based on whether hedging under the PRA would capture all three elements of dynamic risk management – i.e. risk identification, analysis and mitigation – or only some of them. They are:

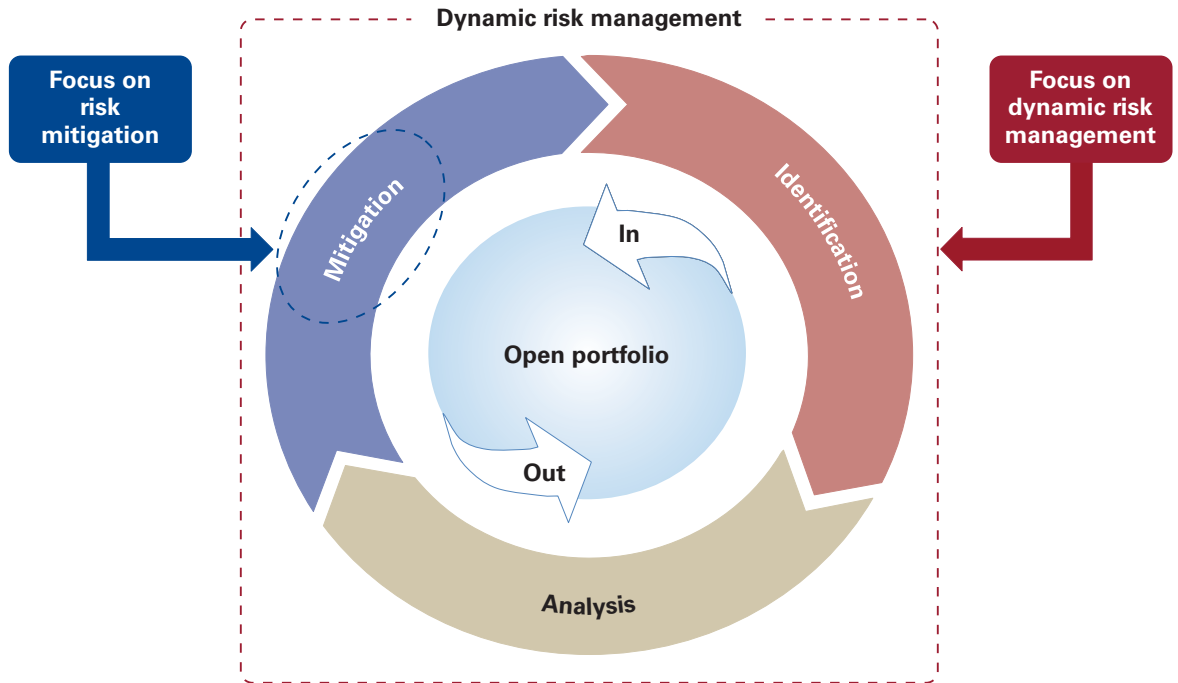
- a focus on dynamic risk management; and
- a focus on risk mitigation.

DP 5.1.4


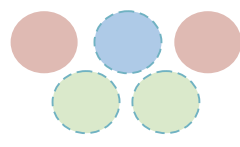
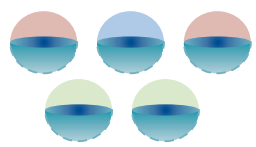
The issue of scope alternatives is linked to the issue of whether applying the PRA should be mandatory or optional (see 7.5.2). Furthermore, the interaction with the general hedge accounting requirements under current IFRS needs to be addressed.

DP 5.1.5

The DP considers whether and how the scope alternatives would represent the objectives of dynamic risk management more faithfully, while reducing operational complexity.



DP 5.2.1–15

Focus on dynamic risk management	
<p>The PRA would apply if any one of the three elements of dynamic risk management is present – e.g. the PRA would apply to all net open risk positions regardless of whether they have been hedged.</p>	<p>All dynamically managed risk positions</p> 
Focus on risk mitigation	
<p>The PRA would apply only when all three elements of dynamic risk management are present – e.g. the PRA would only apply to those circumstances in which the company has undertaken risk mitigation activities through hedging.</p> <p>The PRA could be limited to only dynamically managed sub-portfolios that have been hedged, or alternatively, the PRA could be applied to proportions of portfolios if hedged positions are determined as a proportion of a dynamically managed portfolio.</p>	<p>Risk mitigation performed on a portfolio basis</p> <div style="display: flex; justify-content: space-around;"> <div style="text-align: center;"> <p>Hedged sub-portfolios</p>  <p>(e.g. three portfolios)</p> </div> <div style="text-align: center;"> <p>Hedged proportions of portfolios</p>  <p>(e.g. 60% of each portfolio)</p> </div> </div>

DP 5.2.2–25

The DP weighs up the advantages and disadvantages of the scope alternatives.

Alternative	Advantages	Disadvantages
Focus on dynamic risk management	<ul style="list-style-type: none"> • This alternative would provide a complete picture of the net open interest rate risk positions together with the risk management instruments. • It would enable users of financial statements to understand the profits and the corresponding risks by profit source, as well as provide comparability among companies that dynamically manage interest rate risk. • This alternative would make greater use of existing risk management data for accounting purposes. 	<ul style="list-style-type: none"> • Some may believe that considering all net open risk positions would not result in useful information for decision-making purposes. • Comparability between companies that dynamically manage interest rate risk and those that do not could become an issue (see observations on Question 15, below). • Even though existing risk management data could be used, the costs could outweigh the benefits in some circumstances. For example, the effect of the PRA for a bank that dynamically manages interest rate risk from a portfolio made up of predominantly floating interest rate exposures may be too small to justify the cost of investing in systems.
Focus on risk mitigation	<ul style="list-style-type: none"> • Some may believe that the accounting provides more useful information when it reflects how successful companies have been in meeting their dynamic risk management objectives. • Because this scope alternative is similar to current IFRS, the interaction with current IFRS would be easier to understand and explain. • It may be more operationally feasible. 	<ul style="list-style-type: none"> • Under this alternative, information about the effect of decisions not to hedge would not be portrayed, except through some of the disclosures required in IFRS 7 <i>Financial Instruments: Disclosures</i>. • This alternative would further confuse the understanding of dynamic risk management, because a piecemeal application of the PRA may not be aligned with the dynamic risk management view. • Even if this alternative were operationally feasible, it is possible that the practical burdens associated with current IFRS would remain – e.g. a certain degree of tracking of individual exposures.

Question 15 – Scope of the PRA

The DP asks whether the PRA should be applied to all managed portfolios that are included in a company's dynamic risk management – i.e. its scope should be a focus on dynamic risk management – or restricted to circumstances in which a company has undertaken risk mitigation through hedging – i.e. its scope should be a focus on risk mitigation.

The DP also requests comments on:

- the usefulness of the information that would result from applying the PRA under each scope alternative; and
- the operational feasibility of applying the PRA for each scope alternative – and, in the case of a focus on risk mitigation, how the need for frequent changes to the identified hedged sub-portfolio and/or proportion could be accommodated.

In addition, the DP asks whether the answers provided for the above questions would change when considering risks other than interest rate risk – e.g. commodity price risk or foreign exchange risk.

Considerations for comment letter responses

Companies may want to consider the scope alternatives in the DP in light of the way they currently apply hedge accounting and the possibilities under the IFRS 9 general hedging model. They should evaluate which approach would provide the most faithful representation of their dynamic risk management activities, while also weighing up the cost of implementing a revised approach and providing additional disclosures that may be commercially sensitive.

Companies may want to consider the potential impact on the classification and measurement requirements for financial instruments if the scope were a focus on dynamic risk management. Under this scope alternative, applying the PRA would mean that unhedged exposures that are classified and measured in accordance with IFRS 9 would be remeasured for changes in the managed risk. This could have the effect of over-riding the classification and measurement principles in IFRS 9, and could result in the introduction of a potential new business model. That is because IFRS 9 generally requires amortised cost accounting for plain-vanilla debt instruments that are held to collect the contractual cash flows. Under that model, fair value changes that are expected to reverse over the life of an asset are considered not to be relevant for accounting purposes. Applying the PRA with a focus on dynamic risk management could result in a large proportion of a bank's banking book assets and liabilities no longer being measured at amortised cost, which might be difficult to justify or explain to users.

Many banks that manage interest rate risk on their banking book (which comprises a bank's non-trading portfolio) could face significant volatility in profit or loss if the scope were a focus on dynamic risk management, because unhedged positions would be remeasured.

DP 5.2.7

If the scope were a focus on dynamic risk management, then comparability between companies that dynamically manage interest rate risk and those that do not may become an issue. This is because a company that does not undertake dynamic risk management would not report volatility in profit or loss, whereas a company that does undertake dynamic risk management but does not hedge the whole of the risk exposure would report a more volatile profit or loss.

DP 9.2

To address the issue described in the previous point, the DP considers an alternative approach of recognising both:

- the revaluation of risk-managed portfolios with respect to the managed risk; and
- the fair value changes of the hedging instruments

in OCI rather than in profit or loss (see 8.2.3).

7.5.2

Mandatory or optional application

DP 5.3.1

The DP considers whether applying 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.

DP 5.3.2, 5.3.4

Mandating the PRA would raise issues about the interaction of the PRA with the current hedge accounting models. Making the PRA optional, however, would also raise issues – e.g. the fact that this would add to, rather than reduce, the existing patchwork of hedge accounting requirements. If applying the PRA were optional, then a company engaging in dynamic risk management activities might consider the following accounting alternatives.

Alternative	Description
Apply neither hedge accounting requirements in accordance with current IFRS nor the PRA	Companies would account for individual items without regard to their risk management activities – i.e. they would simply follow the classification and measurement requirements of current IFRS.
Apply only current hedge accounting requirements	Accounting information would reflect the information produced through hedge designations under current IFRS.
Apply only the PRA	Accounting information would reflect portfolio revaluations by risk for some or all exposures that are dynamically risk managed.
Apply current hedge accounting requirements and the PRA if the scope is a focus on risk mitigation	Accounting information would reflect: <ul style="list-style-type: none"> • portfolio revaluations by risk for some exposures that are dynamically risk managed, and to which the PRA is applied; and • information that is produced through hedge designations under current IFRS for other exposures.

Question 16 – Mandatory or optional application of the PRA

The DP asks whether the application of the PRA should be mandatory if its scope were:

- a focus on dynamic risk management; or
- a focus on risk mitigation.

Considerations for comment letter responses

It would be difficult to achieve complete alignment with risk management, given the different purposes of financial reporting and risk management, the variety of risk management practices, and ongoing developments in this area. However, some may believe that focusing only on hedge accounting solutions to address accounting mismatches would be too narrow a basis for the deliberations on accounting for dynamic risk management.

Mandatory application of the PRA could effectively mean introducing a new classification category, because the revaluation mechanism would effectively over-ride the classification and measurement requirements of IFRS 9.

Hedge accounting has traditionally been voluntary, so mandating hedge accounting for dynamic risk management activities would be a significant change.

If the PRA were made mandatory, companies may want the IASB to clarify whether the IFRS 9 general hedging model would be available for optional application in circumstances where they do not meet the dynamic risk management definition.

There may be some interaction between the way dynamic risk management activities are defined in a final standard, the scope of that standard (see 7.5.1) and whether application were mandatory or optional.

- If applying the PRA were mandatory, then dynamic risk management activities would need to be defined precisely, so that it is clear when the PRA should be applied. However, this could be difficult, due to diversity in risk management practices.
- If applying the PRA were optional, then companies may want a broad definition of dynamic risk management activities, to give them more alternatives for reporting their risk management activities in the financial statements.

Some companies may want the PRA model to be optional so that they could use it alongside the IFRS 9 general hedging model as they deem appropriate to their circumstances. This might support their desired objective of reducing profit or loss volatility as much as possible.

7.5.3

DP 5.4.1–2

Other eligibility criteria

If the PRA were mandatory and the scope were a focus on dynamic risk management, then additional effectiveness criteria to be met on initial designation or subsequently may not be required. This is because the revaluation would automatically capture the ineffectiveness arising from any remaining open risk position.

However, if the scope were a focus on risk mitigation, then additional requirements might need to be developed. In addition, if the application of the PRA were optional, criteria regarding stopping and starting the application of the PRA – including the accounting mechanics – would need to be determined.

Question 17 – Other eligibility criteria

Focus on dynamic risk management

The DP asks whether any additional criteria would be required to qualify for applying the PRA if its scope were a focus on dynamic risk management – and whether the answer to that question would depend on whether application of the PRA was mandatory or optional.

It also asks what criteria regarding starting and stopping the application of the PRA would be appropriate if its scope were a focus on dynamic risk management and its application were optional.

Focus on risk mitigation

The DP asks whether additional eligibility criteria would be needed regarding what is considered to be risk mitigation through hedging under dynamic risk management if the scope of the PRA were a focus on risk mitigation – and whether the answer to that question would depend on whether application of the PRA was mandatory or optional.

It also asks what criteria regarding starting and stopping the application of the PRA would be appropriate if its scope were a focus on risk mitigation and its application were optional.

Considerations for comment letter responses

If the scope of the PRA were a focus on dynamic risk management and its application were made mandatory, then some may argue that no other criteria should be necessary because its application would be intended to be broad.

If the scope of the PRA were a focus on dynamic risk management and its application were made optional, then some may argue that some sort of designation and documentation would be necessary so that it is clear when the PRA would be applied and when it would not. Furthermore, and similar to the IFRS 9 general hedging model, companies may want to think about whether the optional application of the PRA should only be on a prospective basis, so that they are not using the benefit of hindsight.

If the scope of the PRA were a focus on risk mitigation and its application were made optional, then its interaction with current hedge accounting requirements would need to be considered, because companies may have valid reasons for electing to use either of the available hedge accounting models.

7.6

Other considerations

7.6.1

Date of inclusion and removal of exposures

DP 7.1.1

The DP asks whether the PRA should allow for exposures to be included in the managed portfolio after a company first becomes a party to a contract if those exposures are included in the managed exposures. If exposures are included after the company first becomes a party to the contract, then the difference between the current revaluation and the revaluation at the initiation of the contract would have to be recognised as a day one gain or loss or amortised in profit or loss; this would lead to operational complexity.

DP 7.2.1–2

The DP also considers the impact of removing the managed exposures from the managed portfolio. This would create issues over how to remove the revaluation adjustments from the statement of financial position and recognise them in profit or loss. If managed exposures are prepaid or sold, they would be derecognised and any revaluation adjustments would need to be removed from the statement of financial position and recognised in profit or loss.

However, if managed exposures are permitted to be removed from the managed portfolio before their maturity or derecognition, whichever is earlier, then this would require either:

- amortisation of the revaluation adjustment recognised to that point, which may be operationally burdensome; or
- immediate recognition of the revaluation adjustment in profit or loss, which may be unlikely to reflect the outcome of the dynamic risk management activity.

Question 22 – Date of inclusion of exposures in a managed portfolio

The DP asks whether the PRA should allow for the inclusion of exposures in managed portfolios after a company first becomes a party to a contract and under what circumstances.

The DP also asks how any non-zero day one revaluations should be accounted for.

Considerations for comment letter responses

If exposures could not be included in the managed portfolios after a company first becomes party to a contract, then the application of the PRA would not reflect some dynamic risk management decisions that are made after the contract is put in place.

Companies may want to evaluate whether in all cases there would be a non-zero day one revaluation. For example, if an exposure were included in the managed portfolio after the transaction date, but the managed risk were identified as the market funding index – e.g. three-month LIBOR – then there would be no gain or loss on the day one revaluation. This is because the funding index used to determine the cash flows used for revaluation would be the same as the funding index used for the discount rate. In such cases, exposures could arguably be included in the managed portfolio after the transaction date without any additional operational complexity.

It may be challenging to document what changes in circumstances resulted in the exposure being included in the managed portfolio after initial recognition if the dynamic risk management objective remains the same.

If the difference between the current revaluation and the revaluation at the initiation of the contract would have to be recognised as a day one gain or loss or amortised in profit or loss, then counter-intuitive results might arise. This is because gains and losses would be recognised for previous periods in which the risk was not dynamically managed. An alternative approach would be to only remeasure for changes in the managed risk that occur after the exposure is included within the managed portfolio.

Question 23 – Removal of exposures from a managed portfolio

The DP asks whether constituents support the criterion that once exposures are included within a managed portfolio they should remain there until derecognition.

The DP also asks:

- whether there are any circumstances, other than those considered in the DP, under which it would be appropriate to remove exposures from a managed portfolio; and
- if exposures are removed from a managed portfolio before maturity, then how the recognised revaluation adjustment should be accounted for.

Considerations for comment letter responses

The IFRS 9 general hedging model precludes a company voluntarily terminating a designated hedging relationship if the risk management objective has not changed. Some companies may view the restriction on the removal of exposures from the managed portfolio as being similar to the preclusion of voluntary termination under IFRS 9 if the objective of dynamic risk management has not changed.

If the scope of the PRA were a focus on risk mitigation and its application were optional, then companies may want to consider whether they might ever want to move exposures from one sub-portfolio where they are applying the PRA to another sub-portfolio where they are not, to optimise the impact of revaluation. If so, they may have to remove exposures from a sub-portfolio before their maturity or prepayment date.

7.6.2

Dynamic risk management of foreign currency instruments

DP 7.3.1

It is common for banks to raise funding and make loans in currencies other than their functional currency. Banks are therefore likely to be exposed to foreign currency risk as well as interest rate risk from these portfolios. It is therefore important to consider how the PRA could be applied for dynamic risk management of both foreign currency risk and interest rate risk.

DP 7.3.3–5

The DP considers the following scenarios in discussing the potential application of the PRA to the dynamic risk management of foreign currency instruments.

Scenario	Description
Scenario A	A bank manages its business in its functional currency and therefore all foreign currency exposures – e.g. foreign currency debt issued – are converted into functional currency exposures using derivatives on a one-to-one basis. The resulting net open functional currency interest rate risk position is included in the bank's dynamic risk management of interest rate risk.
Scenario B	A bank only raises funding in a foreign currency for lending in the same currency – i.e. interest rate risk in each foreign currency portfolio is dynamically managed in that foreign currency.
Scenario C	A bank lends and raises funds in a foreign currency in the normal course of business, and this is managed using cross-currency derivatives on a portfolio basis. The interest rate risk for each foreign currency portfolio is dynamically managed in that foreign currency.

DP 7.3.6–9

Potential approaches for applying the PRA can be analysed as follows.

Scenario	Approach(es)
Scenario A	<p>Approach 1: Similar to the IFRS 9 guidance on aggregated exposures, the managed exposures for the purposes of applying the PRA would be a combination of, for example, the foreign currency debt and the foreign currency derivatives.</p> <p>Approach 2: The foreign currency loan and debt would be part of the managed exposures for the purposes of applying the PRA. The risk management instruments would include any interest rate and currency swaps associated with the dynamic risk management of the foreign currency loan and the debt.</p>
Scenario B	<p>The PRA would be applied to the foreign currency lending and funding exposures. Fair value movements from risk management instruments that mitigate the interest rate risk in the foreign currency portfolio would offset the effect of revaluation due to the managed interest rate risk in profit or loss. However, the interaction of the PRA with IAS 21 <i>The Effects of Changes in Foreign Exchange Rates</i> may need to be considered – i.e. any offsetting revaluation effect due to foreign currency risk and interest rate risk would be presented in the same profit or loss line, so that any economic offsetting would be reflected.</p>
Scenario C	<p>Similar to Approach 2 in Scenario A, the application of the PRA should include both foreign currency risk and interest rate risk.</p>

Question 24 – Dynamic risk management of foreign currency instruments

The DP asks whether it would be possible to apply the PRA to the dynamic risk management of foreign exchange risk in conjunction with the interest rate risk that is being dynamically managed.

The DP also asks for comments on its overview of such a dynamic risk management approach, how the PRA could be applied, and if it could not be applied, then the reasons why it could not.

Considerations for comment letter responses

In our experience, banks often fund lending or investing in one currency with funding in the same currency, such that any foreign currency risk is naturally hedged through the normal translation process for all monetary items in accordance with IAS 21.

Sometimes the funding and lending/investing in a foreign currency are undertaken through a subsidiary or a foreign operation with the same functional currency as the foreign currency. In this case, the foreign currency exposure is an exposure to the net investment in a foreign operation, which might not be compatible with the PRA.

Some banks might wish to understand how foreign exchange risks would be incorporated in the PRA. In particular:

- some banks might want to keep using cash flow hedges for foreign exchange risk positions, and keep designating them separately from hedges of interest rate risk; and
- some banks might want to use the special accounting for ‘costs of hedging’ that is available under the IFRS 9 general hedge accounting model.

8 Presentation and disclosures

8.1 Statement of financial position presentation

DP 6.1.4

The DP describes three alternative approaches for presenting the revaluation adjustments from exposures that are included in the revalued portfolio in the statement of financial position:

- line-by-line gross-up;
- aggregate adjustment; and
- single net line item.

The accounting and presentation for the hedging instruments in the statement of financial position would be unchanged – they would continue to be held at fair value.

8.1.1 Line-by-line gross-up

DP 6.1.4(a)

Individual line item exposures in the statement of financial position that are included in the revalued portfolio would be presented at their default carrying amounts under IFRS – e.g. amortised cost – plus the associated revaluation adjustments for the managed risk. Managed exposures that are not yet recognised under IFRS but that meet the definition of an asset or a liability – e.g. firm commitments – would be presented in a separate line item in the statement of financial position – e.g. ‘revaluation of firm commitments’.

DP 6.1.8

However, the DP considers the difficulty in arguing that a revaluation adjustment for either pipeline transactions or the EMB should be recognised as an asset or a liability (a difficulty that would arise under all three approaches).

DP 6.1.7

This approach would provide information about the value of each exposure that makes up the managed portfolio. However, this may be the most operationally burdensome approach.

8.1.2 Aggregate adjustment

DP 6.1.4(b)

Revaluation adjustments for all assets included in the revalued portfolio would be presented in a single asset revaluation line item in the statement of financial position. A similar line item would be presented for revaluation adjustments for all liabilities in the managed portfolio.

This approach may be less operationally challenging than the line-by-line gross-up approach.

8.1.3 Single net line item

DP 6.1.4(c)

The net revaluation adjustment for the entire revalued portfolio would be presented in a single line item in the statement of financial position.

This approach would reflect the fact that risk management activities are undertaken on a net basis, and may be operationally easy to achieve.

Example – Presentation alternatives – Statement of financial position

DP 6.1.5

Bank H has a portfolio of fixed-rate loans, fixed-rate debt securities, demand deposits and derivative contracts. Assume that H recognises revaluation adjustments of 11 arising from loans, -20 from debt securities and 5 from deposits when applying the PRA. In this example, the presentation alternatives in the statement of financial position can be illustrated as follows.

	Assumptions			Presentation alternatives		
	Before revaluation adjustments	Revaluation adjustments	After revaluation adjustments	Line-by-line gross-up	Aggregate adjustment	Single net line item
Assets						
Loans	1,000	11	1,011	1,011	1,000	1,000
Debt securities	500	(20)	480	480	500	500
Revaluation line item	-	-	-	-	(9)	(4)
Derivatives	10	-	10	10	10	10
Liabilities						
Deposits	(400)	5	(395)	(395)	(400)	(400)
Revaluation line item	-	-	-	-	5	-

Question 18(a), (c) – Presentation alternatives – Statement of financial position

The DP asks which presentation alternative would be preferred in the statement of financial position.

It also requests details of any alternative presentation in the statement of financial position that might result in a better representation of dynamic risk management activities.

Considerations for comment letter responses

Compared to the line-by-line gross-up approach, the aggregate adjustment and the single net line item alternatives may be more consistent with a focus on dynamic risk management. This is because presenting the revaluation adjustment in the statement of financial position on a line-by-line basis could be viewed as inconsistent with a focus on dynamic risk management for the net risk position.

Even under the aggregate adjustment approach or the single net line item approach, additional disclosures may be required – e.g. the breakdown of the gross revaluation adjustments – in order to provide useful information for readers of financial statements. Therefore, the single net line item approach may not be operationally easy to achieve after all.

Under the single net line item presentation approach, the amortised cost measurement for individual assets and liabilities (and line items) would not be obscured by partial fair value adjustments, which may be easier for users to understand.

DP 6.1.7

8.2 Statement of profit or loss and OCI presentation

The DP describes two alternatives for presenting the outcome of the PRA in the statement of profit or loss and OCI:

- the stable net interest income approach; and
- the actual net interest income approach.

8.2.1 Stable net interest income approach

DP 6.1.13

Net interest income would be reported as if a company achieves a fully stabilised net interest margin against changes in benchmark interest rates. Net interest income would reflect a combination of all managed exposures, which would be the same as:

- the accrual of interest revenue or expense based on the interest rate exposures being managed – e.g. benchmark interest rates; and
- the accrual of the other margins earned or payable that are incremental to the interest rate exposures being managed – e.g. the product margin.

All changes to the revaluation adjustment from dynamic risk management activities, and to the fair value of the hedging instrument, would be presented in a single line item – e.g. ‘revaluation effect from dynamic risk management’. This new line item would not form part of net interest income.

8.2.2 Actual net interest income approach

DP 6.1.13

Actual interest income and expense on the managed exposures would be reported using the effective interest method under IFRS 9 – i.e. there would be no stabilisation assumption.

Separately, a new profit or loss line item would be included within net interest income – e.g. ‘net interest from risk management’. Net interest accruals from the hedging instruments would be reported within this new interest line. Therefore, interest revenue and interest expense would reflect the position before risk management, but net interest income would reflect the actual net interest achieved after risk management.

In addition, a profit or loss line item would be presented for the effect of dynamic interest rate risk management – e.g. ‘revaluation effect from dynamic risk management’. This would reflect net clean changes to the revaluation adjustment for the revalued portfolio, and clean changes to the fair value of the hedging instruments.

Example – Presentation alternatives – Statement of profit or loss and OCI

Bank J has a portfolio of fixed-rate loans of 100, which are funded by six-month LIBOR floating-rate liabilities of 100. J has chosen to eliminate 80% of the existing interest rate mismatch using an interest rate swap with a notional of 80. The swap has a receive-six-month-LIBOR-floating leg and a pay-1.5%-fixed leg. Actual interest income on fixed-rate loans is 2.0 (being fixed-rate loans of 100 x 2.0% – i.e. the initial benchmark rate of 1.5% plus the customer/product margin of 0.5%). Actual interest expense on the floating-rate liabilities is assumed to be 1.37. The example assumes that the scope for applying the PRA is a focus on dynamic risk management – i.e. the PRA is applied to the whole portfolio of loans as well as the floating-rate liabilities.

	Presentation alternatives	
	Stable net interest income approach	Actual net interest income approach
Interest income	1.87	2.00
Interest expense	(1.37)	(1.37)
Net interest from dynamic risk management	-	(0.10)
Net interest income	0.50	0.53
Revaluation effect from dynamic risk management	0.24	0.21
Total profit or loss for the period	0.74	0.74

Stable net interest income approach

Interest income represents the customer/product margin of 0.5 and interest accrual of 1.37 for the exposure that reflects the risk being managed – i.e. six-month LIBOR. Net interest income reflects the risk management objective of stabilising net interest income. In this fact pattern, this approach reflects a locked-in net margin of 0.5 for this reporting period. Under this approach, interest income is presented as if 100% of managed exposures are hedged – even though only 80% are hedged in this example.

The revaluation effect from dynamic risk management represents the net impact of fair value changes from the hedging instruments and revaluation changes from the exposures, reflecting the valuation of the unhedged position (20% in this fact pattern), less the stabilisation impact reported in the net interest income that was not achieved through actual dynamic risk management.

Actual net interest income approach

Interest income and interest expense represent the actual interest income and expense. Net interest from dynamic risk management represents net interest accruals from the hedging instruments, reflecting the valuation of the hedged position (80% in this fact pattern).

The revaluation effect from dynamic risk management represents the net clean fair value changes from the hedging instruments and clean revaluation changes from the exposures in the revalued portfolio, reflecting the clean valuation of the unhedged position (20% in this fact pattern).

DP 6.1.21

The stable net interest income approach would present the net interest income that a bank did not actually achieve. However, it would also provide additional information on the customer margin that a bank has maintained through its dynamic risk management activities. The amount of the adjustment between the actual net interest income and the revaluation effect to achieve a stable net interest income would provide users of financial statements with relevant information about the source of a bank's profit or loss and its sustainability. This would allow them to understand these different sources of profit in accordance with their nature.

Question 18(b) and (c) – Presentation alternatives – Statement of profit or loss and OCI

The DP asks which presentation alternative would be preferred in the statement of profit or loss and OCI.

It also requests details of any alternative presentation in the statement of profit or loss and OCI that might result in a better representation of dynamic risk management activities.

Considerations for comment letter responses

The stable net interest income approach may not paint a true picture of a company's ability to stabilise the net interest margin, because it does not consider the actual net exposure that has been hedged – i.e. it tries to portray the aspirational nature of the dynamic risk management objective by presenting net interest income as if it has been fully hedged, rather than portray management's actual risk management activities.

Companies may find the actual net interest income approach consistent with the way they already present net interest income under the current accounting requirements.

Users may find the actual net interest income approach easier to understand, because the effects of the PRA are presented separately. Interest income and expense would continue to be based on the effective interest rate method under IFRS 9, and would not be affected by the PRA.

8.2.3

Alternative of presenting the revaluation effect from dynamic risk management in OCI, rather than through profit or loss

DP 9.2

The DP discusses the alternative of recognising *both* the effect of revaluing risk-managed portfolios with respect to the managed risk *and* the changes in fair value of the hedging instruments in OCI rather than in profit or loss. This would result in the revaluation effect from dynamic risk management being recognised in OCI, which would prevent revaluation volatility from unhedged positions affecting profit or loss if the scope were a focus on dynamic risk management.

When considering applying this 'PRA through OCI approach', only the actual net interest income presentation approach would be applied, and not the stable net interest income approach. This is because under the stable net interest income approach, the profit or loss would always present a perfectly hedged position – which will not always be the case.

Example – Presentation alternative of PRA through OCI

Continuing the example in 8.2.2, the alternative for presenting the revaluation effect from dynamic risk management in OCI can be illustrated as follows. This is based on the actual net interest income approach.

Profit or loss	
Interest income	2.00
Interest expense	(1.37)
Net interest from dynamic risk management	(0.10)
Net interest income	0.53
Total profit or loss for the period	0.53
Other comprehensive income	
Revaluation effect from dynamic risk management	0.21
Total comprehensive income for the period	0.74

DP 9.7

There are practical and conceptual issues to be considered before this approach could be pursued – for example:

- this alternative is inconsistent with an assumption that the IASB has applied in developing the PRA – i.e. that all risk management instruments would be measured at fair value, with changes in fair value being recognised in profit or loss;
- the treatment of internal derivatives may need to be changed or reconsidered, because the gross presentation of internal derivatives would no longer net to zero in profit or loss (see 8.2.4);
- reclassification from OCI into profit or loss would not occur if managed exposures are sold or risk management instruments are terminated; and
- it is unclear whether the approach would be consistent with the suggestions in the IASB’s discussion paper on its conceptual framework – i.e. the use of OCI.

Question 26 – PRA through OCI approach

The DP asks whether an approach incorporating the use of OCI should be considered.

Considerations for comment letter responses

The PRA through OCI approach would contradict a key assumption in the DP that the PRA would not change the accounting for hedging instruments; in addition, the interaction with the classification and measurement requirements for the risk management instruments would need to be considered.

Some preparers’ accounting choices may also be influenced by the impact of relevant prudential regulations.

8.2.4

Role and presentation of internal derivatives

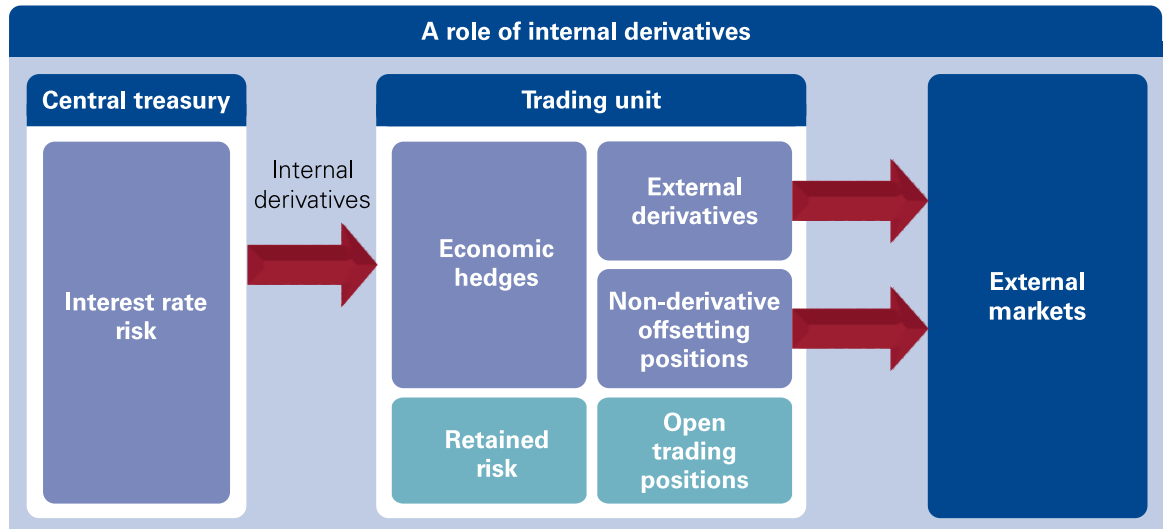
DP 6.2.1

Banks often manage interest rate risk positions from open portfolios by transferring risk from the ALM unit to a trading unit using internal derivatives. The traders then treat the risk position that they assume from the internal derivatives in the same way as they would treat risk positions from external exposures. Traders consider their overall exposure and may have offsetting positions from other derivatives. Consequently, the traders sometimes do, and sometimes do not, transact external derivatives to fully eliminate the risk transferred via internal derivatives.

DP 6.2.2, A4.2.2

The main aim of a bank’s dynamic interest rate risk management is to manage the bank’s net interest income from lending and funding (banking book) activities, so that the margin responds to a desired extent to changes in interest rates. By contrast, a trading unit has trading profit objectives. To separately reflect dynamic risk management and trading activity in the financial statements, the DP explores a gross-up presentation for internal derivatives to present the effect of offsetting internal derivatives in the statement of profit or loss and OCI. The net impact in profit or loss from internal derivatives would be zero in the consolidated financial statements.

Current IFRS requires that hedging relationships involve an external derivative, and states that internal derivatives do not qualify as hedging instruments by themselves. However, a trading unit does not always use external derivatives to manage the interest rate risk positions received from the group treasury unit. Instead, the trading unit may attempt to minimise the risk position without using external derivatives – e.g. by entering into an offsetting non-derivative contract that has a similar duration. Alternatively, it may incorporate the interest rate exposure into a trading position – e.g. by using the position to speculate on the future movement of interest rates, instead of hedging the position and entering into a separate position for that purpose. The following diagram illustrates the three alternatives (a number of variations on these alternatives are possible).

**DP A4.2.14**

Banks currently apply a variety of practices to achieve hedge accounting. These practices include requiring trading units to externalise internal derivatives on a one-to-one basis, or subsequently identifying and designating the best (but possibly unrelated) matching external derivative in the trading portfolio. These approaches create operational challenges, either by restricting the normal activities of the trading unit or by requiring additional identification and tracking procedures. Requiring the externalisation of risk management instruments under the PRA would impose many of the same accounting-driven procedures.

DP A4.2.13–A4.2.18

Under the PRA, a company would not be required to demonstrate the externalisation of a managed risk that is transferred via internal risk management instruments. However, the DP considers whether there should be supplementary qualifying criteria – for example:

- the trading unit has ‘substantially externalised’ the interest rate risk using an external derivative; or
- internal derivatives are deemed to be substantially externalised as long as the predefined risk limits are not breached.

DP A4.2.19

If particular criteria are needed to prove an appropriate level of externalisation, then the question arises as to what happens if the criteria are not met for a particular period. Addressing this issue is likely to introduce additional complexity to the accounting.

Example – Presentation of internal derivatives

The banking unit within Bank K eliminates 100% of its managed interest rate exposures using internal derivatives with K’s trading unit under K’s dynamic risk management activities. The internal derivatives in the trading unit are externalised, together with other trading positions.

The assumptions can be summarised as follows.

Risk management/banking unit		Trading unit	
Managed exposures		Internal derivatives	
Net interest income	1.0	Change in fair value	1.9
Revaluation profit or loss	1.9	External derivatives	
Internal derivatives		Change in fair value – externalised position of internal derivatives	(2.3)
Change in fair value	(1.9)	Change in fair value – other trading positions	0.2

Bank K considers three scenarios.

- A. Neither hedge accounting nor PRA is applied
- B. PRA is applied – No gross-up
- C. PRA is applied – Gross-up

The following table shows the presentation of profit or loss for each scenario. Interest accruals on external derivatives are ignored for this example.

Profit or loss	A. Neither hedge accounting nor PRA is applied	Presentation of internal derivatives if PRA is applied	
		B. No gross-up	C. Gross-up
Net interest income	1.0	1.0	1.0
Revaluation profit or loss	-	(0.4)	-
Trading profit or loss	(2.1)	0.2	(0.2)
Total profit or loss	(1.1)	0.8	0.8

	Scenario	Accounting treatment
A	Neither hedge accounting nor PRA is applied	<ul style="list-style-type: none"> • Net interest income represents net interest income arising from managed exposures. • The profit or loss line item 'revaluation profit or loss' is irrelevant if the PRA is not applied, because no revaluation adjustment is made. • Trading profit or loss represents trading results arising from external trades by trading units – i.e. $-2.3 + 0.2$. • The effects of internal derivatives are offset and no gross-up presentation is provided.

	Scenario	Accounting treatment
B	PRA is applied – No gross-up	<p>Net interest income represents net interest income arising from managed exposures.</p> <p>The revaluation profit or loss represents revaluation adjustments arising from managed exposures and external hedging instruments – i.e. 1.9 -2.3.</p> <p>The trading profit or loss represents trading results arising from instruments other than hedging instruments that mitigate managed exposures – i.e. 0.2.</p> <p>The effects of internal derivatives are offset, and no gross-up presentation is provided.</p>
C	PRA is applied – Gross-up	<ul style="list-style-type: none"> • Net interest income represents net interest income arising from managed exposures. • The revaluation profit or loss represents revaluation adjustments arising from managed exposures and internal hedging instruments – i.e. 1.9 -1.9. • The trading profit or loss represents the trading unit's net trading results, including both internal and external derivatives – i.e. 1.9 - 2.3 + 0.2.

The net difference in profit or loss between Scenarios A and B, or between Scenarios A and C, is -1.9 (being -1.1 - 0.8), which represents the effect of revaluation profit or loss on the managed exposures.

Question 19 – Presentation of internal derivatives

The DP asks:

- whether internal derivatives used as part of dynamic risk management should be eligible for inclusion in the application of the PRA, which would lead to a gross presentation of internal derivatives in the statement of profit or loss and OCI;
- whether the presentation of internal derivatives enhances the operational feasibility of the PRA; and
- whether additional conditions should be required in order for internal derivatives to be included in the application of the PRA.

Considerations for comment letter responses

Presenting internal derivatives on a gross basis may be consistent with the way the exposures are actually managed by some banks and treasury centres in corporate entities.

The DP does not consider the need to prove that internal derivatives are externalised – there may be instances where there are no external derivatives (for example, because the trading unit had offsetting derivatives and did not find a need to externalise the derivatives that it transacted with the banking unit) but hedge accounting would still be applied through the PRA. Companies may want to consider whether the dynamic risk management activities of one unit within the company – e.g. the banking unit – or the dynamic risk management activities of the company as a whole provide a better reflection in the financial statements. If it is the latter, then internal derivatives may need to be externalised to ensure risk mitigation at the overall company level.

DP A4.2.4

If the PRA through OCI approach were applied, then the effect of internal derivatives would no longer be eliminated in the consolidated profit or loss (see 8.2.3).

8.3 Disclosures

DP 6.3.1

The disclosures accompanying the PRA should help users of financial statements to understand a company's dynamic risk management activities and how the PRA has been applied in the financial statements.

DP 6.3.2

The DP identifies four possible disclosure themes that would need to be developed for the PRA:

- qualitative information on the objectives and policies for dynamic risk management, including the identification of risks within exposures;
- qualitative and quantitative information on the net open risk position and its impact on applying the PRA;
- applying the PRA; and
- qualitative and quantitative information on the impact of dynamic risk management on the current and future performance of a company.

8.3.1

Qualitative information on the objectives and policies for dynamic risk management, including the identification of risks within exposures

DP 6.3.3

The aim of these disclosures would be to provide users of financial statements with information that would enable them to understand:

- the risks being managed;
- the objective of a company's dynamic risk management activities with respect to those risks;
- how the company undertakes its risk management activities; and
- the financial outcome of such activities.

These disclosures should also enable users of financial statements to better understand the effect of dynamic risk management on net interest income, and the risks involved in the business.

DP 6.3.4

A company would provide a qualitative description of the different types of exposures considered in its dynamic risk management activities, and how the company perceives the risk arising from such exposures. Information would be provided to help users of financial statements understand how the managed exposure is determined and how it links into the company's dynamic risk management objective.

DP 6.3.5

For each type of managed exposure, information would be provided to enable users of financial statements to understand the basis on which the risk is measured and analysed. This could include information about whether the managed risk is monitored based on the contractual terms of the exposures, or, for example, based on their behaviour.

DP 6.3.6

Qualitative information would also include the following disclosures:

- the company's dynamic risk management policies and performance objectives;
- a high-level description of the company's dynamic risk management processes; and
- the extent to which risk management instruments are transacted with external or internal counterparties – e.g. the trading unit.

8.3.2 Qualitative and quantitative information on the net open risk position and its impact on applying the PRA

DP 6.3.8 A company would provide qualitative disclosures on the way its net open risk position is determined, which should be consistent with the dynamic risk management approach. This would include the following disclosures:

- a description of the method used to measure risk within the managed portfolio;
- an explanation of the methodology used to calculate the revaluation adjustments on applying the PRA;
- any changes made to the techniques used during the period; and
- an explanation of the reason for the changes.

In addition, information would be provided on the estimation techniques that are used for dynamic risk management and accounting purposes. In particular, information about any reliance on subjective or judgemental inputs would be important – e.g. the role of prepayment curves or other non-market-driven factors.

DP 6.3.9 Quantitative information would be provided on the net open risk positions and on the portfolio revaluation adjustment recognised at the reporting date. Some information about a company's risk position can be commercially sensitive, so the DP asks preparers to provide suggestions about information that would be useful to users of financial statements without compromising companies' commercial sensitivities.

DP 6.3.13 Most of the disclosures would be based on existing risk information that companies currently use; however, there may be an operational impact as a result of providing this information.

8.3.3 Applying the PRA

DP 6.3.14 To explain the extent to which the accounting represents dynamic risk management and the way it is reflected in the financial statements, companies would need to disclose the differences between the accounting applied and the dynamic risk management approach taken.

DP 6.3.15 A full description of a company's accounting policy in applying the PRA would be required by IAS 1 *Presentation of Financial Statements*. If a final standard were to include a choice of scope, then additional disclosures would be required – e.g. how portfolios were selected for inclusion, why the approach has not been applied to all dynamically managed exposures, and which exposures were selected for inclusion in the scope of the PRA.

8.3.4 Qualitative and quantitative information on the impact of dynamic risk management on the current and future performance of a company

DP 6.3.18 The aim of these disclosures would be to help users of financial statements better understand the impact of dynamic risk management on a company's financial statements in current and future periods.

DP 6.3.19–20 If the actual net interest income approach were selected (see 8.2), it would present pre- and post-dynamic risk management activities, and so reduce the need for extensive disclosures. For example, users of financial statements are likely to be interested in information on the sensitivity of a company's future net interest income to changes in interest rates after dynamic risk management, based on the company's net open risk positions at the reporting date. However, because that information is likely to be considered commercially sensitive, the DP requests suggestions of ways to provide information that is helpful for users of financial statements while being mindful of these considerations.

DP 6.3.21 Users of financial statements may also find it helpful to understand the drivers of the profit or loss from the PRA – e.g. through disclosures on the sensitivity of both the reported net interest income and the revaluation effect in the period. This could include a sensitivity disclosure for changes in the managed risk and the key assumptions.

Question 20 – Disclosures

The DP asks whether each of the four identified themes would provide useful information on dynamic risk management and what additional disclosures would result in useful information about a company's dynamic risk management activities.

Considerations for comment letter responses

If the aim of the disclosures is to enable users to better understand companies' dynamic risk management activities, then the disclosure requirements should consider the key risks that arise from those activities and how the risks are monitored, measured and managed.

It is also important to consider the extent to which current IFRS disclosure requirements represent dynamic risk management activities before introducing new disclosure requirements. Some may view the current disclosures as already burdensome and overlapping – e.g. banks make disclosures under both IFRS and a number of regulatory disclosure requirements, as well as considering the recommendations of the Enhanced Disclosure Task Force. Any new disclosure requirements should be decision-useful to users of financial statements and should not overlap with existing disclosure requirements, while ensuring that commercially sensitive information is not required. In addition, if an objective of the project is to better reflect dynamic risk management in the financial statements, one might expect that less disclosure would be necessary.

8.3.5

Scope of disclosures

DP 6.3.22

The IASB will also need to consider whether the disclosures should:

- follow the scope of the application of the PRA if the scope is a focus on risk mitigation; or
- be extended to a focus on dynamic risk management, based on the existence of dynamic risk management.

DP 6.3.23

Disclosure of a company's full exposure to dynamically managed risks could improve comparability between companies applying the PRA, if accounting choices are available. Otherwise, companies with similar approaches to dynamic risk management could have different disclosures if they make different accounting choices.

Question 21 – Scope of disclosures

The DP asks whether the scope of the disclosures should be the same as the scope of the application of the PRA.

Considerations for comment letter responses

The following issues may arise if the scope of the disclosures is a focus on dynamic risk management, but the scope of the PRA is a focus on risk mitigation.

- The disclosure requirements could bring the same operational burdens as the scope alternative of a focus on dynamic risk management.
- Disclosures in the financial statements would be disconnected from the accounting outcome in the financial statements. If the purpose of disclosures is to inform users of financial statements about accounting methods used in the financial statements and the effect of such accounting, then the disconnect between the accounting outcome and disclosures in the financial statements may not deliver useful information to those users.

9 Application to other risks

DP IN5, IN14, 1.54

The IASB decided to focus on the way in which banks dynamically manage their interest rate risk as a starting point for the DP, because this is a common example of a risk for which dynamic risk management is undertaken. However, the IASB's objective is to develop an approach to accounting for dynamic risk management that would apply to companies in all industries that engage in dynamic risk management activities. These activities may manage risks such as interest rate risk, commodity price risk or foreign exchange risk.

9.1 Commodity price risk management

It is common for corporates to hedge commodity price risk if they have commodity businesses. A company may seek to maintain a stable net margin by hedging the net commodity price risk inherent in its purchases, sales and inventory holdings. To mitigate the commodity price risk from that net fixed-price position, risk managers may sell forward (or buy forward) the commodity at a fixed price using derivatives. Alternatively, a company may dynamically manage commodity price risk for either purchases or sales – e.g. an airline that hedges the price of jet fuel, or a mining company that hedges future sales of gold.

If a commodity price risk is dynamically managed on a fair value basis, the use of the current fair value option for own-use contracts may be a better alternative for accounting for some companies' risk management activities. Similarly, cash flow hedge accounting may sometimes be a better alternative.

DP 8.10(a)

A company may manage the price risk from portfolios of purchases and sales separately, if the price drivers of its purchases and sales are not the same. This could be because of price regulation, customer expectations (price inelasticity) or other pricing factors that are only evident in either purchases or sales. Different dynamic risk management strategies are available under these scenarios, as the following examples illustrate.

Example – Commodity risk management – Company wishing to achieve a stable margin

DP 8.10(a)(i)

If a company wants to achieve a stable margin, then its strategy may be to achieve fixed prices in the portfolios of purchases and sales separately, but over similar time-frames.

Under this scenario, if the PRA were applied to a risk management strategy to achieve fixed prices in either purchases or sales separately, then it may not result in useful information. Application of the cash flow hedge accounting requirements under current IFRS would produce a more faithful representation of the actual risk management.

Example – Commodity risk management – Company wishing to participate in changes in a particular market price

DP 8.10(a)(ii)

If a company wishes to participate in changes in a particular market price, then its strategy may be to reintroduce variable pricing by transacting derivatives.

For example, Mining Company M has fixed costs that are unrelated to the commodity price risk – e.g. extraction costs – but sales prices that are sensitive to commodity prices. If a large proportion of sales are from fixed-price contracts, M may enter into commodity forward contracts at a fixed price to unwind the pricing effect of the fixed-price sales contracts, allowing M to participate in future changes in the commodity price. Revaluation of the portfolio of sales contracts for changes in the commodity price risk may provide an offset to the fair value of the commodity price risk management instruments.

9.2 Foreign currency risk management

Many companies are exposed to foreign currency risk and frequently choose to economically hedge foreign currency risk on an open portfolio basis. Risk management is often performed centrally by a treasury function that considers:

- forecast or committed foreign currency sales or purchases;
- forecast or committed foreign currency capital expenditure;
- foreign currency risk in recognised non-monetary assets – e.g. crude oil inventory; and
- net investments in foreign operations.

DP 8.14

The conceptual difficulties of applying the revaluation approach to interest rate pipeline transactions may also be applicable to the foreign currency risk management of forecast transactions – i.e. it may be conceptually difficult to justify recognising assets and liabilities for forecast transactions.

Example – Foreign currency risk management

DP 8.10(b)

A company may manage foreign currency risk dynamically from committed sale and purchase contracts on a portfolio basis, hedging the net foreign currency risk from committed purchases and sales with forward contracts. Revaluation of the net foreign currency risk and the fair value changes in forward contracts could provide useful information on the risk management activities.

9.3 Differences between banks' dynamic risk management of interest rate risk and the dynamic risk management of other risks

DP 8.15

The following are some key differences between banks' dynamic risk management of interest rate risk and the dynamic management of other risks.

- When hedging foreign currency risk arising from a portfolio of monetary items, the requirements of IAS 21 to retranslate such exposures may make an incremental accounting approach for such dynamic risk management unnecessary.
- The calculation of commodity price risk positions often includes inventory (treated as a fixed-price asset). In this case, inventory would need to be revalued for the managed risk on application of the PRA to reflect dynamic risk management.
- There may be situations in which the pricing of the purchase and sale contracts making up the net margin have significantly different degrees of sensitivity to the particular commodity price. This could be due to different geographical locations; levels of refinement; quality or purity; regulatory influences; or customer behaviour with respect to pricing. In these circumstances, it is unclear whether revaluing those exposures for changes in the same commodity price would provide useful information about those dynamic risk management activities.
- Dynamic risk management may be undertaken on a full fair value basis, rather than focusing on a particular pricing sensitivity of the managed exposures – i.e. by risk. When the exposures are contracts to buy or sell non-financial items that are deemed to be own-use contracts, the company may consider whether the fair value option (see 6.1.5) would provide the best representation of its dynamic risk management activities.

- Although valuations are often integrated into banks' processes and systems, companies other than banks may have less robust valuation capabilities.

Question 25 – Application of the PRA to other risks

The DP asks whether the PRA should be available for dynamic risk management other than banks' dynamic interest rate risk management.

Considerations for comment letter responses

Corporates that engage in active commodity price risk and foreign currency risk management of their exposures may want to explore how the PRA might be applied in their circumstances.

Companies dealing in commodity contracts may want to evaluate the pros and cons of the PRA in relation to their ability to designate own-use contracts as at FVTPL on a contract-by-contract basis to avoid an accounting mismatch.¹¹ For example, for fixed price contracts, some may favour the ability to designate individual contracts at FVTPL to avoid an accounting mismatch, rather than using the PRA for all fixed-price contracts that are dynamically managed.

Insurance companies have exposure to and manage interest rate, equity price and inflation risks. They may want to explore whether the PRA would provide a faithful representation of their risk management activities.

Companies that engage in dynamic risk management for forecast foreign exchange transactions may want to use the PRA for these transactions.

¹¹ IFRS 9 introduced a consequential amendment to paragraph 5A of IAS 39 to permit an irrevocable fair value option for contracts that meet the definition of 'own-use' contracts. For more details, see paragraphs 5 and 5A of IAS 39.

10 Summary of questions in the DP

DP A6

The following table summarises the questions for constituents contained in the DP. It also provides cross-references to the related section in this publication where we have included our preliminary considerations for respondents to these questions.

Questions		Reference
1	Need for an accounting approach for dynamic risk management	4.3
2	Current difficulties in representing dynamic risk management in companies' financial statements	6.2
3	Description of dynamic risk management	5.1
4(a)	Pipeline transactions	7.3.1
4(b)	Equity model book	7.3.2
4(c)	Behaviouralisation	7.3.4
5	Prepayment risk	7.3.4
6	Recognition of changes in customer behaviour	7.3.4
7	Bottom layers and proportions of managed exposures	7.3.5
8	Risk limits	7.3.3
9	Core demand deposits	7.3.4
10	Sub-benchmark rate managed risk instruments	7.3.6
11	Revaluation of the managed exposures	7.4.1, 7.4.2
12	Transfer pricing transactions	7.4.2
13	Selection of funding index	7.4.3
14	Pricing index	7.4.4
15	Scope of the PRA	7.5.1
16	Mandatory or optional application of the PRA	7.5.2
17	Other eligibility criteria	7.5.3
18	Presentation alternatives	8.1.3, 8.2.2
19	Presentation of internal derivatives	8.2.4
20	Disclosures	8.3.4
21	Scope of disclosures	8.3.5
22	Date of inclusion of exposures in a managed portfolio	7.6.1
23	Removal of exposures from a managed portfolio	7.6.1
24	Dynamic risk management of foreign currency instruments	7.6.2
25	Application of the PRA to other risks	9.3
26	PRA through OCI approach	8.2.3

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Our *New on the Horizon* publications are prepared on the release of a new proposed IFRS, or proposed amendment(s) to the requirements of existing IFRSs, or a discussion paper. They include a discussion of the key elements of the new proposals/discussion points and highlight areas that may result in a change of practice.

This edition of *New on the Horizon* considers the requirements of the IASB's discussion paper on accounting for dynamic risk management activities.

The text of this publication is referenced to the discussion paper and to selected other current IFRSs in issue at 30 June 2014. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed for an entity to consider the potential impact of the discussion paper in light of the entity's own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change.

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GAAP comparison	IFRS compared to US GAAP	Highlights significant differences between IFRS and US GAAP. The focus is on recognition, measurement and presentation; therefore, disclosure differences are generally not discussed.
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Acknowledgements

We would like to acknowledge the efforts of the principal authors of this publication. The authors include Enrique Tejerina and Hiroaki Hori of the KPMG International Standards Group, Mahesh Narayanasami of KPMG in Canada and Robert Sledge of KPMG in the US.

We would also like to thank the members of KPMG's global IFRS Financial Instruments Topic Team for their contributions:

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Tara Smith	South Africa
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Patricia Stebbens	Australia
Enrique Tejerina (Deputy leader)	United States
Venkataramanan Vishwanath	India
Danny Vitan	Israel
Andreas Wolsiffer	Germany

Finally, we would like to thank the following individuals for their contributions:

Christian Garz	Germany
Colin Martin	United Kingdom
Mark Northan	United States
Tamami Okawa	Japan
Anders Torgander	Sweden



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Publication name: *New on the Horizon: Accounting for dynamic risk management activities*

Publication number: 131894

Publication date: July 2014

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