

## **JOINT OUTREACH EVENT**

# **IASB DISCUSSION PAPER *ACCOUNTING FOR DYNAMIC RISK MANAGEMENT: A PORTFOLIO REVALUATION APPROACH TO MACRO HEDGING***

**BRUSSELS**

**7 JULY 2014**

This summary report has been prepared for the convenience of European constituents by the EFRAG secretariat and has not been subject to review or discussion by the EFRAG Technical Expert Group. It has been reviewed by the EFFAS and ABAF Secretariats and by IASB staff and has been jointly approved for publication by representatives of EFRAG, EFFAS, ABAF and the IASB who participated in the outreach event.

## Introduction

EFRAG, EFFAS/ABAF and the IASB joined forces to hold a series of events aimed at gathering input from the user community on a series of topical issues in financial reporting.

## The event

As part of this series, on 7 July 2014 an outreach event was held in Brussels to discuss the IASB Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* and user understanding of dynamic risk management practices and their impact on the financial statements.

## Introduction and welcome

EFRAG Chairman Françoise Flores welcomed attendees to the outreach event. She explained that the EFRAG draft comment letter had been published, and that due to the complex and ground-breaking nature of the Discussion Paper, there were an unusually high number of questions asked in the draft comment letter. This reflects a wide diversity of views and EFRAG needed input from constituents, including users, for the publication of the final comment letter.

The joint outreach event was held in three parts, covering current practices in banking and insurance with presentations from analysts and preparers for each sector, current thoughts of the IASB and EFRAG and a Question and Answer session.

## Current practices in banking and insurance

The first session was on current dynamic risk management practices in the banking and insurance industries and how the impacts of this are analysed. Profiles of speakers are available at the end of this summary report and their presentations are available on the macro hedging project page on the [EFRAG website](#).

### Banking

Giuseppe Loforese of Intesa Sanpaolo and member of the European Banking Federation Asset Liability Management Working Group explained current practices in the banking industry and the difficulties with current accounting requirements. Jean Baptiste Bellon, a banking analyst and member of the EFFAS Executive Management Committee and the EFRAG User Panel, discussed what is currently found in financial statements and what is missing for understanding macro hedging practices. He emphasised the need for analysts to know the impact on future cash flows and underlined the need for improved disclosures.

### Insurance

Jean-Michel Pinton, CNP Assurances and member of the EFRAG Insurance Accounting Working Group and Roman Sauer of Allianz provided their perspective from the insurance industry on accounting for macro hedges. Carsten Zielke, Vice-Chairman of the EFRAG User Panel and former EFRAG TEG member gave the perspective of an insurance analyst and highlighted analysts' needs in relation to financial reporting and disclosures in the financial statements. He also referred to the role of non-GAAP measures.

## The Discussion Paper and EFRAG's initial thoughts

*IASB Board Member Martin Edelmann*

IASB Board Member Martin Edelmann explained the thinking of the IASB and the development of the Discussion Paper. The IASB has used the example of dynamic interest rate risk management by banks for illustrative purposes, but the principles are designed to be applicable to other risks (for example, commodity price and foreign currency exchange risk). He set out what the IASB sees as the challenges under the general hedge accounting requirements of IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* for dynamic risk management. To address these challenges, the Discussion Paper explores what it calls the Portfolio Revaluation Approach, which the IASB expected could bring improvements to accounting for dynamic risk management. The IASB were requesting comments to, to be received before 17 October 2014.

*EFRAG Chairman Françoise Flores*

EFRAG Chairman Françoise Flores explained that the EFRAG draft comment letter had been [published on 1 July 2014](#). In the draft comment letter EFRAG welcomed the IASB's thorough analysis of banking risk management practices and that progress was being made to eliminate the European carve-out. The Discussion Paper showed a willingness to develop financial reporting that reflects reality rather than forcing reality into accounting constructs. The Discussion Paper also highlighted the importance of the provision of information for users on the extent and effects of hedging activities. However EFRAG had concerns regarding the scope to which the model could be applied and had doubts about whether it was operationally practicable. EFRAG was eager to engage with constituents, both through receiving comment letters and other input such as meetings or conference calls with the EFRAG staff.

## Attendees' Initial Thoughts and Question and Answer Session

Attendees had the opportunity to ask questions about any of the presentations and to give their initial thoughts on the proposals in the Discussion Paper and EFRAG's tentative response. The session was facilitated by Patricia McBride, EFRAG Technical Director. The discussion is summarised below, and is organised around the main themes raised by participants.

### Details of the Portfolio Revaluation Approach and consequences for financial reporting

*If the scope of Dynamic Risk Management was chosen, should the model become mandatory for those who perform Dynamic Risk Management?*

*The scope chosen for the Portfolio Revaluation Approach was key.*

An auditor noted that part of the reluctance to include the whole banking book in the revalued portfolio is because of the part that is unhedged. Any solution to avoid this would involve a certain amount of complexity. If the whole Dynamic Risk Management scope was the end outcome, would it make sense to have the accounting requirements be mandatory for those who Dynamically Risk Manage.

Carsen Zielke said that having the Portfolio Revaluation Approach be optional would, as with all accounting options, reduce comparability.

Jean-Michel Pinton thought that the appropriate scope was linked to an entity's business model. Using that logic, once the appropriate business model was identified then other decisions naturally flow from that.

### *What would be the boundaries of the revalued portfolio be?*

*The boundaries of the revalued portfolio would depend on the entity.*

Martin Edelmann said that the boundaries of the revalued portfolio would vary from bank to bank depending on risk management practices. In particular, it would depend on to what extent interest rate risk was passed on from local business units to the central Asset-Liability Management function. If some interest rate risk remained in local business units and was not dynamically risk managed, then it would not make sense to include these risks in the revalued portfolio.

There were also different views about the appropriate scope to which the model should be applied, as some banks may stabilise net interest income rather than eliminate risk. There was no desire to have the future optimised margin presented in profit or loss immediately. The tentative preferred scope was for the full banking book, but if the Asset-Liability Management function only hedged 60% of the interest rate risk then this created new volatility in profit or loss. A lot of this would depend on the business model of each bank.

Françoise Flores said that one of the arguments against the wider scope was that it did not match the overall objectives for a hedge accounting solution.

### *The Discussion Paper proposes all changes in assumptions be reflected in profit or loss immediately, are there concerns about the impact this will have on profit or loss?*

*The approach had the potential to be used for earnings management.*

Françoise Flores agreed that there were concerns about the impact of behavioural assumptions on profit or loss as it could lead to assumptions being changed to get the result wanted, i.e. earnings management. However, it was not clear what the best way to deal with this was. Amortisation was the obvious answer, but it as the challenge was accounting for Dynamic Risk Management it was not clear what sort of amortisation was appropriate.

### *How would the Portfolio Revaluation Approach interact with IFRS 9 and the hedging of non-financial instruments?*

*It was difficult to see how the model would interact with IFRS 9 for the hedging of non-financial risk*

An attendee from a utility thought it was difficult to assess how the model would interact with the hedging requirements of IFRS 9 *Financial instruments*, especially in relation to non-financial instruments. They had particular concerns about net positions and rebalancing. For entities that were not financial institutions, the overall objective was the same as in banking, to reduce the risk. For some risks, such as foreign currency exchange, it was easy to draw a distinction between hedging and trading. It was less easy to draw this boundary for interest rate and commodity risks. They also identified some practical difficulties and how OCI is used across IFRS. For example, power plants are not financial instruments but industry practice was to stabilise their production margin (the 'spark spread'). It was difficult to see what the difference was between this and forecast transactions. Recycling from OCI also caused difficulties as the triggers were not always aligned with the recognition in profit or loss of other transactions.

For Martin Edelmann, it was difficult to identify a principle that would allow adjustments to be put into OCI. He agreed it was easier to determine if transactions were risk mitigating for foreign currency exchange risk than for other risks.

### **The role of models, including the equity model book and core demand deposits**

#### *How reliable and robust are the models used for the equity model book and core demand deposits, which are key parts of the Portfolio Revaluation Approach?*

*The role of the regulator was key in ensuring robust modelling.*

An attendee from the banking industry responded that the robustness of models was ensured by having risk managers separate from risk measurers, with separate reporting lines and separation of duties. Regulators also require that the models used are explained to their satisfaction.

An attendee from the insurance industry also replied that the role of the regulator was important in the use of models. If the regulators were giving permission to use them for solvency based regulation, then he would not object if they were also used for accounting.

Martin Edelmann was not as comfortable, giving the example of core demand deposits where he was not sure if bank regulators were really looking at it frequently and in depth. If duration changed, and thus impacted profit or loss, it was not clear that the

assumptions involved were really open to be challenged. Similar issues also applied with respect to pipeline transactions, it was not clear if anybody external to a bank was really looking at the area in detail.

A different attendee from the insurance industry noted that, due to the financial crisis, lots of tools that were frequently used in modelling and valuation, including Gaussian curves and the risk-free rate, had to be abandoned. There was not a single model that would last forever, and the changes to these models were critical. One example he was aware of was of a test involving full stochastic cash flows but the outcome could be documented in almost anyway. What mattered was not just the quality of the model but how it was calibrated. A model was only as robust as its inputs.

For pipeline transactions, an attendee from the banking industry thought it would be appropriate if these were indeed included as from his experience they were incorporated as actual risks in risk management processes. He also agreed that the extent to which models were tested was widely varied and was linked to how strong the regulatory environment was.

For Carsten Zielke, models were only as robust as the inputs. It was not just about wanting to have a robust model at a point in time, but the model would also adjust to any situation. In general he favoured a book yield approach to determining insurance liabilities.

### *Would the extensive use of models just mean the Portfolio Revaluation Approach becomes a tool for earnings management?*

*There was a risk that the extensive use of models would mean the Portfolio Revaluation Approach would be used for earnings management, but the use of models was inextricably linked to the use of risk management tools.*

An attendee from the banking industry expressed concern with the focus on Dynamic Risk Management and focus determining what was allowed to be included in the revalued portfolio. Part of this concern was because of the danger of risk management models becoming a tool for earnings – rather than risk – management.

Martin Edelmann thought if an accounting solution for dynamic risk management was what was being developed, then this needed to reflect what was being managed. The boundaries would be about how it was ensured that the information included was reliable and what it needed to be decided what sort of boundaries were appropriate. If the risk management tools were not to be allowed, then a different solution to the Portfolio Revaluation Approach would be needed.

An attendee from the banking industry believed that there would be some limits on what was acceptable, as a form of safety net. Pressure from regulators and auditors would probably cause eventual convergence of models.

*Given models are already used in some parts of IFRS did the concerns expressed mean different thresholds for the use of models for assets and for liabilities?*

*Although models were used throughout IFRS, they needed to be amenable to appropriate review.*

An attendee from the banking industry expressed support for the use of models and especially for the modelling of core demand deposits. The attendee pointed out that models were already frequently used in financial reporting, especially for the impairment of assets. Did the reluctance expressed mean there was a higher threshold for the use of models related to liabilities than to assets?

Martin Edelmann did not agree that the thresholds were different, but noted that in the impairment project respondents had said they wanted inputs that were amenable to external review and could be audited. His views on modelling of core demand deposits were similar.

**The link between accounting and regulatory requirements and the role of risk management**

*The importance of the regulatory environment*

*There is strict regulation of bank exposure to risk in the banking book, especially with respect to interest rate and liquidity risk*

An attendee highlighted that the regulatory environment is an important consideration with respect to dynamic risk management in the banking book. Regulators are very interested in the management of interest rate and liquidity risk and acknowledge that the activities of Asset-Liability Management units mitigate these risks rather than creating them.

Therefore, when developing accounting requirements it was important that this was done in the context of the regulatory environment and to distinguish between the trading book and banking book activities.

It was important to mitigate the accounting mismatch between banking book assets and derivatives. If additional disclosures were required in order to do reach a solution for overcoming the accounting mismatch, then that would be acceptable.

*What would the role of the regulator be in the use of models?*

*The IASB could not set*

An auditor asked if there would be interaction with regulatory

*regulatory requirements and any accounting solution would also have to work for entities that are not regulated.*

oversight of models. For some of the models under discussion, permission used to have to be obtained from regulators and the question was then how to be comfortable over that.

Martin Edelmann said that the IASB could not set regulatory requirements, and that any accounting solution would also have to work for entities that are not regulated.

### *Where should the boundary be drawn between risk management tools and accounting?*

*It was not clear where the boundaries should be drawn between risk management tools and accounting*

An attendee from a credit rating agency thought that it was clear that some recognised risks were not assets and liabilities. Excluding some of these items from inclusion in the accounting model would lead to problems, and there appeared to be a continuum between fully accepting everything because it was viewed as a risk by risk managers and staying within accounting conventions.

Martin Edelmann agreed that there were risk management tools not in present in the financial reporting world. His tentative opinion is that these should be included in an accounting solution for dynamic risk management because if they were excluded financial statements would not show the net risk position being managed. The question to be addressed was how this gap should be bridged.

If these risk management tools were not included, financial statements would not reflect what happens in risk management. He expected that a compromise would be arrived at. For tools such as core demand deposits he was not comfortable that internal models were appropriate and some boundaries on what was acceptable would be needed.

### **Alternative ideas to address dynamic risk management**

#### *Was it better to address the accounting for derivatives?*

*Although having simple derivatives, such as swaps, at amortised cost was possible there were serious consequences for transparency.*

An attendee thought that the requirements of IAS 39 *Financial Instruments* had proven complex for preparers and did not always result in useful information. This was particularly the case with simple instruments, such as swaps, being measured on a fair value basis. Perhaps the solution was to simplify these requirements and use amortised cost for more instruments.

Martin Edelmann was not supportive of having swaps at amortised cost, particularly due to what was seen during the financial crisis.

### *Was there potential to use OCI for changes in the fair value of derivatives?*

*There was merit to exploring the use of OCI for changes in fair value in some sectors.*

Jean-Michel Pinton thought there was some merit to exploring the use of OCI for changes in fair value of swaps, and that it would be consistent with the current discussions in the Insurance project to allow it as a global option. This would also be consistent with the decisions on classification and measurement in IFRS 9.

Martin Edelmann did not believe there was as much potential to use OCI in the banking sector. However, if OCI was used for the presentation of interest-rate changes in insurance liabilities it would potentially make sense to allow it in order to remove an accounting mismatch. However, another option was to revalue the insurance liability through profit or loss.

### *Was there an alternative option based on using OCI rather than the balance sheet?*

*The financial reporting resulting from the Portfolio Revaluation Approach had the potential to be very complex.*

An auditor believed that there was a tension between having a holistic approach to risk management and the existing hedge accounting tools. She did not believe it was appropriate to recognise as assets or liabilities and on the balance sheet, but that for at least some hedged items it would be more appropriate to use OCI to defer gains or losses from being presented in profit or loss.

It was also clear that the outcome would be very complex, and she was worried that it would not be understandable to users, particularly with respect to behavioural assumptions which could be material.

Martin Edelmann said that the IASB had considered other options, but that none of them were ideal. Full fair value accounting was not an option for a number of reasons. One possibility was to allow amortised cost for derivatives used for hedging, but that raised other significant issues.

Of the three alternative presentation choices in the Discussion Paper he would be personally happy for the adjustment to be presented in a net single line item. For presentation in the income statement there would be more visibility on net interest margin, particularly if internal derivatives were allowed to better portray the split between trading and dynamic risk management revaluation.

### *Could some of the ideas in the Discussion Paper be put into the IFRS 9 hedging model?*

*The IAS 39/IFRS 9 hedging*

An auditor expressed support for some of the high level thinking in

*models include complex and burdensome designation and tracking requirements.*

the Discussion Paper, and asked if some of the concepts, such as core demand deposits, could be used to extend IFRS 9 as a simpler approach than a full new standard.

Martin Edelmann thought that it was important that a comprehensive solution to macro hedging was developed, particularly because some of the current requirements, including designation and de-designation, were not appropriate. The desire was to get rid of these requirements, meaning that banks would no longer need to have large teams working solely on hedge documentation. It was also important for users to improve the clarity of current practices.

An attendee from a utility enterprise thought that some of the content in the Discussion Paper had been particularly good, especially around hedging strategies. It was not clear that some of these could be implemented in IAS 39/IFRS 9. This was particularly the case with respect to whether a transaction was hedging an open position or a forecast transaction. While hedge documentation was burdensome, the required link between risk and hedging transaction was already relatively thin in IAS 39/IFRS 9.

Roman Sauer thought most exposures could theoretically be included in the IAS 39/IFRS 9 models, but for closed portfolios only. Hedge accounting documentation was indeed burdensome, but hopefully most hedging transactions would be operable with IFRS 9 and IFRS 4 *Insurance Contracts*. It was also important that reinvestment risk was included as something that could be hedged.

## Closing Comments

Françoise Flores thanked the panellists and the attendees for the discussion, particularly given the complexity of the topic. The Portfolio Revaluation Approach took a while to understand properly and the discussion had brought to light some new thoughts. In writing the draft comment letter EFRAG had come to the conclusion that it was important to focus on the objective, which should be to find a macro hedge accounting solution and not modify the meaning of profit or loss. This conclusion brings with it a very strong boundary on what will be an acceptable accounting solution. Everybody agreed that it was important to explore the options, but what was needed was a macro hedge accounting solution and not a reassessment of the basic Classification and Measurement decisions of IFRS 9. Whether another solution could be found, including open portfolios in IFRS 9, was a discussion for the future.

EFRAG was continuing its outreach during the comment period and would welcome further discussion with all stakeholders to assist in reaching a final position.

**Panellist profiles**



**Giuseppe LOFORESE**

Mr Loforese is Head of ALM at Intesa Sanpaolo. His main responsibilities include the management of strategic interest rate risk and strategic liquidity risk as well as the definition of Fund Transfer Pricing. He is member of the Hedge Accounting WG and the IRRBB WG for both the European Banking Federation and the Italian Banking Association.



**Jean-Baptiste BELLON**

Mr Bellon is an independent financial analyst (Trapeza Conseil) servicing asset managers, institutional investors, consultants and brokers in the field of banking firm and banking industry analysis.

He worked as an analyst for an industry intelligence company in Paris (DAFSA) then worked at CCF (now HSBC France) in Paris in 1987-1995, first in the corporate finance department and then at the equity broker subsidiary. He then moved to Deutsche Bank European equity broker in 1995-2004 with banking coverage.

Mr Bellon holds a PhD in Economics (1982, growth and inequality) from Paris Panthéon-Sorbonne University and graduated from Sciences-Po Paris (1981, IEP, Economie et Finances).

He became Board Member of the French Association of Financial Analyst (SFAF) in 2013, of which he has been a member for more than 25 years.

He has further been a Member of EFFAS and ACIIA Boards since 2013, as well as member of EFRAG User Panel and French accounting standard setter (ANC) International Committee.

Mr Bellon is teaching banking analysis and corporate finance in various universities and schools (SFAF, Edhec, ESCP Paris, CFVG Hanoi, and HCMC, Paris Dauphine, Paris XIII, ...).



### **Roman SAUER**

Mr Sauer graduated in Business administration in 2003 and holds a master in Business Research and a doctorate in Business Administration from Munich University.

He started his career as Group Accounting Policy Department with Allianz SE, Munich in 2006-2008 and became Head of Planning and Performance Management with Allianz Global Corporate & Specialty France, Paris (2008-2011).

Since September 2011, he has been Head of Group Accounting Policy with Allianz SE, Munich

Mr Sauer is also External Lecturer for the Executive Master of Insurance Programme, University of Munich (LMU) and Member of the IFRS Committee of the Accounting Standards Committee of Germany (ASCG).



### **Carsten ZIELKE**

Dr. Carsten Zielke (46) is owner and managing partner of Zielke Research Consult GmbH. This company is specialised in producing independent research and giving Asset-Liability Management advice to insurance companies. Until March 2013, he was Managing Director at Société Générale, heading the German speaking ALM advisory business. For more than ten years, Dr. Zielke has been a member and observer of various accounting working groups advising the European Commission. He is married, father of two children and an enthusiastic triathlete.



### **Jean-Michel PINTON**

Since 2007, Jean-Michel Pinton has been Group Accounting Officer of CNP Assurances, which he joined after a six-year assignment as deputy director in charge of economic & financial affairs of the French insurance trade association (FFSA). Graduate of Master degree in financial techniques of ESSEC business school and member of the French institute of actuaries, Jean-Michel began his career at the broker Oddo & Cie as an equity financial analyst. In 1993, he joined the rating agency IBCA (now FitchRatings) to create and develop the insurance sector in Paris until 1995 and from 1999 to 2000. From 1995 to 1998 he was "fondé de pouvoir" in the Corporate financial department of the AGF Group (now Allianz's French subsidiary). He is also a

	<p>member of the Insurance Working Group of EFRAG (European Financial Reporting Advisory Group).</p>
	<p><b>Martin EDELMANN</b></p> <p>Mr Edelmann served as a member of the German Accounting Standards Board (GASB) from 2006 until 2011. He is a former Head of Group Reporting at Deutsche Bank AG, where he was responsible for internal and external reporting activities between 1997 and 2011. During his time at the Bank, he oversaw a number of major projects including the Bank's conversion from US GAAP to IFRS in 2007. Before joining Deutsche Bank, Mr Edelmann worked at KPMG for nine years providing audit services primarily for financial institution. During that time with KPMG he qualified as a Chartered Accountant. Until joining the IASB he was a senior adviser at German consultancy firm zeb/rolfes.schierenbeck.associates (Zeb).</p> <p>Mr Edelmann was also a member of the Accounting Working Group of the German Banking Association for 14 years and served as its Chairman from 2004-2011.</p>
	<p><b>Françoise FLORES</b></p> <p>Françoise Flores has been Chairman of EFRAG since 1 April 2010.</p> <p>Prior to joining EFRAG as Chairman, she was a partner of Mazars in France and one of the IFRS experts of the firm. In that capacity, she has been acting for several years as IFRS Technical Advisor to large European businesses (through Acteo, ERT and BUSINESSSEUROPE). She has been a member of EFRAG TEG since April 2004.</p> <p>Her IFRS expertise is backed up by over 20 years in controlling and financial reporting, of which 10 years as CFO, in the context of large and medium-sized international listed corporations.</p>



### **Patricia McBride**

Patricia McBride joined EFRAG on 29 April 2014.

Although she is a UK citizen, she has spent most of her career working in Asia-Oceania. She is well known in the international IFRS arena for her technical roles supporting the standard setters in Australia, New Zealand and Hong Kong. Part of her career was spent in academia and in her earlier days she was Chief Accountant of a subsidiary of a large German corporate for eight years. She has written for textbooks, academic journals and newspapers and has extensive experience explaining technical accounting issues to non-accountants.



### **Hans BUYSSE**

Hans Buysse is a partner of Syncap Belgium, based in Brussels. SynCap Belgium is the Belgian Partner Firm of Clairfield International, a worldwide corporate finance firm that provides advisory services, mainly in cross-border mergers and acquisitions, to both international corporations and family-owned enterprises across an array of industries. Hans has more than 20 years banking and corporate finance experience. This includes buy side and sell side assignments, as well as MBO and IBO, within the energy & utilities sector, telecom, real estate and infrastructure. He also has extensive experience in structured finance, financial restructuring, strategic advisory, valuations and PPP. He was involved in most large Belgian PPP deals.

He started his career at KU Leuven, moved to Generale Bank in 1992 (Corporate Banking, Group Treasury (financial markets) and Central Credit Department). He cofounded the Corporate Finance division at Deloitte & Touche Belgium in 1997, worked as a partner for KPMG Corporate Finance up to 2007 and at NIBC Bank Belgium where he was head of Advisory.

Hans is vice Chairman of the Belgian Association of Financial Analysts ([www.abaf-bvfa.be](http://www.abaf-bvfa.be)). He is EFFAS Executive Management Committee member and Treasurer ([www.effas.org](http://www.effas.org)) and XBRL Europe Executive Committee member. He is also member of the ESMA Corporate Reporting Standing Committee's Consultative Working Group ([www.esma.europa.eu](http://www.esma.europa.eu)).

He holds a master degree in Applied economics, specialised in finance, a master degree in management and a degree in Tax. He is a Certified European Financial Analyst (FSA accredited).