

Financial instruments

IFRS Newsletter



“Addressing prepayment risk and core deposits will be key to developing an accounting solution for dynamic risk management.”

- Chris Spall
KPMG’s global IFRS
financial instruments leader

The future of financial instruments accounting

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

Highlights

Dynamic risk management

The IASB staff presented an education session to the Board in which it discussed:

- prepayment risk and ways to manage it; and
- hedge accounting and capacity.

The Board did not make any decisions, but generally agreed with the staff’s observations and summary. Depending on the progress of the Board’s discussions, possible future outcomes might include the issue of a second discussion paper (DP) on the subject or the issue of an exposure draft (ED).

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Dynamic risk management

The story so far...

Although current IFRS – specifically, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* – provides models for macro hedge accounting, these contain restrictions that limit companies' ability to reflect some DRM activities. Moreover, some of these models deal specifically with interest rate risk management, rather than other types of risk. Without an accounting model that reflects the broader use of DRM activities, some have asserted that it can be difficult to faithfully represent these activities in financial statements.

In April 2014, the IASB published its discussion paper *DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the April 2014 DP). The DP outlined one possible approach to macro hedge accounting – the portfolio revaluation approach (PRA) – under which companies' managed exposures would be identified and revalued for changes in the managed risk. As the project involves fundamental accounting questions and is not simply a modification of current hedge accounting models, the IASB did not proceed straight to issuing an ED. Our publication [New on the Horizon: Accounting for dynamic risk management activities](#) provides a detailed analysis of the proposals.

Respondents to the April 2014 DP broadly supported the macro hedging project, although several acknowledged that aligning financial reporting and DRM activities would be challenging. Despite this general support, many respondents felt that the objectives were unclear, and different stakeholder groups disagreed on what those objectives should be.

The Board decided that the project would remain as a research project, instead of being transferred to the Board's standards agenda, and that a second DP would be published before issuing an ED. Furthermore, the Board decided to keep open the possibility of moving directly to an ED if a solution emerges that addresses the disclosure, recognition and measurement issues. In March 2017, following further research carried out, the Board reopened its discussions on the project with the first of a series of education sessions.

	Key points covered by education session
March 2017	<ul style="list-style-type: none">– Project approach, stages and next steps.– Indication by the staff that the focus areas for the project would include DRM activities undertaken to stabilise the net interest margin (NIM) and core deposit modelling.
May 2017	<ul style="list-style-type: none">– Why and how DRM activities are undertaken to stabilise NIM.– How derivatives are used to transform portfolios when stabilising NIM.– NIM reconciliations.
June 2017	<ul style="list-style-type: none">– Events that result in changes to the DRM portfolio, including:<ul style="list-style-type: none">- how new originations impact management's target profile for the repricing of loan portfolios;- how DRM reacts to changes in the DRM portfolio; and- information relevant to financial reporting.

The staff's education session covered prepayment risk and how to manage it.

Dynamic risk management

What's the issue?

In September 2017, the staff's education session to the Board focused on:

- prepayment risk and ways to manage it; and
- hedge accounting and capacity.

The staff presented a number of cases studies and examples to illustrate some of the key points for these items. The staff also provided a recap of previous discussions by presenting a summary of what DRM is.

Prepayment risk and ways to manage it

The staff provided an overview of prepayment risk in the context of DRM and noted that in some lending arrangements, borrowers can choose to prepay certain loans. The staff noted that because of these prepayment features, an assumption cannot be made that asset portfolios would exist from origination to contract maturity. The staff explained that prepayment risk results in NIM repricing earlier than expected and since the objective of DRM is to manage how NIM reprices, DRM should therefore also consider prepayment risk.

Prepayment risk management strategy 1: Callable debt

The staff noted that one of the simplest methods to manage prepayment risk was by issuing callable debt rather than the use of derivatives. They explained that using callable debt allowed the issuing bank to simultaneously return funding to investors when customers prepay loans. The staff did, however, outline some challenges to the use of callable debt such as limited market depth, the requirement for frequent issuances and mismatches in notional amounts because individual loans are smaller in comparison to a single debt issuance.

Prepayment risk management strategy 2: Managing NIM repricing for prepayable loan portfolios

The staff outlined that there are three key 'buckets' in a pool of homogenous prepayable loans:

Bucket	Characteristics
Core prepayments	These prepayments will occur regardless of the level of interest rates because of factors such as individuals moving homes or death. This 'core' portion of the loan portfolio is treated as short-term in nature because of prepayments. For DRM, the core prepayment portion of the asset portfolio is compared against the target profile to inform the necessary risk-mitigating actions.
Bottom layer	The bottom layer represents loans in the portfolio that will mature at their contractual maturity date. These borrowers will not exercise their prepayment options and prepay – regardless of economic incentives.
Rate-sensitive prepayments	This bucket comprises rate-sensitive customers. Their behaviour depends on the market level of interest rates and is difficult to accurately predict.

The staff's education session also covered hedge accounting and capacity.

The staff pointed out that strategies for managing NIM repricing for prepayable loan portfolios are focused on:

- predicting when a loan will reprice; or
- enabling a bank to cancel the repricing.

The staff then explained that a more direct method of managing prepayment risk was to use option hedging strategies. In particular, the staff noted that buying options allows banks to maintain NIM for a specific time period regardless of prepayment risk. The staff did, however, note that practical problems with option strategies included option markets not being as liquid compared to other derivatives (such as swaps) and an adverse impact on long-run profitability due to the cost of hedging – i.e. option premiums paid.

KPMG insight

The staff discussed the bottom layer in a portfolio of prepayable loans but did not discuss hedging strategies involving a bottom layer approach.

Under a bottom layer approach, entities hedge the portion of loans in the portfolio that are expected to remain in existence until maturity – i.e. the last items to 'prepay'. For example, in a notional portfolio of loans equal to 100, 30 are expected to remain outstanding for their full contractual term. Derivatives of 30 are entered into and considered to hedge the last 30 items to prepay.

For DRM purposes, entities would consider this type of hedging strategy if they wanted to fix a minimum proportion of their NIM. Providing that prepayment doesn't exceed 70, the hedge would be deemed successful as the hedged loans remain outstanding up to their contractual maturity. At all times the entity has locked in a minimum of 30% (being 30/100) of their exposure at a fixed NIM.

An accounting solution that reflects the application of a bottom layer approach would involve amortisation and tracking requirements when changes to the level of the bottom layer occur.

Hedge accounting and capacity

Hedge accounting

The staff provided examples of the application of hedge accounting in both a non-banking and banking environment with a particular focus on how the relevant risk management activities are reflected in the financial statements.

When discussing hedge accounting in non-banking environments, the staff noted that other industries also use derivatives to stabilise their margins over time. They provided an example of a coffee processor concerned with stabilising the price difference between coffee beans purchased from growers and finished coffee sold to customers. The example showed that the designation of the purchase and sale elements of margin can result in the alignment of risk management and accounting – because the margin recorded in profit or loss is equal to the locked-in hedge amount at the time of sale.

On the subject of hedge accounting in a banking environment, the staff provided two examples as follows.

	Bank A	Bank B
Asset/Liability profile	– Fixed rate assets funded entirely by debt.	– Fixed rate assets funded entirely by core deposits.
NIM repricing risk	– NIM profile transformed by executing interest rate swaps.	– NIM profile transformed by executing interest rate swaps.
Accounting	<ul style="list-style-type: none"> – Fair value hedge accounting applied to reflect DRM. – Designation of the purchase (debt) and sale (asset) elements of margin has resulted in the alignment of risk management and accounting. – The margin recorded in profit or loss is equal to the locked-in margin achieved by DRM. 	<ul style="list-style-type: none"> – Core deposits do not have cash out flows as they are perpetual in nature nor are they subject to fair value risk. – Because of these characteristics, qualifying hedge designations for core deposits are not possible.

Capacity

The staff discussed the concept of ‘capacity’ with reference to the hedge accounting examples presented and pointed out that – in this context – capacity relates to items that are eligible for designation for hedge accounting purposes.

In the case of a bank which is entirely funded by core deposits, the economic uniqueness of core deposits results in banks not having sufficient gross cash inflows and outflows against which derivatives may be designated. This lack of capacity is the main reason why entities use alternative hedge designations for accounting purposes. Entities that are faced with a lack of capacity (because they are funded with core deposits) apply ‘proxy hedging’, use alternative performance metrics or do not hedge.

KPMG insight

The use of ‘proxy hedge’ designations is widely applied in practice. Although any proposed accounting solution should aim to reflect risk management activities in the financial statements, there may be instances where there is a disconnect between accounting and risk management that can be addressed through the designations of proxy hedges.

What did the IASB decide?

The Board did not make any decisions, but generally agreed with the examples and summary presented by the staff.

Next steps

The project timeline outlined by the staff at the March 2017 meeting indicated that a preferred accounting approach would be selected and developed in the forthcoming months. Depending on the progress of the Board's discussions, possible future outcomes might include the issue of a second DP on the subject or the issue of an ED.

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***IFRS Newsletter: Financial Instruments* is KPMG's update on the IASB's financial instruments project.**

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