Dynamic risk management : Feedback on the EU carve out Issues Paper

Objective

1 The objective of this paper is to present the feedback obtained on the EU carve out from IAS 39 *Financial Instruments: Measurement and Recognition*. The feedback covers perceptions as to how it is working and the extent to which it is used.

Background information

2 The feedback[2] on how the carve out is working, was received from auditors/accountants, regulators and users. As to the extent to which the carve out is used in Europe, the EFRAG Secretariat received answers from some participants of the outreach with the IASB and an audit firm.

EFRAG Secretariat's conclusions of the outreach exercise

3 The outreach confirmed that the carve-out is widely used in many European countries, mostly for consolidated groups but in some cases, such as in Italy also for the separate accounts of banks. Missing a specific guidance in the standard, practices have been established and have commonalities mainly at country level.

4 In the absence of specific disclosure requirements, disclosures about the use of the carve out is not uniform and unclear and detailed information about the hedging accounting practices is not often presented. However, the use of carve-out is not an area of focus in the communication to the market or an area that raises questions from users. Some possible additions to consider in terms of disclosures are described in paragraphs 34 and 35.

5 The EFRAG Secretariat collected quantitative data about the use of the carve out, however considers that such data are not relevant or informative for a number of reasons (explained in paragraph 47).

Feedback from auditors and accountants

Introductory comments

6 The regulatory environment requires the monitoring of interest rate risk in the banking book (IRRBB), which consists of the amortised cost and FVOCI assets. For hedge accounting purposes, hedged items are identified and designated on a gross basis, as required by IAS 39 that does not allow hedge designation of a net position. This means that the hedging documentation and designation often differ significantly from the risk management practices which take place on a net basis.

7 Banks may do micro hedging on specific transactions like issuances or structured finance transactions. But demand deposits are hedged on a portfolio basis necessitating the use of the EU carve out.

[1] Didier Andries, Fredré Ferreira (team co-ordinator) and Sapna Heeralall.

[2] As always, the EFRAG Secretariat is deeply appreciative of everyone who made the effort to respond to our requests for information. We would like to thank the EBF specifically for their help in the outreach with preparers as well as ACE for arranging an open discussion with their members on the topic. A special word of gratitude to an EFRAG TEG member who provided information on an anonymised basis of several European banks increasing the sample size considerably.

8 The extent of use of the carve out depends on local specificities, e.g., the use of fixed rate products, the use of prepayment features, or the proportion of fixed versus variable rate exposures. Some countries also have very specific regimes for certain liabilities such regulated deposits.

9 Where the hedged item is demand deposits, the hedge may be adjusted dynamically, and may add a derivative with opposite sign rather than cancel existing ones, therefore may have derivatives in both asset and liability positions. Banks use both NIM[3] and EVE[4] for risk management purposes.

Application of carve out

France

10 The use of the carve out is very common given that most mortgages are at fixed rates. However, the prepayment penalties do not generally prevent prepayments in the context of a long contract period. Where a customer moves house, there is no prepayment penalty, and prepayment penalties can be negotiated at inception of the loan where the repayment is funded by savings. This may result in no penalty or only where repayment occurs in the early years of the loan.

11 In practice, most demand deposits do not carry interest. For some regulated deposits in France (Plan d'Epargne Logement) the older vintage deposits have significantly higher rates compared to the more recent ones. As these deposits can be transferred to family members, they act as perpetual instruments and may create an additional risk position.

Germany

12 Many banks use portfolio fair value hedging ('FVH') including the carve out, to apply hedge accounting to the whole banking book. Banks may use micro FVH for specific situations such as significant transactions. Some SEC filers use the carve out in the published financial statements but also disclose the full IAS 39 (as issued by the IASB) in their SEC filings.

13 The carve out was not popular in Germany initially, but the decrease in interest rates has led to an increase in prepayments and pressures on the NIM. Hence, the carve out has grown in importance to protect the NIM. The banks apply the carve out where it is beneficial, e.g., fixed rate instruments with prepayment risk.

14 In Germany clients pay a prepayment penalty before 10 years even if moving house, but not after the ten years and banks have similar products as the Plan d'Epargne Logement mentioned under France.

Italy

15 Portfolio FVH including the carve out has been widely used since 2005 given that the banking books are mainly at fixed rate. This is true for the larger and smaller banks as all banks have to use IFRS for their consolidated and separate accounts. The carve out is therefore used for fixed rate mortgages and commercial loans and less for securities. Prepayment risk has also increased in the last decade as a change in law now allows prepayment of mortgages without penalties.

Portugal

16 The carve out is not used as mortgages are at variable rates and instruments with fixed rates generally have short terms of around five years. There is a significant penalty for prepayments for fixed rate instruments (200bps) and therefore, the carve

[3] Net interest margin – a short-term indicator.

[4] Economic value of equity – a longer-term indicator.

out do not need to be used as the issue of over-hedging due to unexpected prepayments is not relevant. Prepayment penalties apply also if selling house.

Disclosures

17 Participants to the outreach noted that banks generally do not include hedge accounting in their key performance measures communicated to the market outside the financial statements (such as in their investor presentations). Also, their understanding is that hedge accounting is not a topic that raises questions from users.

18 IAS 39 requirements make it difficult for preparers to explain the differences between the accounting results and the risk management approach. There may also be significant sensitivities around the provision of prospective information.

Consistency of application or guidance

19 **France:** preparers and auditors have developed a common understanding about past practice and what is acceptable. The decrease in the fixed rates for mortgages from 5% to 0% in the previous decade resulted in extensive discussions. The economic situation resulted in repayments and refinancing of loans at lower interest rates to a significant extent. This exposed banks to the risk of systematic over-hedging. This resulted in a common local approach with hedge effectiveness being assessed using a vintage approach. This means that the hedging derivatives are 'allocated' to asset vintages with the same/equivalent interest rates and the equivalence of the notionals monitored. Where the bottom layer of the vintage is breached, ineffectiveness has been recognised.

20 **Germany:** while products may not be exactly the same as those in France, similar concerns arose due to the low-interest environment. While there had been discussions around the application of the carve out the guidance is not as detailed as for France.

21 **Italy:** Extensive discussions in 2004 have led to a general accepted approach which has not been a subject of significant debate in recent times.

22 **Portugal:** not applicable.

23 There have been no significant cross-border discussions on the application of the carve out as hedge accounting is generally more decentralised. Subsidiaries need to manage the interest rate risk locally to the satisfaction of the local regulator.

Benefits of the carve out

24 The carve out could be beneficial to other territories to reduce the practical difficulties arising from applying IAS 39 as issued by the IASB. Participants to this part of the outreach considered that practices are well established and that the elimination of the carve-out is not a goal of itself. Entities that are SEC filers may have some benefits of such an elimination, A remaining concern relates to the transition approach to a new model when moving away from the carve out.

Feedback from a regulator

25 The primary focus for regulators remains the risk management practices in banks rather than use of the carve-out. The supervisory approach does not distinguish between banks that use the carve-out and those that do not (e.g., in terms of capital treatment).

26 They consider that users could benefit from more transparency about the practices applied and indicated that specific disclosure requirements on the use of carve out is lacking. Furthermore, an increase in required disclosures could indirectly foster better internal control over the reported information. The control environment is important especially in the context of dynamic hedging.

27 As the carve-out is principles-based, the detailed approach of banks includes a degree of flexibility especially given the absence of literature from auditors about acceptable or unacceptable practices. In addition, the disclosures on hedging are too aggregated to explain the related effects.

Feedback from users

28 The EFRAG Secretariat had contacted nearly 100 banking users to complete a survey in order to understand views of investors and analysts on certain accounting practices used by EU banks currently when reporting on management of interest rate risk in the banking book. A news item was also published for users to complete this survey. The EFRAG Secretariat also contacted specific users to share the survey in their network.

29 Three responses were received. They are all equity analysts and two indicated that they are buy-side analysts.

Views on the EU Carve out:

30 On the *IAS 39 Carve-out*, one user considered that the carve-out is a reasonable approach, another did not consider it important to understand the EU carve-out and its implications and another was uncertain.

31 One user did not think that it would be better to have a tighter hedge accounting framework/ more documentation on hedging of interest rate risk as this would introduce volatility into the banks' earnings.

32 *What is used currently*: Currently, sensitivity analysis published by banks are used to anticipate any positive or negative impact of rates variations on revenues and on the balance sheet (two users). The EFRAG Secretariat notes that this refers to the disclosures required by IFRS 7 *Financial Instruments: Disclosures*.

33 *Improvements needed in the current information on interest rate risk*: All three users considered that the information about financial risks (including interest rate risks), both in the financial statements and for Pillar 3, could be improved.

Possible improvements to disclosures

34 Disclosure about the accounting practices:

(a) The implementation and mechanics of the carve out such as the hedged item(s), ineffectiveness and its causes as well as the accounting on voluntary or involuntary discontinuation of hedging relationships;

(b) The requirements, if any, on the inclusion or exclusion of the hedged items in the bottom layer;

(c) More information on the modelling of core deposits and the treatment of changes in volumes as well as the composition by type of deposits; and

(d) Disclosure on entity-specific governance controls without providing confidential information.

35 Disclosures about sensitivity measures and profitability

(a) A standardised table of sensitivity of earnings to 100bp to positive yield curve after one year and extended to 5 years and also by significant currency;

(b) An assessment of its effective duration of the interest rate sensitivity of its deposit base and how it changes over time;

(c) Standardised and comparable disclosures on the appetite is to hedge the interest rate risk and how it does that hedging;

(d) Information on assumptions on non-interest rate sensitivity paid deposits;

(e) The impact of changes in interest rate on both equity and profitability;

(f) Information/disclosures on fixed versus floating rate exposures;

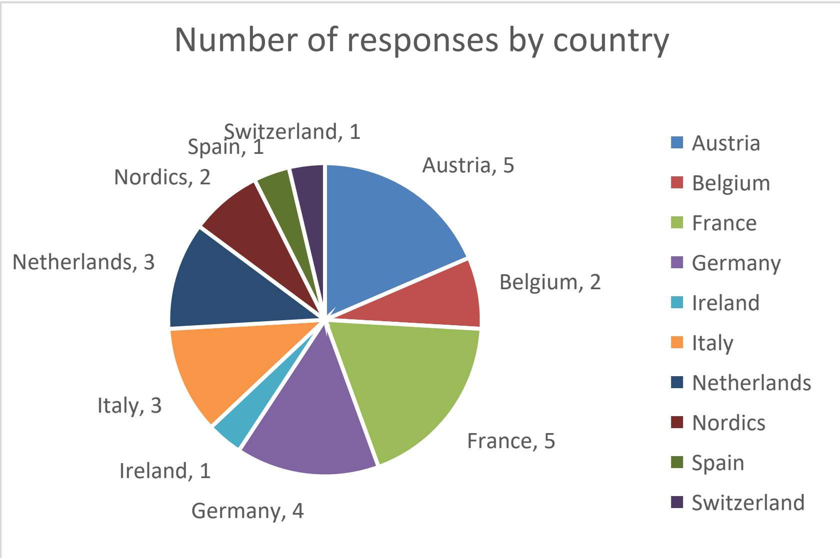
(g) Assumptions under three different scenarios: parallel shock of rates, steepening of the yield curve, rate curve flattening; and

(h) Final expected impact including behavioural impacts of clients or competitors when rates rise or decline; and

(i) Impact on the net interest margin expected for each of the next five years to come.

Feedback from preparers: extent of use

36 Information for 27 preparers have been received representing a total of € 16.4 trillion in total assets including one preparer from Switzerland that do not use the carve out. The following graph shows the breakdown of the responses received by country:



37 Based on the feedback from the participants, the countries applying the carve-out are Austria, Belgium, Germany, Italy, Netherlands, Spain, and Sweden.

38 One participant has indicated that none of the banks in Greece and Portugal apply the carve-out.

Question 1 - Why do preparers apply the carve out to particular assets/liabilities and other hedge accounting to other assets/liabilities?

39 Reasons provided are as follows:

(a) The carve-out is particularly important for portfolio fair value hedge relationships that are not stable (such as a portfolio of prepayable assets or demand deposits) (four participants);

(b) In order to reflect a more realistic situation of the bank's risk management activities on its financial performance (three participants);

(c) The carve-out relaxes some of the effectiveness requirements (two participants), therefore reducing the accounting ineffectiveness that originates from a more rigid designation and de-designation process;

(d) For bottom layer hedges (two participants). One of the preparers indicated that the carve-out is used since few years ago when prepayable fixed rate loans became more voluminous in the portfolio.

(e) Due to the bank's balance sheet structure; large, fixed-rate mortgage portfolio which are (partly) funded by core demand deposits (one participant);

(f) To cope with negative margins in micro hedges (one participant);

(g) Due to a lighter operational burden, and reasonable results from hedge accounting (one participant);

40 Two participants indicated that the carve-out is not important for micro fair value hedge relationships where it does not impact the hedge accounting application.

41 Not applied for core demand deposit hedges due to a strict interpretation from the auditors requiring that if the contractual rate of demand deposits changes, the items can no longer be considered as fixed rate and the hedges have to be terminated (one participant).

42 One participant indicated that they did not apply the carve out in a significant way.

Question 2 - How do preparers communicate internally and externally about risk management effectiveness and performance result?

43 Internal communication:

(a) Communication in various committees, e.g., ALCO Committee (two participants). One of them indicated that internal reporting is based on simplified effectiveness tests.

(b) The ALCO Committee establishes (and adjusts) the global interest rate risk management strategy, risk profile by entity and global limits of interest risk. Performance measures depends on the specific strategy approved by ALCO Committee (one participant).

(c) Hedge results are shared internally with all relevant stakeholders and results are shown in the P&L of the department that manages the risk (one participant).

(d) At the end of each reporting period, a macro-hedging monitoring report is prepared which contains among others (i) the retrospective and prospective effectiveness assessment of the hedge (verifying that it is within the limits set by IAS 39) and (ii) the current and prospective sufficiency assessment of the hedged items (in order to determine any over-hedging) (one participant).

(e) Ineffectiveness in hedge accounting is part of the quarterly analyses of the income statement to the management (one participant).

(f) Internal memos on hedge effectiveness (one participant).

44 External communication:

(a) Primarily in the Annual Report/ Financial statements in the risk management section (seven participants)

(b) One participant indicated that an assessment is made of the main performance measures by geography.

(c) Another indicated that there are IFRS figures in the financial statements reflecting the application of the hedge accounting requirements under IAS 39 including the carve out. Also, further information on risk management activities is reflected in the MD&A.

(d) The financial statements are supplemented by a management report which has a risk management section but not specific to hedge accounting (one participant).

(e) External reporting consists of a description of main sources of ineffectiveness (one participant).

Question 3 - Do preparers get questions from users on hedge accounting and the carve out? And about risk management approaches and strategies?

	No. of participants
No	6
Not frequent questions	1
Yes, from regulatory supervisors and external auditors	1
Questions only on risk management and strategies	2

Question 4 - Do preparers use non-GAAP or regulatory disclosures instead to explain the impact of using the carve out?

	No. of participants	**Comments**
No	9	
Yes	1	The net result IFRS-EU, the EU carve-out adjustments and the net result IFRS-IASB are disclosed in the SEC filing

Impact of the carve out

45 One preparer provided the following information on the effect of the carve out on its financial statements which is also available in its SEC annual filing:

	2020	**2019**	**2018**	**2017**	**2016**	**2015**
Net result EU IFRS	2,485	4,781	4,703	4,905	4,651	4,010
EU-carve out adjustments	-234	-878	58	559	324	916
Net result IFRS as issued by IASB	2,251	3,903	4,761	5,464	4,975	4,926

46 Another preparer stated in its financial statements that: "For the financial year ended December 31, 2020, application of the EU carve out version of IAS 39 had a positive impact of € 18 million on net revenues and profit before taxes and of € 12 million on profit post taxes. The Group's regulatory capital and ratios thereof are also reported on the basis of the EU carve out version of IAS 39. The impact on profit after taxes also impacts the calculation of the CET 1 capital ratio and had a positive impact of less than 1 basis point as of December 31, 2020."

EFRAG Secretariat's views on why the collected data are not informative

47 While the EFRAG Secretariat collected information about the hedging coverage of the banking book, this has not been included in this paper as it does not necessarily reflect the importance of the carve out specifically or hedge accounting in general. This is due to the following reasons:

(a) risk management occurs on a net basis, but the hedge accounting requirements under IAS 39 requires designation on a gross basis;

(b) component hedging (i.e., hedging various aspects of a transaction separately) may make interpretation of numbers very difficult

(c) 'natural' off-setting between assets and liabilities which means derivatives are not required for risk management;

(d) use of the fair value option for issued bonds rather than hedge accounting for derivatives in banking book;

(e) hedging of interest rate sensitive items which excludes other assets, taxes etc. which form part of the banking book;

(f) some exposures may not be hedged as the intention is to transfer out the related risks by way of e.g., securitisation;

(g) the bank's expectations around interest rates in the medium and longer term;

(h) micro hedges (including of groups of items) may be sufficient to achieve the entity's objectives;

(i) its risk appetite and risk position; and

(j) in some cases, the local GAAP requirements may result in less use of portfolio hedging.

Questions for EFRAG FR TEG

48 Does EFRAG FR TEG have comments on the summary of feedback received?

49 Does EFRAG FR TEG have further questions to EFRAG TEG?