Dynamic Risk Management – Hedging equity
Issues Paper

Objective

1 The objective of this session is for members to provide input on whether equity should be eligible for hedge item designation in the Dynamic Risk Management ('DRM') model.

Background and introduction

2 When managing interest rate risk exposures, it is common for banks to take a holistic view of their interest rate risk exposures and use interest rate derivatives to economically reduce the sensitivity of earnings and economic values due to interest rate changes. As part of their interest rate risk management, some banks include equity as a source of funding.

3 However, currently, equity is not an eligible hedged item in either IFRS 9 or IAS 39, therefore, hedge accounting is precluded.

4 The IASB will have a session on DRM its ASAF[1] meeting on 11-12 July and will be asking for input from National Standard-Setters to further develop the DRM model. In particular, they will be asking whether equity should be eligible for designation in the DRM model. Also, if equity should be eligible for designation, which equity balances are deemed to have interest rate risk exposure and why.

IASB's 2014 DP – Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach ('PRA') to Macro Hedging

5 Below are some points that are reflected in the 2014 IASB Discussion Paper.

6 Some banks manage the interest rate risk exposure that arises from their own equity instruments by disaggregating its return into:

(a) a base return that is similar to interest (compensation to equity holders for providing funding); and

(b) a residual return that results from the total net income that accrues to equity holders.

7 When return on equity is managed in this way, it is common for dynamic interest rate risk management to be used to attain a target base return. This is done by modelling the target base return as if it is an interest exposure by using the targeted interest rate profile for the return on equity. This is sometimes called a replication portfolio. This replication portfolio is included as an additional interest rate exposure

[1] Accounting Standards Advisory Forum

for dynamic risk management purposes and managed along with other interest rate exposures in the managed portfolio.

8 Below are views favouring the inclusion of the equity as a hedged item in the PRA:

(a) Accepting the inclusion of equity would reflect actual risk management.

(b) This may provide enhanced transparency to users of financial statements on a bank's ability to achieve its targeted base return on equity.

(c) It could be argued that the conversion of the variable return into the desired fixed return through dynamic risk management is a better reflection of the economics of dynamic risk management.

(d) Since an indirect way of revaluing equity is already permitted through the use of cash flow hedge accounting, it would be inconsistent to prohibit representing this aspect of dynamic risk management directly.

9 Below are views against including equity as a hedged item in the PRA:

(a) Some may disagree with the usefulness of this as they consider the approach to be either arbitrary or artificial.

(b) The revaluation adjustment for equity arises from items that do not satisfy the definition of assets or liabilities under the *Conceptual Framework for Financial Reporting*.

(c) For many users of financial statements, especially where the loss absorption function of equity is considered to be important, equity should not result in any revaluation gains or losses being recognised in the financial statements.

Feedback received by the IASB on the 2014 IASB DP

10 Mixed views were expressed about the inclusion of equity in the PRA. Respondents who currently include them in their DRM supported the inclusion in the PRA because this enables them to show their DRM activities faithfully without resorting to proxy hedging. However, they acknowledged conceptual concessions would be necessary in order to represent such aspects of DRM directly rather than relying on an indirect representation through proxy hedging.

11 In contrast, however, many other respondents have shown concerns over the inclusion of equity in the PRA because of the conflicts that arise with the *Conceptual Framework for Financial Reporting*.

EFRAG's comment letter in response to the IASB DP regarding the equity method book

12 EFRAG acknowledged the concern that including equity as a hedged item in the PRA would, in essence, mean a (partial) remeasurement of equity, which would be in conflict with the Conceptual Framework and IFRS 9. However, EFRAG believed that it should be considered if the PRA is to deliver on its promise of reflecting hedging activities.

13 Excluding equity from the scope of the model would have an influence on the value of the hedging derivatives in the model and thus on the performance of the entity, making the resulting information less relevant and reliable. Hence EFRAG considered that the conceptual concern over revaluing the own equity of an entity is outweighed by the advantage of including it in the scope of the model as it would contribute to the usefulness of the information which results from doing so.

Findings from EFRAG's 2016 outreach

14 Below is a summary of findings on equity based on EFRAG's report *Dynamic Risk Management: How do banks manage interest rate risk?*.

15 More than half of the banks modelled the maturity of equity (eight out of fifteen banks). Of those that did, the main objective for assigning maturities to modelled equity was to stabilise and/or reduce volatility in net interest income (‘NIM’).

16 Practices in defining modelled equity differed between banks. Some banks considered that equity was partly invested in non-interest-bearing assets (for example real estate, equity investments or intangible assets), in addition to investments in interest-bearing assets. The inclusion of non-interest-bearing assets in the modelling allowed banks to assign a long-term economic income to their shareholders.

17 In addition to this, some banks saw modelled equity as being broader than IFRS equity and integrated other liabilities in their modelling of equity (for example loan loss provisions or tax liabilities).

18 Other banks defined equity as the difference between interest-bearing assets and interest-bearing liabilities. Still others used IFRS accounting equity as a starting point but adapted that to fit their situation.

19 Some banks modelled equity implicitly, meaning that they considered equity to be available for long-term funding and investing on this basis would stabilise net interest income.

Findings from the 2021 IASB and EFRAG’s outreach on the core model and on risk management strategies

20 Below is a summary of findings on the inclusion of equity in the model based on the 2021 outreach on the viability and operability of the DRM core model.

(a) Some participants noted that they use equity as part of their interest rate risk position. In particular the free capital and retained earnings, not the additional hybrid instruments.

(b) They noted that equity was interest rate inelastic (so the effect on equity of balancing out an interest position is only an opportunity change, with no resulting change in profit or loss), it has a long duration as shareholders cannot ask their money back, they can only sell their shares. If equity would not qualify it would lead to a lot of volatility in profit or loss.

(c) One participant included equity as an open risk position to reflect the interest rate risk of this position (where equity was considered to reflect the duration of net assets). This approach would also work in the DRM approach. The open position could be hedged to zero if that was the mandate. Another participant specified that equity is modelled in the same way as deposits (laddered), and the model’s tenor is comparable to the average interest rate asset tenor of the participant. Several banks noted that equity was replicated longer term (without specifying the duration).

(d) One participant suggested that in the DRM model equity bucketing is to be based on the bank’s internal risk management models.

21 Also, based on feedback on risk management strategies, banks consider equity as a source of funding that economically needs to be rewarded and so will hedge it like other sources of funding to protect the ability to pay dividends.

Questions for EFRAG FR TEG-CFSS

22 Do you consider that equity should be eligible for designation in the DRM model? Please explain why.

23 If you consider that equity should be eligible for designation, which equity balances are deemed to have interest rate risk exposure and why?

24 In paragraph 15, it has been indicated that an intention may be to stabilise NIM. Given that payments to shareholders do not form part of NIM, please explain further what is meant by this.