



# CIPFA Workshop

**Financial instrument risk disclosures**

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Spring 2017





# Introduction - scope: Public versus private disclosures



# Agenda

**PRAG guidance**

**Fair value hierarchy**

— **Levelling**

— **Information sources**

— **Valuation sensitivity**

**Risk disclosures**

# PRAG guidance

1

**Statement of Recommended Practice 'SORP' (November 2014)**

2

**Practical guidance investment disclosures (May 2016)**

3

**Accounting for derivatives in pension schemes (2007)**



# Fair value hierarchy

# Fair value hierarchy post FRED 62

## Level 1

**The unadjusted quoted price in an active market for identical assets or liabilities that the entity can access at the measurement date**

## Level 2

**Valuation techniques using inputs that are observable (i.e. developed using market data) either directly or indirectly**

## Level 3

**Valuation techniques using inputs that are unobservable (i.e. for when market data is unavailable)**

# PRAG/IA guidance - May 2016

Asset classes	The most likely fair value category
Equity Quoted (traded in active markets)	1
Exchange Traded Funds (traded in active markets)	1
Exchange Traded Derivatives (traded in active markets)	1
Cash	1
Corporate Bond	2
Government Bond	2
Short Term Investments	2
Collateral and margin balances	2
Repo and reverse repo	2
Contract for Differences	2
Asset Backed Securities	2 or 3
Mortgage Backed Securities	2 or 3

# PRAG/IA guidance - May 2016 (cont.)

Asset classes	The most likely fair value category
Unquoted Pooled Funds (see Pooled Funds below)	2 or 3
Hedge Funds	2 or 3
OTC Derivatives	2 or 3
Limited Partnership	3
Structured Products	3
Private Placements	3
Insurance Policies	3
Property	3
Special Purpose Vehicles	3
Equity Unquoted	3

# Fair value hierarchy

## Segregated investments

### **Government Securities – Level 1 or Level 2?**

- G7 government bonds can be Level 1

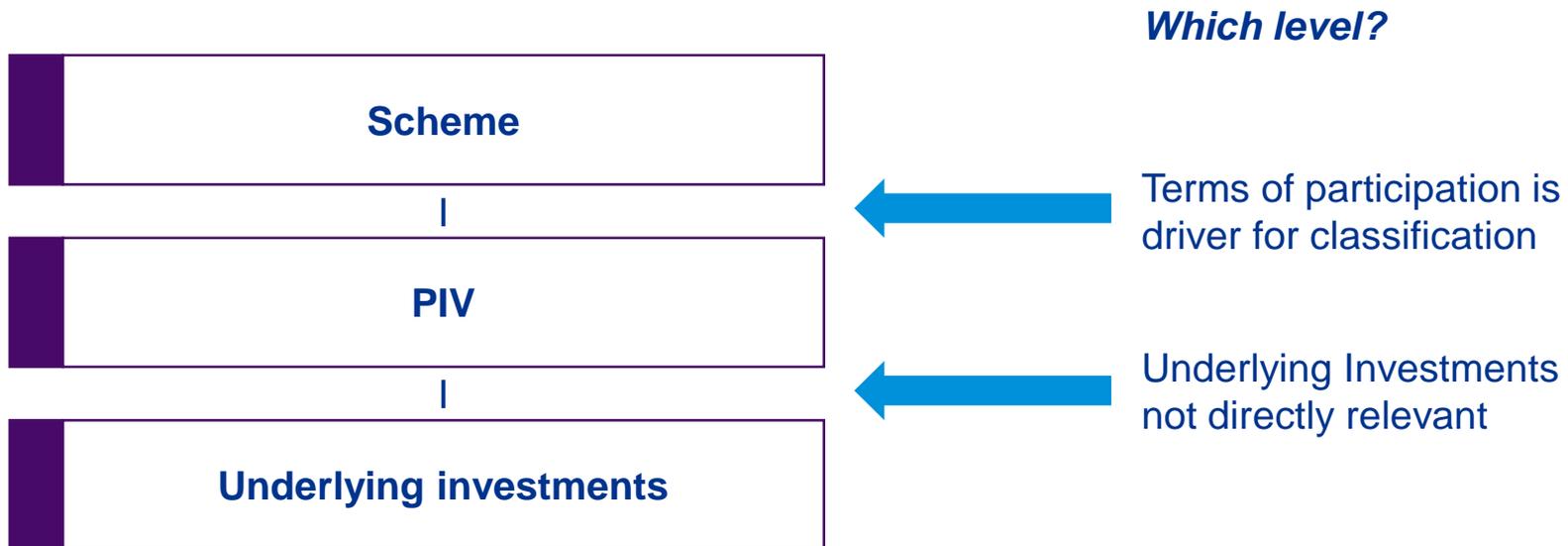
### **Other non-exchange traded bonds – Level 1 or Level 2**

- Pricing methodology – Level 2
- Volume of transactions – if actively traded can be Level 1

# Fair value hierarchy (cont.)

## Pooled investment vehicles

**PRAG/IA guidance: Consideration should be given to the extent to which the redemption terms represent the schemes' ability to exit the position**



# Pooled investment vehicles

## Question: 1, 2 or 3?

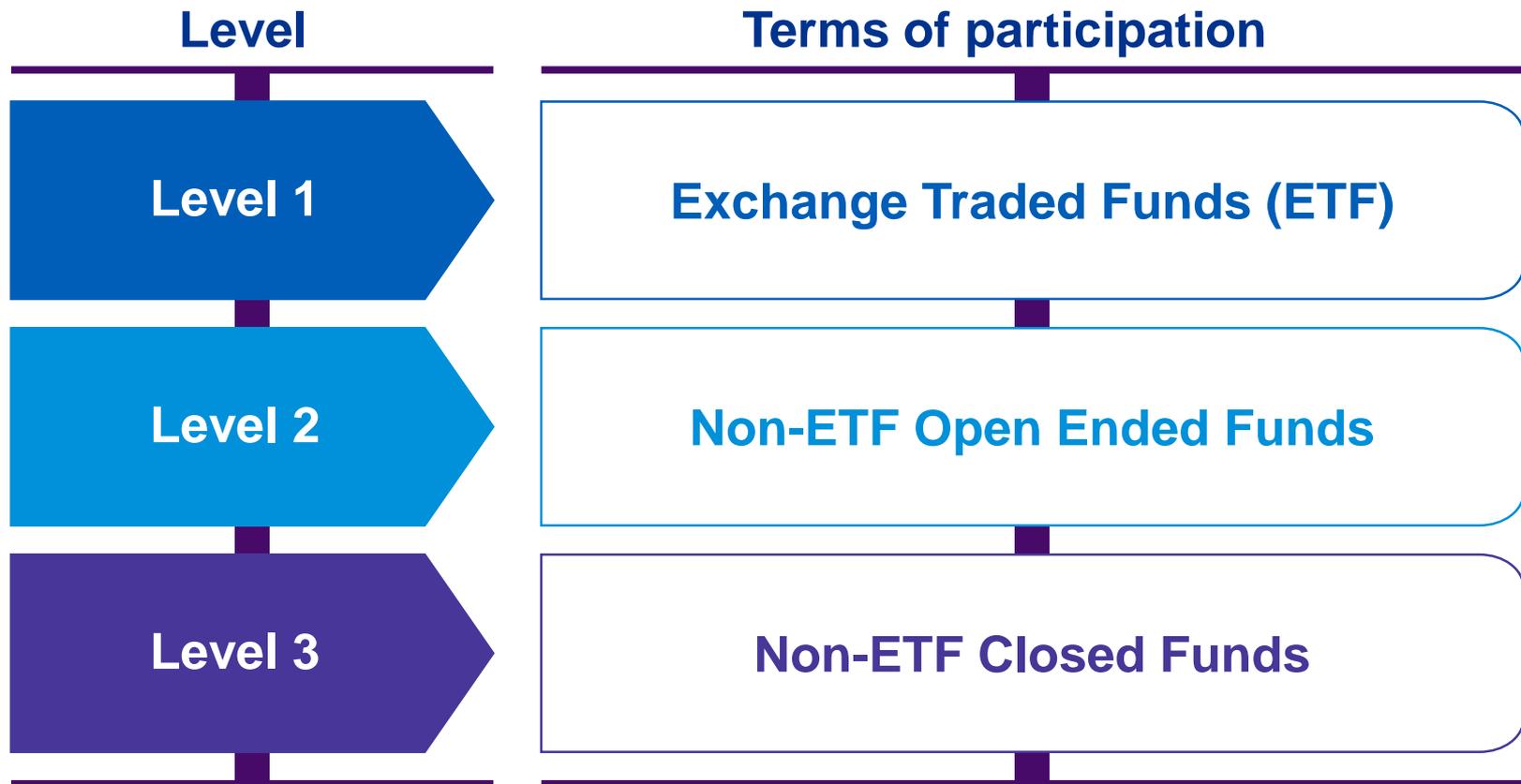
- Answer: It depends ...
- Per SORP:
  - Quoted/unquoted
  - Open ended/closed
  - Frequency of pricing
  - Nature of pricing
  - Trading terms
  - Trading frequency
  - Redemption terms

# PRAG/IA Guidance - Pooled funds

Types of fund	Category	
Exchange traded	1	
Open ended Daily priced Weekly priced	2	<ul style="list-style-type: none"> <li>✓ Market active</li> <li>✓ Redeem at any time</li> <li>✓ NAV accessible by all holders without limit</li> <li>✓ No subjectivity to NAV</li> <li>✓ Legally/contractually required to redeem at NAV</li> </ul>
Open ended Monthly priced	2	<ul style="list-style-type: none"> <li>✓ Market not active</li> <li>✓ Corroborate NAV with redemptions/subscriptions</li> </ul>
Closed Monthly priced	3	<ul style="list-style-type: none"> <li>✓ Market not active</li> <li>✓ Unable to corroborate NAV</li> </ul>

# Fair value hierarchy

## Pooled Investment Vehicles – A practical approach



# Information sources

- **Segregated portfolio**

- **Pooled vehicles**

- **Custodian**

- **Fund manager – Terms of participation**

- **Scheme accountant – Allocation to levels**



# Risk disclosures

# Investment risk disclosures

FRS 102 34.43 – A retirement benefit plan shall disclose information that enables users of its financial statements to evaluate the nature and extent of credit and market risks arising from financial instruments at the end of the reporting period

## Risks

- Credit risk
- Market risk
  - FX risk
  - Interest rate risk
  - Other price risk

## Disclosures

- Nature and extent of risks arising on financial instruments at year end
- Exposures to risk and how they arise
- Objectives, policies and processes for managing the risk and methods used to measure the risk
- Changes to the above from previous period

## SORP extends to all investment assets

# FRS 102 definitions of risk

**Credit risk** – The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation

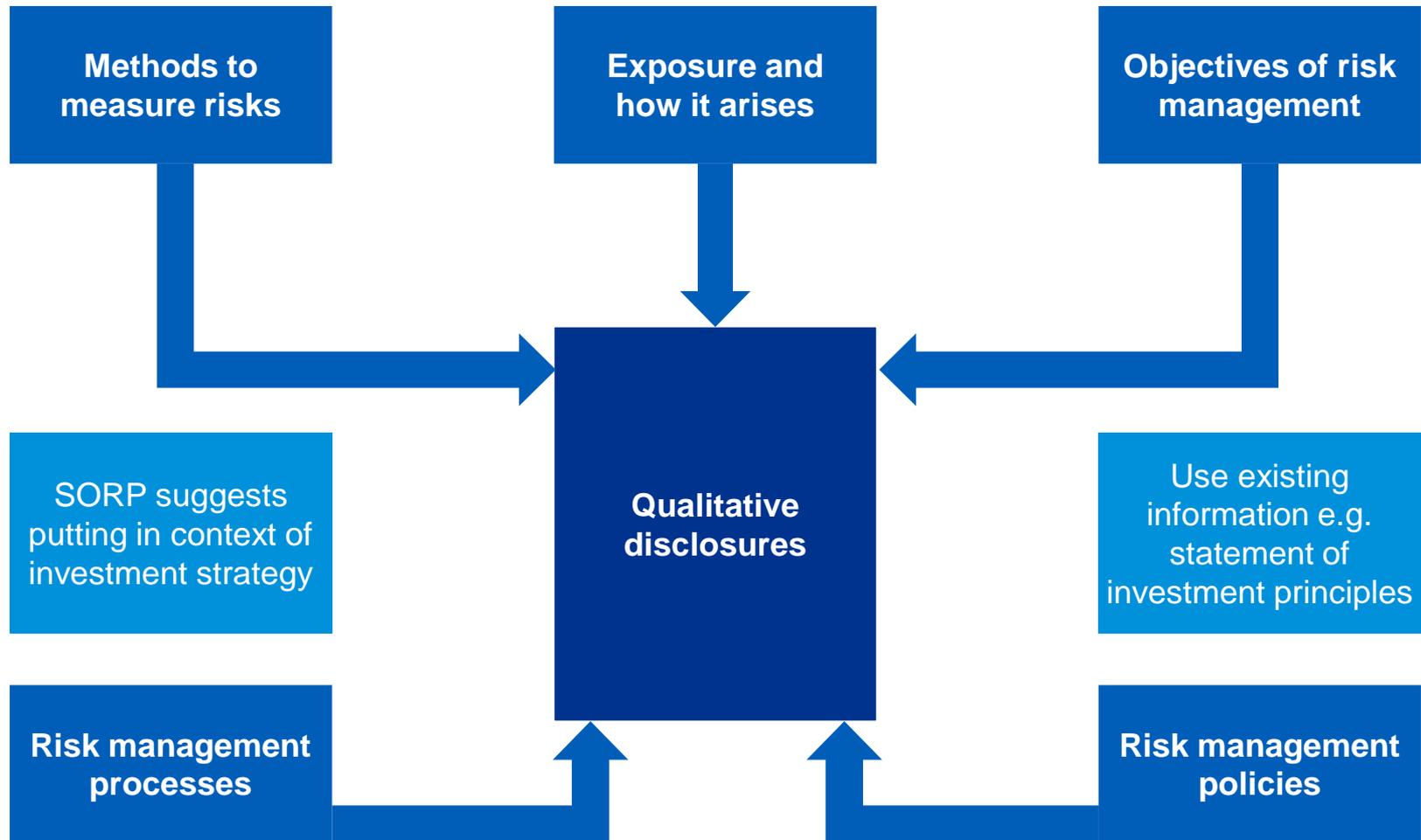
**Market risk** – The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk:

- **FX risk** – The risk resulting from changes in foreign exchange rates
- **Interest rate risk** – The risk resulting from changes in market interest rates
- **Other price risk** – The risk resulting from changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market

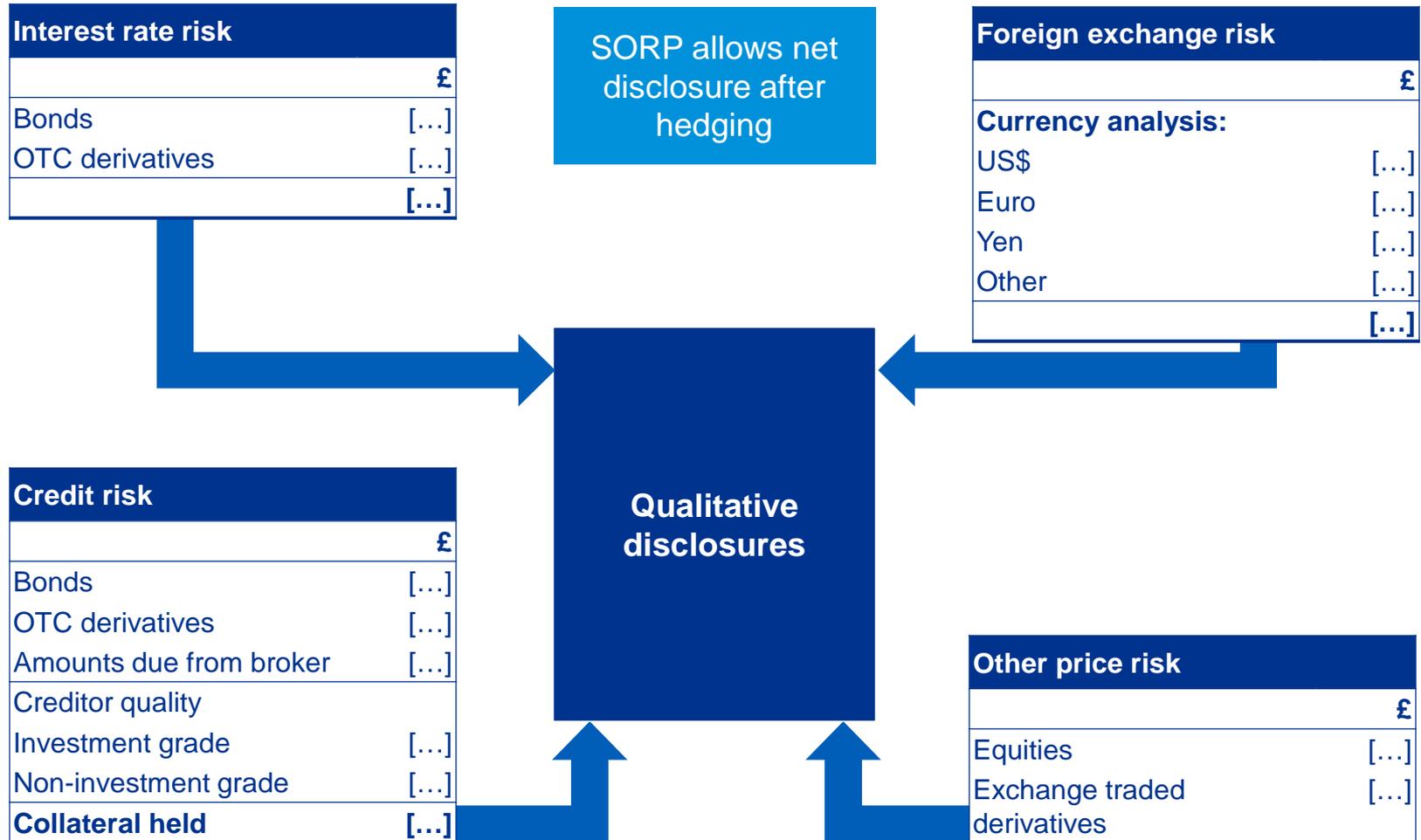
(Note: Private sector schemes are not required to disclose sensitivity analysis)

**Liquidity risk** (Local Authority Scheme requirement) – A maturity analysis for financial liabilities that shows the remaining contractual maturities an undiscounted amounts separated between derivative and non-derivative financial liabilities

# Qualitative disclosures



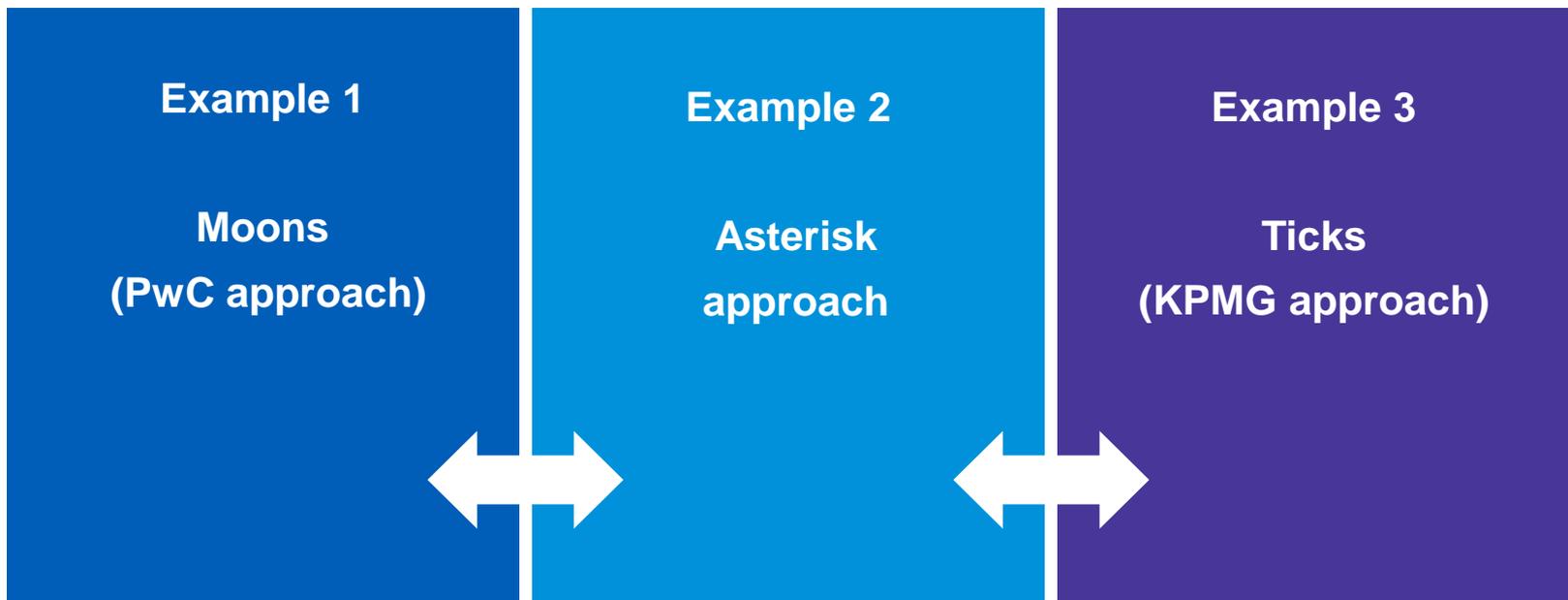
# Quantitative disclosures



# Investment risk disclosures

We are seeing differing approaches develop but common underlying themes:

## Some Example Approaches:



# Example 1: Moons (PwC approach)

The following table summarises the extent to which the various classes of investments are affected by financial risks:

	Credit risk	Market risk			20X5	20X4
		Currency	Interest rate	Other price	Value	Value
<b>Defined benefit section</b>						
Equities	○	●	○	●	11,067	9,122
Bonds	●	●	●	○	10,436	8,422
Property	●	●	○	●	1,010	995
Pooled investment vehicles						
Direct	●	●	●	●		
Indirect	●	●	●	●	4,996	3,780
Derivatives	●	●	●	●	210	162
Insurance policies	●	○	●	●	69	50
Other investments	●	○	●	○	9,300	-
AVC investments	●	○	○	●	65	49
Cash deposits and other net investment assets	●	●	○	○	808	788
<b>Total DB section investments</b>					<b>37,961</b>	<b>23,368</b>
<b>Defined contribution section</b>						
Pooled investment vehicles	●	●	●	●	2,146	680

In the above table, the risk noted affects the asset class [●] significantly, [●] partially or [○] hardly/ not at all.

# Example 2: Asterisk approach

The following table summarises the extent to which the various classes of investments are affected by financial risk:

	Credit risk		Market risk		Other price	2016	2015
		Currency	Interest rate	Inflation rate		£ million	£ million
<b>Defined benefits section</b>							
Equities	-	*	-	-	X	0.1	512.4
Bonds	*	-	X	X	*	2,745.8	4,131.1
Pooled investment vehicles	*	*	*	*	*	3,625.7	1,748.8
Derivatives	X	*	X	X	*	(137.4)	(218.2)
Longevity hedge	X	*	X	X	*	(24.0)	(12.0)
Cash and Other investment assets	X	-	X	*	-	(1,397.1)	(1,105.7)
<b>Total</b>						<u>4,813.1</u>	<u>5,056.4</u>

As at 31 March 2016 the Fund was in a transition period to a new investment strategy. In the above table, the risks noted effect the asset class (X) significantly, (\*) partially or (-) hardly/not at all.

# Example 3: Ticks (KPMG approach)

## ii. Indirect credit and market risks

The DCS is also subject to indirect credit and market risk arising from the underlying investments held in the TAM funds. The funds which have significant exposure to these risks are set out below:

### 2016 and 2015

	<b>Credit risk</b>	<b>Foreign exchange risk</b>	<b>Interest rate risk</b>	<b>Other price risk</b>
ABC Scheme Equities	-	✓	-	✓
ABC Scheme Bonds	✓	✓	✓	-
ABC Scheme Cash	✓	-	✓	-
ABC Scheme Diversified Growth	✓	✓	✓	✓

The analysis of these risks set out above is at Scheme level. Member level risk exposures will depend on the funds invested in by members.

The Trustees have selected the above funds and have considered the indirect risks in the context of the investment strategy described in the Trustees' Report.

# Investment risk disclosures – General observations

- Inconsistencies between risk disclosures and the rest of the financial statements
  - Wording
  - Numbers
- Content and approach to credit quality disclosures sometimes incomplete/ includes items with no credit risk and/or offset of investment assets and liabilities
- Credit quality disclosures sometimes overlooked
- PIV legal structure analysis often overlooked
- Currency risk – Dealing with PIVs and derivative economic exposures

# Investment risk disclosures – Consistency

## A mapping guide

Statement of Net Assets		PIV note		Investment risk note				
£000				Credit risk: PIV Legal structure	Other price risk:	Interest rate risk:	Currency risk:	
Equities	5					5		
Bonds	10			10			10	
PIVs	50	Equity fund	10	Insurance contracts	30	Equity fund	10	
		Bond fund	30	OEICs	10	Bond fund	30	
		Hedge fund	10	LLP	10	Hedge fund	10	Hedge fund
<b>Total</b>	<b>65</b>		<b>50</b>		<b>60</b>	<b>25</b>	<b>40</b>	<b>10</b>

Consistency from primary statements to note disclosures

# Risk disclosures: Allocation of investments to strategic investment portfolios

## Another way could be:

	2016	2015	Credit risk	Market risk		
	£	£		Interest rate risk	Other price risk	Foreign exchange risk
Matching portfolio	[...]	[...]	●	●	●	●
Growth portfolio	[...]	[...]	●	●	●	●
Other investments	[...]	[...]	●	●	●	●
<b>Total Investments</b>	<b>[...]</b>	<b>[...]</b>				

Key:

- Significant exposure
- Some exposure
- No exposure



# Questions



Thank you



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