Dynamic Risk Management
Issues Paper

Objective of Session

1 This session seeks EFRAG TEG-CFSS members input on possible approaches to outreach on the IASB Dynamic Risk Management model (DRM model) that is in the research phase of the standard setting due process. EFRAG TEG and CFSS input is sought for the following reasons:

(a) As outlined in accompanying **Paper 07-02 (IASB October 2019 ASAF Paper)**, the IASB will not be issuing a due process document in 2019 and will commence outreach on the DRM core model in Q4 2019. The outreach will help the IASB to subsequently decide on whether to issue a Discussion Paper or Exposure Draft. Hence, the IASB is in the process of developing an outreach plan on the DRM model and seeks recommendations from ASAF members on the nature and format of the outreach.

(b) To contribute to an evidence-based development of the DRM model, EFRAG is formulating plans for an early stage analysis and outreach to European stakeholders. As part of the early stage analysis and outreach, EFRAG can potentially build on its earlier work towards understanding banks' practices for the stabilisation and optimisation of net interest income as reflected in the 2017 EFRAG publication Dynamic Risk Management- How do banks manage interest rate risk? The publication focused on banks' modelling of core demand deposits and equity whilst managing net interest income and was informed by access to 15 EU banks.

Overview

2 IFRS 9 *Financial Instruments* allows an accounting policy choice where entities can still apply IAS 39 *Financial Instruments: Recognition and Measurement* macro-hedge accounting requirements for dynamic risk management with open portfolios. The focus of the DRM model is on replacing IAS 39 macro-hedge accounting requirements where fair value hedge accounting is applied and the DRM model will address the limitations of a static, one to one designation of hedging instrument to hedged item as presently required under IFRS 9 micro-hedge accounting requirements.

3 The DRM model development follows earlier efforts in the 2014 Discussion Paper[1] *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*.

[1]https://www.ifrs.org/news-and-events/2014/04/17---iasb-publishes-discussion-paper-on-accounting-for-macro-hedging/

4 The DRM model is being developed in two phases:

(a) Phase I (CORE model) currently ongoing – The focus of phase I is on interest rate risk management and core demand deposits[2]. Eligible items when considering asset-liability management portfolios include those measured at amortised cost. The derivatives used for risk management in the CORE model are linear payoff hedging instruments such as swaps.

(b) Phase II will follow Phase I – It will be an extension of the CORE model rather than a fundamental change. Phase II will address equity, eligible items for asset-liability management portfolios will include those measured at FVOCI, and derivatives will include non-linear payoff hedging instruments such as options.

5 Paper 07-02 (ASAF Paper) highlights the DRM core model objectives, outline, components and includes a few illustrative examples. It highlights the following key components of the DRM model:

(a) Asset profile are the financial assets that are subject to transformation;

(b) Target profile (Transformation objective). It is the asset profile that requires no derivative to meet the risk management objective. In effect, asset profile + benchmark derivative= target profile;

(c) Designated derivatives are the actual derivatives used for portfolio risk management; and

(d) Benchmark derivative (s) is the derivative(s) that transforms the asset profile to target profile. In effect, the benchmark derivative is a hypothetical derivative that in combination with the asset profile results in the representation of the risk management objective on the financial statements. It is not an actual derivative.

EFRAG Secretariat initial views on outreach considerations

6 The IASB staff are requesting views or recommendations on the nature and format of the outreach that could assist the IASB in developing its outreach plan. Paper 07-02 (ASAF paper) does not include any IASB staff preliminary ideas for outreach approaches. Hence, this paper only reflects EFRAG Secretariat initial views on outreach consideration and these are informed by

(a) input from the EFRAG FIWG;

(b) possible areas of focus highlighted during the April and July 2019 IASB meetings; and

(c) EFRAG's past work reflected in the 2017 publication Dynamic Risk Management- How do banks manage interest rate risk?

7 The EFRAG Secretariat's initial views on outreach considerations are broken into the following sub-sections:

(a) Target audience;

(b) Development of appropriate educational material;

[2] Defined as those stable deposits that do not reprice but have demand features yet are unlikely to be withdrawn by customers. These deposits can be considered analogous to fixed maturity, fixed rate liabilities.

(c) Feedback on whether the proposed accounting reflects risk management practices;

(d) Feedback on performance reporting expectations; and

(e) Assess possible scale of applicability of DRM model .

Target audience (financial institutions)

8 The objectives outlined in IASB staff papers[3] for the April and July 2019 IASB meetings suggest that the outreach ought to include preparer banks, users (including investors and analysts) and regulatory authorities:

(a) Transparency: Increasing transparency would enable users to evaluate management's approach and rationale for their decisions;

(b) Eligibility: Addressing the capacity issue (i.e. where derivatives required to accomplish the portfolio risk management objective exceed the eligible hedged items under micro-hedge accounting requirements);

(c) Dynamic nature of risk management: Resolving challenges that result from the application of IFRS 9 hedge accounting requirements to dynamic portfolios (frequent de-designations); and

(d) Performance measurement*.* Providing a simple and understandable metric demonstrating if management was successful in achieving their risk management objective as desired would be relevant information for economic decision-making.

9 However, as discussed during the July 2019 IASB meeting, given the need to first test the operationality of the model and because comprehensive disclosures are yet to be developed, it may be appropriate to prioritise the outreach to banks, insurance companies and prudential regulators at this stage of development of the model and to either conduct outreach to users at later stages of development of the DRM model or restrict the outreach to users to questions on presentation approaches. User feedback from past outreach efforts during the development of IFRS 9 hedge accounting requirements and the 2014 DRM Portfolio Revaluation Approach discussion paper could be used to develop the related comprehensive disclosure requirements.

Development of appropriate educational material

10 EFRAG FIWG proposed that, for outreach purposes, the IASB and where appropriate EFRAG should consider developing educational material that can help constituents to understand how the DRM model works in practice.

Feedback on whether proposed accounting approach reflects risk management practices

11 EFRAG FIWG members proposed that any outreach should consider whether and how the target profile component of the DRM model, reflects how banking entities undertake portfolio risk management activities. Practical implications could include:

[3] https://www.ifrs.org/-/media/feature/meetings/2019/april/iasb/ap4a-drm.pdf

https://www.ifrs.org/-/media/feature/meetings/2019/july/iasb/ap4b-drm.pdf

(a) An assessment of whether cash flow hedge mechanics and the inclusion of a hypothetical/benchmark derivative as one of the DRM model components, mirrors real world risk management practices.

(b) The implications of risk management practices including:

(i) banks' focus on a target range in their interest rate risk management objective;

(ii) consideration of the interaction of different risk types whilst managing portfolios; and

(iii) hedging of net positions.

(c) Any unique considerations that may arise for smaller banks.

(d) The effect of regulatory requirements on portfolio management choices and the prudential impacts of the cash flow hedge reserve.

12 The analysis of banks risk management practices in the 2017 publication Dynamic Risk Management- How do banks manage interest rate risk? could be one of the inputs for assessing whether the DRM CORE model will reflect risk management practices.

Feedback on performance reporting expectations

13 The IASB has made several tentative decisions on the presentation of designated derivatives in the main financial statements and disclosures in the notes. It will be useful to get feedback on the extent to which these decisions could contribute to clarity on a bank's risk management objective and assessment of risk management effectiveness. The outreach should also aim to clarify whether or not to separately present the aligned portion[4] as part of the net interest income subtotal.

Assess possible scale of applicability of DRM model

14 With the introduction of the DRM model, and on the assumption that the existing hedge accounting options remain, entities will have several options to reflect their portfolio risk management strategies including:

(a) DRM model;

(b) Macro-hedge accounting under IAS 39 (cash flow hedges);

(c) Hedge accounting under IFRS 9 (e.g. via proxy hedging for deposits); and

(d) Not electing any form of hedge accounting (economic hedges).

15 Furthermore, it is expected that entities can make an irrevocable election to apply the DRM towards eligible portfolios. Hence, to the extent that banking and insurance entities have readily available indicative data at this early stage of the due process, it may be possible to request the extent to which dynamic risk management currently occurs to manage interest rate risk, the accounting presently applied and the extent to which entities would be likely to elect to apply the DRM model.

[4] The aligned portion is the difference between the designated derivatives and benchmark derivative, which is recognised in the statement of profit or loss (P&L) such that the target profile objective is reflected in the P&L.

Questions for EFRAG TEG and EFRAG CFSS

16 **Question 1 –** Which stakeholders should the outreach by the IASB and EFRAG focus on?

17 **Question 2 –** What aspects of the DRM model should be the focus of the outreach?

18 **Question 3 –** What data from banks and insurance entities should be requested during the outreach?