

# Dynamic risk management

EFRAG FR TEG – Agenda paper 03-04

22 March 2022



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# OVERVIEW

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## **IASB February 2022 meeting**

- Staff paper
- Board discussion
- FIWG reaction

## **Feedback on EU carve out**

- Auditors
- Regulators
- Users
- Preparers





# IASB FEBRUARY 2022 MEETING

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# IASB February 2022 meeting

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## BACKGROUND

FV portfolio hedging	PRA	DRM v.1
<ul style="list-style-type: none"><li>- IAS 39</li><li>- FVH</li><li>- Separate line item</li></ul>	<ul style="list-style-type: none"><li>- 2014 DP</li><li>- FVH</li><li>- Reflected risk appetite</li></ul>	<ul style="list-style-type: none"><li>- Current discussions</li><li>- CFH</li><li>- Concerns around equity volatility</li></ul>

# IASB February 2022 meeting

## Staff paper proposal 2 approaches

<b>Approach A</b>	<b>What is valued?</b>	<b>What is recognised in the statement of financial position?</b>	<b>What is recognised in statement of profit or loss?</b>
<b>Hedged item</b>	Risk mitigation intention	Fair value of the risk mitigation intention	Changes in fair value of the risk mitigation intention
<b>Hedging instrument</b>	Designated derivatives	Fair value of the designated derivatives	Changes in fair value of designated derivatives

Approach A is a symmetrical approach, which is similar to the fair value hedge mechanics, but with some changes to reflect to the characteristics of DRM.

<b>Approach B</b>	<b>What is valued?</b>	<b>What is recognised in the statement of financial position?</b>	<b>What is recognised in statement of profit or loss?</b>
<b>Hedged item</b>	Risk mitigation intention	n/a	n/a
<b>Hedging instrument</b>	Designated derivatives	Fair value of the designated derivatives	Misaligned portion resulting from the lower of test
<b>DRM adjustment</b>	The lower of the above	Aligned portion resulting from the lower of test as a separate line item	

Approach B is a combination of cash flow and fair value hedging mechanics.

# IASB February 2022 meeting

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## IASB DISCUSSION

- Approach B was preferred by most; an option between both approaches was rejected
- DRM adjustment on balance sheet creates conceptual issues with framework, but the discussion relates to presentation of the DRM adjustment.
- Proposal that the DRM adjustment should reflect:
  - a) the lower of accumulated changes in fair value of designated derivatives and combination of fair value changes of benchmark derivatives; and
  - b) effects of unexpected changes from current net open position.
- Disclosures should inform users about entities' DRM activities. In particular:
  - a) Disclosure about what the DRM adjustment represents;
  - b) Disclosure not limited to the "lower of" end of the test but also the higher end.
- The Staff should consider whether DRM model should be mandatory



## EU carve out feedback

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# EU Carve out feedback

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## SUMMARY

- The carve-out is used throughout Europe, in Austria, Belgium, Germany, Italy, Netherlands, Spain, and Sweden.
- Apart from banks in Portugal and Greece as well as one SEC registrant, the EFRAG Secretariat is not aware of other banks not using the carve out. In Italy, where IFRS is required for separate accounts of banks it is relevant also for those accounts.
- Common practices have been established at country level
- Disclosures about the use of the carve out is not uniform and unclear. In the absence of specific disclosure requirements, the information about hedging accounting practices is not often presented.
- However, the use of carve-out does not raise questions from users.

# EU Carve out feedback

## AUDITORS/ ACCOUNTANTS

	Relevant aspects of products	Use of carve out
France	<ul style="list-style-type: none"> <li>Most mortgages are fixed rate loans with prepayment penalties with some exceptions</li> <li>Some regulated deposits (Plan d'Epargne Logement) where the existing older vintages have very high rates compared to the current ones result in effectively perpetual instruments as these can be transferred to the family members.</li> </ul>	<ul style="list-style-type: none"> <li>The use of the carve out is very common</li> <li>Refined methodology to assess hedge effectiveness using a vintage approach. This is to ensure the derivatives are allocated to assets vintages with the same/equivalent rate.</li> </ul>
Germany	<ul style="list-style-type: none"> <li>Prepayment penalty payable if earlier than 10 years even if moving house, but not after the ten years.</li> <li>Similar products as the Plan d'Epargne Logement mentioned under France.</li> </ul>	<ul style="list-style-type: none"> <li>Will apply the carve out where it is beneficial.</li> <li>Increase in use due to the long low-interest rate environment</li> </ul>
Italy	<ul style="list-style-type: none"> <li>Prepayment of mortgages now allowed which increased the prepayment risk</li> </ul>	<ul style="list-style-type: none"> <li>Portfolio FVH widely used since 2005 given the fixed rate banking book.</li> <li>All banks use IFRS for accounts.</li> <li>The carve out is used for fixed rate mortgages and commercial loans and less for securities.</li> </ul>
Portugal	<ul style="list-style-type: none"> <li>Mortgages are at variable rates and fixed-rated instruments have short terms (around 5 years)</li> <li>Significant prepayment penalties for fixed rate instruments</li> </ul>	<ul style="list-style-type: none"> <li>The carve out is not used</li> </ul>

# EU Carve out feedback

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## AUDITORS/ACCOUNTANTS (CONT.)

### **Disclosures:**

- Difficult for banks to explain results given differences between risk management and accounting
- No questions from users

### **Consistency of application:**

- Consistent application per country, but no cross-country discussions

### **Benefit of elimination of the carve out:**

- Benefit for non-EU countries to reduce practical difficulties in IAS 39
- Elimination of carve out not a goal in itself but may benefit SEC filers (less effort)
- Remaining concern relating to transition from carve out to a new model

# EU Carve out feedback

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## REGULATORS

- One regulator had a discussion with EFRAG Staff in December 2021.
- The primary focus 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. No perception of higher or lower risk.
- Users could benefit from more transparency and improved disclosures could indirectly foster better internal control over the reported information
- Some concerns about the degree of flexibility in the absence of literature
- The required disclosures on hedging are too aggregated to explain the related effects

# EU Carve out feedback

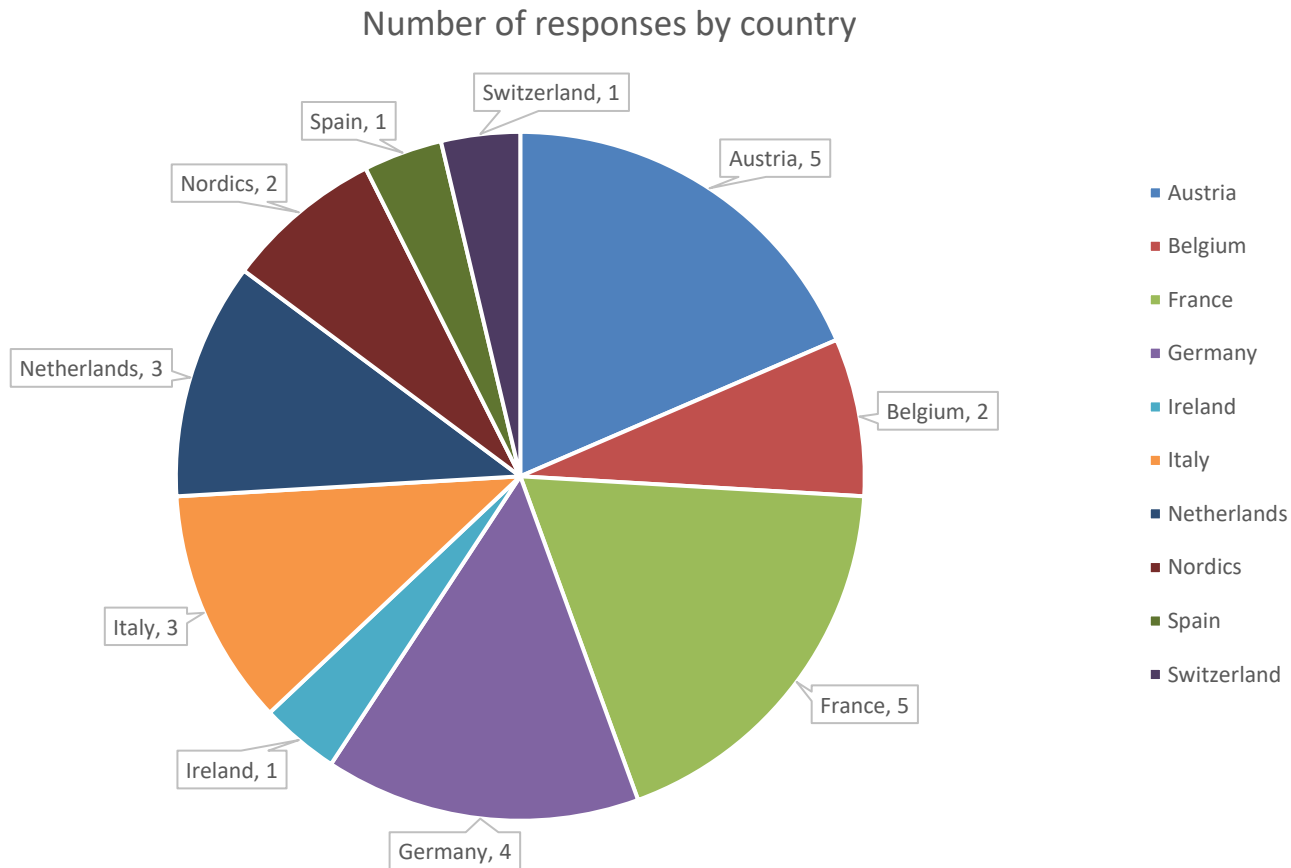
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## USERS/INVESTORS

- Very low engagement
- Little/no weight to use of carve out
- Would prefer more disclosures, but seems to relate to IFRS 7 sensitivity disclosures rather than hedge accounting

# EU Carve out feedback

## PREPARERS: Number of responses by country



# EU Carve out feedback

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## PREPARERS: Question 1 - Carve out vs other hedge accounting

- (a) The carve-out is particularly important for unstable portfolio FVH relationships (due to prepayments or demand deposits);
- (b) To reflect the bank's risk management activities in its financial performance;
- (c) Bottom layer hedges;
- (e) Due to the bank's balance sheet structure (large, fixed-rate mortgage portfolio which are (partly) funded by core demand deposits);
- (f) To cope with negative margins in micro hedges;
- (g) Due to a lighter operational burden, and reasonable results from hedge accounting.

# EU Carve out feedback

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## PREPARERS: Question 2 – Internal and external communication

- (a) The carve-out is particularly important for unstable portfolio FVH relationships (due to prepayments or demand deposits);
- (b) To reflect the bank's risk management activities in its financial performance;
- (c) Bottom layer hedges;
- (e) Due to the bank's balance sheet structure (large, fixed-rate mortgage portfolio which are (partly) funded by core demand deposits);
- (f) To cope with negative margins in micro hedges;
- (g) Due to a lighter operational burden, and reasonable results from hedge accounting.



## EU Carve out feedback

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### PREPARERS: Question 3 – Questions on hedge accounting from users?

	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

### PREPARERS: Question 4 – Other ways to explain hedge accounting results

	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



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