This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG FR TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG FR Board or EFRAG FR TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG FR Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Dynamic risk management: Update of IASB tentative decisions Issues Paper

Objective and Introduction

1 The objective of the session is to update EFRAG FR TEG on the recent IASB decisions on the Dynamic Risk Management ('DRM') project, as follows:

(a) May 2022 IASB discussions on Mechanics of the DRM model and project direction; and

(b) July 2022 IASB discussions on project plan.

2 In its June 2022 EFRAG FR TEG and CFSS meeting (and June 2022 EFRAG FIWG meeting), members discussed whether equity should be eligible for designation in the DRM model and any views on the IASB's recent discussions and tentative decisions. This was in preparation for the July 2022 ASAF meeting. A summary of this can be found in the Appendix to this paper.

3 Also, EFRAG FR TEG has previously discussed the following IASB tentative decisions (links to papers are included). These were also discussed with EFRAG FIWG. A summary of the discussions from both EFRAG FR TEG and EFRAG FIWG can be found in the Appendix to this paper.

	EFRAG FR TEG discussed in its meeting of:
November 2021 IASB discussions: • Refinements to the DRM model – Risk limits; • Designation of a proportion of prepayable assets	December 2021
February 2022 IASB discussions: • Mechanics of the DRM model – Alternative approaches	March 2022

May 2022 IASB tentative decisions

4 In February 2022, the IASB Staff had put forward two alternative approaches for the DRM mechanics. The February 2022 IASB discussion was an educational session, however, most IASB members preferred Approach B.

5 The May 2022 IASB Staff paper presented further analysis on the alternative approaches to the mechanics, considering the feedback from the February 2022 IASB meeting.

Summary of the Approaches

6 The following table illustrates Approach A:

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

Approach B

7 The following table illustrates Approach B

	What is valued?	What is recognised in the statement of financial position?	What is recognised in statement of profit or loss?
Hedged item	Risk mitigation intention	n/a	n/a
Hedging instrument	Designated derivatives	Fair value of the designated derivatives	Misaligned portion resulting from the lower of test
DRM adjustment	The lower of the above (see paragraph **Error! Reference source not found.**)	Aligned portion resulting from the lower of test as a separate line item	

European carve-out and current practices

8 The current practices reflect a mechanism that is similar to approach A in that the fair value of the risk mitigation intention adjusts the hedged item (or is a separate item on the balance sheet). The treatment of the hedging instrument is the same for both and the use of the risk mitigation results in similar treatment to the carve out. As such, implementing approach B would trigger a change from current practices, with the consequent necessity to assess the impact of such change.

9 In particular, changes in fair value of the hedging derivatives are recognised in profit or loss and in the statement of financial performance, to the extent that the corresponding risk position that they intend to hedge is identifiable as part of the portfolio of the designated hedged items. Changes in fair value of the hedged items are also recognised in profit or loss and in the statement of financial performance and they offset the changes in fair value of the hedging derivatives.

10 EFRAG Secretariat investigated the perceptions of the carve-out and how it is perceived to perform after 15 years of continued use. The report can be found here. This work has not identified shortcomings in the information provided, except for some improvements in the disclosure that could be considered.

IASB Staff analysis and recommendations

Mechanics of the DRM model

11 As summarised in paragraph 5 of the IASB Staff agenda paper 4A, the IASB Staff recommends that the IASB changes the mechanics of the DRM model to Approach B as they consider that it provides the most useful information to users of financial statements.

12 The recommendation is based on the following considerations:

(a) *Faithful representation*: Recognition of the DRM adjustment in the statement of financial position provides a faithful representation of the dual purpose of dynamic risk management of repricing risk:

(i) reduced variability in fair value is reflected by recognising in the statement of financial position the extent to which an entity successfully mitigated repricing risk due to changes in interest rates through the designated derivatives; and

(ii) reduced variability in net interest income is reflected through the subsequent unwinding of the DRM adjustment to the net interest income.

(b) *Relevant information*:

(i) In applying Approach B, direct information would be provided about the extent to which an entity achieved the objective of mitigating repricing risk through the "lower of" test (the DRM adjustment is recognised in the statement of financial position only for the aligned portion of the fair value changes of the designated derivatives whereas the misaligned portion would be recognised in the statement of profit or loss).

(ii) In addition, the DRM adjustment would provide direct information about the present value of the future "offset" to the net interest income from the underlying items which will be provided by the designated derivatives. This "offset" will unwind to net interest income over time and therefore reduce net interest income variability.

13 The IASB Staff's analysis concluded that Approach A does not achieve a faithful representation, nor does it provide relevant information. This is mainly due to the fact that, in applying Approach A, the fair value risk mitigation intention is recognised regardless of the extent to which risk mitigation is achieved through derivatives (in other words, regardless of whether an entity is successful in mitigating the relating repricing risk) and it does not provide information about the changes in fair value of the underlying items (there is no direct link between the risk mitigation intention at a point in time and the underlying individual items that it is comprised of). The latter could turn into a "double-counting" risk if the underlying assets are already measured at fair value.

14 About questions that arose from the February 2022 IASB meeting on whether the DRM adjustment would meet the definition of an asset or a liability in the *Conceptual Framework*, IASB Staff noted that the DRM adjustment would not be consistent with these definitions. Nevertheless, IASB Staff considered that departing from the Conceptual Framework definitions may be justified to ensure that the mechanics of the DRM model provide useful information to the users of the financial statements.

Project direction

15 In IASB Staff agenda paper 4B, the IASB Staff recommended to move the DRM project from the research programme to the standard-setting programme and to continue using the expertise of existing advisory bodies without establishing a dedicated consultative group for the project.

May 2022 IASB tentative decisions

16 At its meeting on 23 May 2022, the IASB tentatively decided to change the mechanics of the DRM model to align with Approach B, i.e., to require:

(a) designated derivatives to be measured at fair value in the statement of financial position.

(b) the DRM adjustment to be recognised in the statement of financial position, as the lower of (in absolute amounts):

(i) the cumulative gain or loss on the designated derivatives from the inception of the DRM model; and

(ii) the cumulative change in the fair value of the risk mitigation intention attributable to the repricing risk from inception of the DRM model (which would be calculated using the benchmark derivatives as a proxy).

(c) the net gain or loss from the designated derivatives calculated in accordance with (a) and the DRM adjustment calculated in accordance with (b) to be recognised in the statement of profit or loss.

17 Also, the IASB decided to:

(a) add the Dynamic Risk Management project to its standard-setting programme; and

(b) continue using the expertise of advisory bodies instead of establishing a dedicated consultative group for the project.

18 The IASB provided the following comments during the meeting:

(a) In general, IASB members supported the IASB Staff's arguments as to why the mechanics of Approach B provide more faithful and more relevant information than Approach A.

(b) The "lower of" test gives a faithful representation on the effectiveness of the designated derivatives and hedge strategies and better represents the link between the risk management framework applied by entities and the underlying items.

(c) In respect of departure from the Conceptual Framework, IASB members accepted that, in the end, it would provide more transparent information for the users of financial statements. However, it was reiterated that such a departure could only be applied to the DRM model and cannot be taken any further because the IASB wants to avoid degradation of usefulness of the Conceptual Framework in the long term.

(d) Disclosure requirements should be developed to inform stakeholders about the DRM activities of entities with a focus on: (i) the full fair value size of the risk management intention and related changes, (ii) the description of the underlying items and, (iii) the characteristics of designated derivatives. A starting point could be the disclosures provided by European banks on EU carve out from IAS 39 on a regulatory basis.

(e) In the following stages of the project, more users of financial statements should be appropriately involved, also considering the development of educational sessions and materials.

19 Please refer to paragraph 14 onwards for the EFRAG discussions on the February educational/discussion session on the topic.

Questions for EFRAG FR TEG

20 Does EFRAG FR TEG have any additional comments on the May 2022 IASB's tentative decisions as compared to the March 2022 discussions?

July 2022 IASB meeting discussions

IASB Staff proposal for the project plan

21 In the Agenda Paper 4 of the July 2022 meeting, the IASB Staff set out the areas and topics that need to be further considered in order to complete the developments of the DRM model together with a proposed order of future discussions for the next stage of the project.

22 The areas and topics identified are the following (the order of the list also represents the proposed order in which the IASB will discuss them):

(a) Eligible items and the determination of the current net open risk position.

(i) Eligible items: further analysis might be necessary to consider whether own equity balances, equity instruments with characteristics of debt, financial assets classified as fair value through OCI, and financial assets classified as fair value through profit or loss could be eligible for inclusion in the DRM model as part of the current net open risk position.

(ii) Modelling of core demand deposits: more guidance may be needed on how the effects could be captured in the DRM model when there are changes in model assumptions for core demand deposits.

(iii) Notional alignment and future transactions: feedback received suggested that the notional amount of assets and liabilities contained in the current net open risk position may not always be aligned in practice. Consequently, it may be necessary to do further analysis of whether the requirement for notional alignment tentatively decided by IASB in March 2018 remains appropriate. The decision on this topic could also have implications on the eligibility for designation of future transactions.

(iv) Defining the hedged risk: further analysis might be necessary to consider if the hedged risk need to be "separately identifiable and reliably measurable" and how to treat an embedded floor or cap in the contractual interest rates of the underlying assets and liabilities.

(v) Unexpected changes: at this stage it is not clear how to reflect, for accounting purposes, the economic effects of potential prepayment / early termination of positions or changes to the expected cash flows in the current net open risk position and how such unexpected changes affect the DRM adjustment.

(b) Target profile[1] and its alignment with an entity's risk management strategy.

(i) Criteria for determining the target profile: further analysis might be necessary to identify a common principle to be used by all entities for the allocation of risk limits in the context of the target profile that considers an appropriate level of granularity necessary to ensure the robustness of the model.

(ii) Changes in target profile and risk management strategy: it should be discussed whether changes in an entity's risk management strategy and therefore its target profile should lead to a discontinuation of the DRM model (as tentatively decided by IASB).

(c) Designated derivatives.

(i) Non-linear derivatives: it is necessary to consider the challenges caused by the use of non-linear derivatives (such as interest rate options) and assess how widely they are used in practice, before deciding whether to allow inclusion in the DRM model.

(ii) Impact from off-market derivatives: more guidance may be needed on the possible use of off-market derivatives (with non-zero fair value at designation date) and the potential impacts from early termination of designated derivatives or trade compression exercises, as well as on the effects on the calculation of DRM adjustment and its subsequent unwinding into the interest margin.

[1] The target profile is defined as the range (risk limits) within which the current net open risk position can vary while still being consistent with the entity's risk management strategy. In other words, it is the amount of the risk the entity is willing to tolerate, which is clearly documented in its risk management strategy.

(d) Risk mitigation intention[2] and the construction of benchmark derivatives.

(i) Evidence the risk mitigation intention: the risk mitigation intention needs to be evidenced by the designated derivatives relating to a specific interest rate risk point. Some outreach participants asked whether the IASB could provide more flexibility in the DRM model to address situations where entities choose to mitigate interest rate risk in some adjacent time buckets instead of the time bucket where the current net open risk position sits. More flexibility has also been requested in cases where the actual derivatives traded with external counterparty may be different to the original intention of risk managers, as they mitigate interest risk via a centralised trading desk and may decide to retain some risks for their own trading purposes.

(ii) Requirement for constructing benchmark derivatives: further clarification on specific defined principles for constructing benchmark derivatives (such as how to determine the notional, tenor, reset terms, benchmark rate, etc…) will help to ensure consistent application of the DRM model.

(e) Performance assessment and subsequent unwinding of DRM adjustments.

(i) Retrospective assessment and effect of unexpected changes: more guidance may be needed on how the retrospective assessment would be applied in practice. In addition, it might be difficult to quantify the direct effect of unexpected changes (and the resulting impacts on performance assessments and measurement), when an entity chooses to partially mitigate its current net open risk position, as in this case the DRM model does not require the extent of risk mitigated to be directly linked to individual underlying items.

(ii) Clarification of subsequent unwinding of DRM adjustment: it is necessary to consider how the mechanics of the model would work in the subsequent unwinding of the DRM adjustment, and what is the presentation requirement for profit or loss in subsequent periods.

(f) Other considerations.

(i) Applicability of the DRM model: further analysis might be necessary to clarify for which risk management strategies the DRM model could be applied, and if more than one DRM model could exist at the same time (i.e., for different business units or for different currencies).

(ii) Transition requirements: in the context of the standard-setting project, the transition requirements of the DRM model will be considered.

(g) Presentation and disclosure requirements: targeted outreach will be conducted with users to assess what additional information will be useful to their decision-making.

23 The IASB staff believed that a transparent discussion on these areas and topics would be the most efficient approach, allowing for continuous interaction with stakeholders throughout the development process of the future exposure draft (which will be published once the discussion of these areas and topics has been completed) and will help clarify how the DRM model would work, improving the overall understanding of the model.

24 On the other hand, the IASB Staff noted that each matter should be carefully assessed against the overall objective of the project and there may be cases where

[2] The risk mitigation intention id described as the extent to which an entity intends to mitigate the current net open risk position through the use of derivatives. In other words, the risk mitigation intention is a single-outcome element and could be determined based on an entity's preferred risk metrics.

it will not be possible to fully reflect the risk management in order to maintain the robustness of the DRM model and ensure useful information is provided.

25 In addition, the IASB Staff believed that it is important to firstly focus on developing a viable DRM model for interest rate risk for financial institutions before exploring whether il could apply to other industries or other types of risk.

26 The IASB Staff planned the preliminary discussions on the first topic in Q4 2022 and noted that the project timing on other topics is currently uncertain because the IASB might need to conduct further outreach or research before proceeding the deliberations.

July 2022 IASB meeting discussions

27 During the meeting of July 2022, the IASB had an initial discussion on the project plan proposed by the IASB Staff and described in the previous paragraphs. The IASB was not asked for any decisions.

28 IASB members were overall supportive to the approach and direction of the project, with particular reference to the IASB Staff views on maintaining the focus on the robustness of the model and ensuring useful information rather than fully reflect the risk management, as well as on focusing primarily on development of a model for interest rate risk only.

29 IASB members asked for an illustration example of the functionality of the entire core model as currently tentatively deliberated in order to help members and stakeholders better understand the complex mechanisms and ensure the consistent application of the model. Members also pointed out the importance of users' needs and, for this reason, it was suggested to consider the disclosure requirements in each stage of the process.

30 Due to the nature and characteristics of the DRM model, several IASB members highlighted that it must be absolutely clear that the DRM model under development for interest rate risk cannot be applied by analogy to similar transactions or other risks, by applying IAS 8, to fill potential IFRS 9 gaps.

31 In order to further highlight the difference between the hedge accounting model and the DRM model, one IASB member suggested not to use the hedge accounting terminology when the Board discusses aspects of the DRM model.

32 Another IASB member suggested to consider as early as possible in the process whether the DRM model should be applied on a voluntary or mandatory basis.

33 Finally, one IASB member suggested considering the prudential reporting requirements as a starting point for outlining the disclosure requirements and for discussing whether the DRM model (or which parts of the model) should be applied on a voluntary or mandatory basis.

Questions for EFRAG FR TEG

34 Does EFRAG FR TEG have any comments on the project plan proposed by IASB Staff, such as additional topics to be considered by the IASB?

35 Does EFRAG FR TEG have any comments on July 2022 IASB's meeting discussions?

Appendix: Summary of previous EFRAG FR TEG and EFRAG FIWG discussions

July 2022 ASAF topics on hedging equity and the IASB's recent discussions and tentative decisions.

June 2022 EFRAG FIWG meeting

Hedging equity

1 Yes, equity should qualify as a hedged item as it is a source of funding. However, not only interest rate risk is of importance, but also currency risk.

2 However, hedging of equity should not include cash flow hedging reserve (does not represent cash flows) or the excess relating to pension assets recognised in equity (as the entity is not in control of the assets). One member considered that an entity may model equity as the difference between interest-bearing assets and interest-bearing liabilities.

3 One member argued that conceptually the inclusion of equity as a hedged item is not allowing a revaluation of equity for the hedged risk (interest rate risk in this case), but rather the revaluation of the effective or aligned portion of the risk management intention.

4 Some members were not sure how the hedging of equity would work especially given that, from an accounting perspective, equity is a residual. Members responded that the accounting split between debt and equity represent a convention (that can change over time) and similarly, risk management has its conventions which may include hedging of equity or not (not all banks hedge their equity positions). For risk managers the source of funding is unimportant, there is an expectation (or contractual obligation) of a return to be provided on such funding.

5 Some members indicated that the net open position is being hedged. Therefore, the model would not be fully aligned with risk management if equity would not be eligible for designation. Otherwise, the banks would have to develop proxies and then assess how those proxies would behave. However, given the progress that has been made with the project so far it would be a step back.

6 It was mentioned that even if the net open position is hedged, this did not mean that equity is being hedged because assets and liabilities can have different maturities compared to equity; there are a lot of open positions and actual cash flows in equity could be in a different currency compared to the functional currency. For risk management, equity (of for example the banking book) is an input to the model, not a residual.

7 One member provided the example that where equity is managed to have zero economic value risk and therefore invested overnight this would not have a stabilising effect on the net interest income given the volatility of the overnight rates. In such a case, a derivative would stabilise the net interest, if temporarily. However, if the bank invested in mortgages with same average maturity, it would also stabilise the net interest income, but would not require a derivative or hedge accounting.

The IASB's tentative decisions to date

8 On the IASB's tentative decisions to date, the EFRAG FIWG members were positive about the direction of the project so far. However, it would be important to assess the draft requirements and to perform field-testing.

June 2022 EFRAG FR TEG-CFSS meeting

Hedging equity

9 In general, members agreed that equity should be eligible for designation in the DRM model as this would reflect how banks manage their risks. Also, proxy hedges should be eliminated as this no reflect how banks manage their risks.

10 Balances relating to cash flows usable for funding should be included, e.g., ordinary shares. Therefore, balances such as the revaluation reserve, foreign currency translation reserve or OCI reserve should not be included.

11 Some questioned whether the objective of hedging equity is to protect value or to lock in cash flows.

The IASB's tentative decisions to date

12 In general, members considered that the project was moving in the right direction and disclosures were considered important to support the recognition of amounts in the statement of financial position.

13 The importance of outreach was also highlighted by some members.

February 2022 IASB educational session on alternative approaches

March 2022 EFRAG FIWG meeting

14 About the proposals for DRM mechanics, most EFRAG FIWG members thought that approach B brought more useful information compared to approach A. Several EFRAG FIWG members expressed their appreciation for moving away from the cash flow hedge mechanics that only defers gains and losses from derivatives in other comprehensive income (OCI) without showing the actual offset created by derivates. Some cautioned and noted that both approaches should be subject to a field test.

15 Few EFRAG FIWG members doubted the usefulness of applying a lower of test in case of recognition of the DRM adjustment on the balance sheet; they noted that the lower of test designed in the context of micro-hedging with a different objective.

16 In addition, few EFRAG FIWG members asked how the adjustment would be tracked in case of derecognition of the hedged item. They referred to the situation in France where in the last decade basically the entire loan book was prepaid in a number of years due to the decrease in interest rates. In case the unwinding of the DRM adjustment was disconnected from the accumulated fair value changes in the hedging derivatives, it was questioned what the DRM adjustment is supposed to reflect and subsequently what the NIM represents [when considering the unwinding of the DRM adjustment].

17 The EFRAG Secretariat commented that the tracking concern may relate to the mechanics of the current hedge accounting framework. Under the DRM mechanics, the accounting would follow the risk management approach, which would use laddering[3] [the volume of core deposits] in the target profile to move between different interest levels over time [regardless of the direction]. The DRM adjustment would reflect that laddering effect and the unwinding of the DRM adjustment would be based on a banking book [portfolio] approach instead of referring to individual financial instruments.

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[3] Interest rate risk management will aim to stabilise net interest income by using modelling, which can be achieved by using moving average interest rates. When modelling, the moving average rate effect is achieved by replacing portfolios with new financial instruments once they arrive to maturity (rollover tranches or ladders).

March 2022 EFRAG FR TEG meeting

18 There was, in general, agreement with the direction of the project.

19 One member indicated that Approach A is consistent with the EU carve-out, therefore this member questioned why EFRAG FIWG members favoured Approach B.

20 Another member indicated that based on input from French banks, the direction of the project is positive and both Approaches were acceptable – there was no preference.

21 Another member doubted that Approach B provided useful information as the adjustment would not be linked to something that is already recognised on the statement of financial position. Also, it was mentioned that Approach B may result in changes in systems which could be costly to implement.

22 One member noted that if there would be a decision that the DRM model would become mandatory that would be a significant change to current practice which may have implications on the acceptation of any more final proposals of the model.

23 It was agreed to consider a field test after Phase 2 of the project and at a later stage, to assess whether the DRM mode should be mandatorily applied.

November 2021 IASB tentative decisions on risk limits and designation of a proportion of prepayable assets

December 2021 EFRAG FIWG meeting

24 Overall, the elements as approved by the IASB are very encouraging in that the model will be much closer aligned to the risk management practices of banks.

25 There was agreement that the bottom layer will probably not be essential given how radically different the DRM approach is compared to today's approach.

(a) Some considered that some of the elements of the model still need to be discussed.

(b) It is not clear how the bottom layer approach would function in a net position model such as DRM compared to the current gross hedge accounting approach.

26 However, some concerns remain:

(a) How would the recycling to P&L of OCI/the hedging adjustment to the balance sheet (depending on the hedging mechanism selected) work? If this would be based on underlying positions, that would be very onerous. If this would be based on the benchmark derivatives, the process would be simpler, but would this result in orphan OCI/balance sheet items' if the underlying items have left the balance sheet? EFRAG FIWG members considered that the new model was very different from current micro hedges and so it may be difficult to derive conclusions based on experiences from current micro hedge experiences.

(b) If the effectiveness tests are based on how regularly the balance sheet changes, this would not be operationally feasible as it effectively changes continuously.

(c) The transposition to cases where banks do not use time buckets but rather use PV011 on an overall basis or VaR2 is still unclear.

(d) How can the moral hazard around the target profile be minimised/avoided given that there would be a strong temptation to set the risk limits as wide as possible given the accounting consequences?

(e) Would there be recognition of ineffectiveness for misalignment for items such as basis differences (3-month rate versus 6-month rate) while in the risk limits?

(f) Recognition in OCI (cash flow mechanism) would not be the preference of most preparers.

27 There was again a call for testing of the model before finalisation, but there was a recognition that it may be better to defer such testing until aspects around phase 2 have been finalised to avoid overburdening of potential participants.

December 2021 EFRAG FR TEG meeting

28 EFRAG FR TEG members agreed that the tentative decisions of the IASB is positive; however, the discussion on the hedge accounting mechanism (to be completed in Q1 2022) is critical.

29 The choice of the mechanism also may impact the amortisation of the basis adjustment (if FVH) and whether this could be simplified compared to the current situation.

30 The frequency of effectiveness testing and this amortisation could increase the operational burden.

31 Field testing will be very important given the importance and size of these hedges and the different risk management methodologies.