Dynamic Risk Management
Project Update

Objective

1 The objective of this session is to update the EFRAG Board on the IASB Project Dynamic Risk Management.

The IASB project

2 IFRS 9 *Financial Instruments* introduced improved hedge accounting and disclosure requirements that enable companies to better reflect their risk management. However, those improvements did not cover specific situations in which a company uses a dynamic risk management strategy and activities to manage interest rate risk arising in open portfolios, i.e. when the risk position being hedged changes frequently in an open portfolio of changing assets and liabilities.

3 The purpose of the Dynamic Risk Management (DRM) project is to improve the usefulness of information provided about interest rate risk management and how it affects a financial institution's current and future economic resources. Consequently, this would also conclude the replacement of IAS 39 *Financial Instruments: Recognition and Measurement* with the replacement of the macro hedge accounting models.

4 Some of the main criticisms of the current macro hedge accounting models are that the application of these models presents operational challenges and complexities for preparers and makes it difficult to reflect appropriately the effects of an entity's dynamic risk management activities in the financial statements. This in turn makes the financial statements very difficult for analysts and investors to understand.

5 At the start of the deliberations on a proposed accounting model for DRM, at its December 2017 meeting, the Board tentatively decided to develop the DRM model in two phases.

6 The first phase would focus on developing the 'core areas' that are central to the model while the second phase would address areas that are extensions of concepts developed during the first phase. The core version of the DRM model focuses on dynamic interest rate risk management activities in financial institutions.

7 The elements that are fundamental to the core model are the:

(a) Target profile;

(b) Asset profile;

(c) DRM derivative instruments; and

(d) Performance assessment and recycling.

8 In the IASB's view, these areas would shape the fundamentals of the core DRM accounting model (core model) and capture a significant portion of DRM activities while providing an adequate basis for an early and thorough assessment on the merits of the model. The IASB therefore decided to gather external feedback on the core model first, before deciding whether to progress to the next phase in order to cover the non-core areas.

EFRAG TEG and FIWG

9 The EFRAG FIWG discussed the topic on 15 November 2019 and an update was provided to EFRAG TEG on 5 December 2019.

10 At the FIWG meeting in November, the IASB Staff presented the IASB's proposal and representatives of the EBF and the ESBG were invited as observers with speaking rights.

11 The IASB's objective is to bring the accounting closer to risk management, however without the ambition of aligning perfectly, as the two perspectives are not aligned.

12 The IASB purpose is to start from lessons learnt with the 2014 DP and define a possible solution to incorporate in IFRS 9, so removing the need for the existing macro fair value hedge solution in IAS 39 and IFRS 9.

13 The IASB approach is to test as a first step a "core model" limited to interest rate risk of portfolios of hedged items measured at amortised cost, before moving to a broader concept of dynamic hedge for other categories.

14 In terms of approach to risk management, the model does not require the strategy to be risk reductive but can include taking a risk position. Derivatives and cash instruments all can contribute in shaping the target profile. The bank would have to define a "target profile" and assess the effectiveness by measuring the distance between the actual and the target profile.

15 The following key messages resulted from the discussion at the FIWG meeting:

(a) achieving comparability could be challenging, as the "target profile" is an entity-specific concept;
(b) members expressed appreciation that the project is to reflect practices by banks, e.g. including core demand deposits with discretionary rates in the scope;
(c) members expressed concerns about the additional volatility resulting in OCI from revaluation of a substantial part of the risk-mitigating derivatives. Such volatility could be material, would be difficult to explain and its treatment for prudential purposes would have to be considered;
(d) the model introduces the new concept of "asset profile", while banks target the sensitivity values considering all asset, liabilities and derivatives together. The model assumes that the bank has a specific target level for the risk management metrics, while in practice banks define "risk appetite", i.e. range of possible values, which is not subject to frequent changes although the position in such a range will change regularly. An issue would be to assess whether each time that the actual profile changes a new target profile has to be defined: this would have to be assessed in practice;
(e) the model excludes interest rate exposures that arise from instruments classified at FVOCI, while such instruments may be at the same time hedged on a micro-hedge perspective and the resulting synthetic position may be included in the overall interest risk management;
(f) the DRM project has to consider the current practices of the banks that apply the carve-out as described above. The field test should include both entities that apply the carve-out and banks that do not apply it. What drives currently the choice to apply the carve-out is not a specific risk management approach but rather the structure of the balance sheet. The carve out is applied by the following two categories of banks:
  i. banks that do not have sufficient floating rate assets to apply "proxy" cash flow hedges for fixed rate exposures resulting from core demand deposit liabilities, as such, they need to be able to hedge directly their core deposits (as allowed by the carve-out);

   ii. banks that have fixed rate loan exposures which they manage on a bottom layer basis. This approach is relevant when dealing with the prepayment risk, as banks only designate the stable part of their mortgage portfolio ("bottom layer"), i.e. prepayments do not affect the hedge unless their volume is so high that it hits the designated bottom layer amount (circumstance allowed by the carve-out).

(g) members considered that the IASB should illustrate the proposed model for a bottom layer approach under the carve-out. This is where the stable part of the portfolio (i.e. the bottom layer) is unlikely to be affected by prepayments and behaves like a fixed rate exposure. In IFRS 9 paragraph BC6.439(b), the IASB acknowledged that "hedging layers of groups of items (for example, a bottom layer) is a common risk management strategy. Therefore, this risk management practice should be reflected in the DRM.

Next steps

16 The IASB met on 23 October 2019 to discuss its plan to consult stakeholders on the core elements of the DRM accounting model. After that consultation, the IASB will decide how best to pursue the next phase of the project, which is to develop the DRM accounting model further. According to the most recent project plan, the IASB will discuss the results of the outreach in Q2 2020.

17 The deadline for financial institutions to confirm their interest in the IASB outreach was December 2019. The EFRAG Secretariat has collected confirmations of interest from a number of European banks with different sizes, business models and countries. The EFRAG Secretariat will develop a proposal for the involvement of EFRAG in the IASB outreach in the next weeks and the EFRAG Board will be updated accordingly.

Agenda Papers

18 In addition to this note, agenda paper 08-02 - Dynamic Risk Management presentation is provided as background only.

Question for EFRAG Board members

19 Do you have comments on this project update? Please explain.