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Dynamic Risk Management[1]
Cover Note

Objective

1 The objective of the session on DRM is to provide to the EFRAG Board on:

(a) the IASB's discussions in September 2021;

(b) concerns about the consequences of the EU carve-out and the current position in the standards;

(c) the progress so far with the plan to obtain views from stakeholders about the carve-out as suggested by the EFRAG Board.

Background

2 IFRS 9 *Financial Instruments* have not changed the hedge accounting requirements for risk management with open portfolios and portfolio hedging under IAS 39 still applies. The IASB is considering a new model to replace these requirements.

3 The replacement is of interest to those in Europe using the EU carve out but also to those banks who currently apply the portfolio hedging option in IAS 39 as issued, who require improvement to the current model.

IASB project (2015 to now)

4 The IASB started its discussions on the current project in 2010. Below is some of the recent highlights in the IASB project, including EFRAG activities/reports.

Project stage	Further details/links	Reference
IASB Core Model and outreach 2015 – 2021	• IASB development of the Core Model • EFRAG TEG/CFSS and EFRAG FIWG • IASB outreach (2020/2021)	Paper 06-04 of May 2021 TEG meeting
Feedback May/June 2021	• EFRAG Board meeting: June 2021	Paper 05-02 and 05-03
This meeting	• **September 2021 discussions of the IASB** • **IASB objections against the carve-out** • **Progress re carve out outreach**	This paper with further details in the TEG papers
Next steps	• The IASB will continue its deliberations and EFRAG will do outreaches on the carve-out. • The EFRAG Secretariat will continue to update EFRAG TEG and Board on these.	

[1] The DRM team consists of the following members: Almudena Alcalá; Didier Andries, Fredré Ferreira (team leader) and Sapna Heeralall.

The IASB's project plan

5 The IASB agreed at its meeting on 24 May 2021 to the following re-deliberation plan:

Indicative timeline	***Topics***
September 2021	Interaction between risk limits and target profile
November 2021	Designation of a proportion of prepayable assets
Q1 2022	Recognising changes in fair value of derivatives in OCI
H1 2022	Decide on project direction

Interaction between risk limits and target profile

6 Participants in the DRM outreach shared the concern that the IASB's model did not reflect the risk management practice of risk limits but focussed on a single outcome.

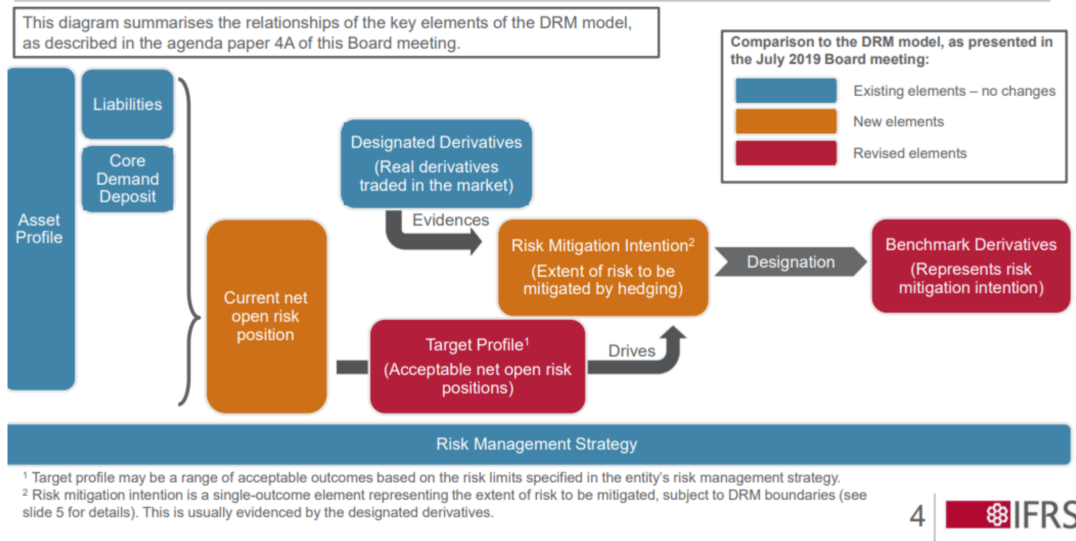
7 At its September 2021 meeting, the IASB discussed proposals from its staff to modify the current model to deal with these comments as follows:

(a) Introduce the concept of a 'Current net open risk position' that refers to the net repricing positions of assets, liabilities and core demand deposits in the hedge;

(b) 'Target profile' to be redefined as the 'acceptable net open risk positions' (i.e., within the risk limits);

(c) A new concept of 'risk mitigation intention' with the designated derivatives (i.e., the traded derivatives) are deemed as providing evidence of such intention;

(d) When comparing the benchmark derivative, aspects such as volume would be derived from the risk mitigation intention. The benchmark derivative would also reflect the characteristics of the open risk positions with respect to interest rates and prepayments etc. as reflecting the risk mitigation intention.



From IASB agenda paper 4B, September 2021

8 Two tests are also introduced to assess whether:

(a) The bank has mitigated the risk (no additional risk has been introduced); and

(b) The target profile has been achieved (the hedged position is within the risk limits).

9 The IASB Staff considered that these changes would not preclude a fair value hedge mechanism as the DRM model is not tied to a specific hedging mechanism.

10 For further information please refer to [EFRAG TEG agenda paper 09-02].

11 The IASB met on 21 September 2021 to discuss these possible modifications, but it was not a decision-making session. The IASB raised the following comments:

(a) Board members commended the IASB Staff for their responsiveness to comments received and in general approved of the new concepts introduced without fundamental changes to the basis recognition of performance.

(b) Some were concerned about the flexibility or reasonability of risk limits, however, others pointed out how heavily these are regulated internally (given the importance to operations) and externally. The IASB Staff also confirmed that hedge accounting would discontinue upon changes to risk limits;

(c) Similarly, some IASB members were concerned that it would not be possible to distinguish between those entities with very wide risk limits compared to those who have a lower risk appetite. In the same way, two identical banks with different risk limits would reflect different outcomes;

(d) Thus, disclosures would be essential for purposes of understandability and comparability. One member asked the Staff to consider disclosure of the risk limits and another advised that prudential reporting may be useful inspiration;

(e) The IASB Staff indicated that generally banks do risk management on entity level, and they would need to reconsider the current definition for portfolios (no mixing of characteristics and currencies) if intending to align the accounting with practice, i.e., on entity level; and

(f) Some cautioned that the model may be becoming too complex and there was a question whether the model should continue to be voluntary, and its fit with classification and measurement under IFRS 9.

*EFRAG FIWG – **4 October 2021***

12 EFRAG FIWG commented as follows:

(a) this is a step in the right direction as being closer aligned to risk management and/or the carve out, but given differences in risk management practices it may be difficult to find a common model;

(b) a test of these proposals is needed before final conclusions can be made;

(c) increased complexity of the model given the effectiveness tests and possible frequent benchmark derivative changes with cost implications. Tracking of limits by time bucket may be difficult and add an artificial allocation step (i.e., transforming a PV01 measure into a repricing gap analysis measure);

(d) share concern that the model may incentivise counter-intuitive actions around risk limits which may require robust countermeasures such as disclosures;

(e) the impact of discontinuation of hedge accounting due to changes to risk limits is a big change from today, however, this currently does not happen often;

(f) the impact of internal transactions/hedges as well as the possibility of a matrix of risk appetites as well as defining decrease of risks (by fixing variable rates, one increases the fair value risk related to those items).

*EFRAG TEG – **21 October 2021***

13 EFRAG TEG members raised the following points:

(a) An easy solution may not be possible given the complexity of the topic, but it is clear that the project is moving in the right direction and that this development is positive. Some remained cautious given early stage of the discussions and the outcomes of the next steps are unclear;

(b) Testing of the updated proposals is essential to assess their validity;

(c) Internal derivatives would need to be addressed given that the Banking Book is generally risk neutral (apart from some basis risk that cannot be or is preferred not to be transferred);

(d) Some questions around how the benchmark derivative would work in practice;

(e) Risk management, risk limits and risk frameworks may exist in a risk matrix and therefore, it may be difficult to apply these concepts in practice;

(f) There is a variety of possible risk management strategies and a mitigating transaction for one bank can be seen as opening a risk position in another bank. The wording around increased risk will have to be clearly defined;

(g) Change in risk limits need to be defined and the related accounting delineated;

(h) The risk framework of banks encompasses all risks, not only risks defined according to the accrual of interest; also, fair value risks are to be considered. Some banks focus on the former, other on the latter.

(i) Supports additional disclosures as where the accounting follows the risk management practices, comparability would be impacted. Still, disclosures can be highly sensitive, e.g., disclosures of risk limits would not be supported.

Questions for EFRAG Board

14 Does EFRAG Board have comments on the summary above?

European Carve out of IAS 39

15 At previous meetings of EFRAG Board, the EFRAG Secretariat was asked to investigate to what extent, after 15 years of continued practice, the IASB concerns that were at the origin of the EU carve out at time of issue (or since) are still valid today.

16 The following issues have been identified:

(a) The use of core demand deposits as a hedged item which is not currently allowed under IAS 39 due to the interaction of IFRS 13 which says that items with a deposit floor cannot be recognised at a lower value. Both the portfolio revaluation approach (PRA DP 2014) ***and the DRM model*** is clear that these would be allowed as hedged items;

(b) Hedged items with a sub-benchmark interest rate where in some cases the accounting may not reflect the economic reality, such as negative interest rates where the market rates are positive. Feedback was requested on the topic with the ***PRA DP*** especially in the context of transfer pricing where below-benchmark rates may be relevant. (Paragraph 3.10.13 of the 2014 DP) The inclusion of these were broadly supported by constituents. The ***DRM model*** currently does not deal specifically with this issue; and

c) Bottom-layer approach when designating hedged items which is not allowed under IAS 39. Use of a bottom layer improves hedge effectiveness.

To illustrate a ‘bottom layer’ approach, in the, the following example[2] was provided in the PRA DP: Assume that a bank has a €100 million portfolio of prepayable fixed interest rate loans with a 5-year contractual maturity. The bank expects prepayments of €35 million with €65 million expected to remain outstanding for the full period. The bank may enter into a 5-year swap to pay fixed and receive variable interest on a notional amount of €60 million, i.e., recognising that there is a margin of error in the behaviouralisation estimate. Is the hedged item then the €100m or €65m or €60m? A bottom layer

[2] Paragraph 3.7.1 of the DP, CU changed to euros.

approach would assume the hedged item is €60m whereas under IAS 39 the most effective designation possible would be €65m of the portfolio.

In substance, in the bottom layer approach, if some assets prepay earlier than expected, such decreases are assumed to be from the unhedged layer, rather than across the whole portfolio. When developing IAS 39, the IASB was concerned that using the bottom layer, not all ineffectiveness is recognised.

Feedback was requested under the ***PRA DP*** and there was wide support to allow to designate a bottom layer, but this concept was not included in the first version of the **DRM model**. However, in the DRM outreach, some indicated that the designation of a bottom layer would represent their risk management view but for others it was only an accounting concept. The IASB will discuss the issue of the designation of a proportion of prepayable assets at its November meeting. Accordingly, a final assessment is not feasible at this stage. Given its September 2021 initial discussions, as the risk mitigation intention will be evidenced by the traded derivatives, this is not expected to be an issue.

17 For further information please refer to EFRAG TEG agenda paper 09-03.

*EFRAG FIWG discussions – **4 October 2021***

18 Agreement that customer demand deposits have been resolved under both the PRA and the DRM core model.

19 On sub-LIBOR issue: this is not yet resolved and require further work by the IASB.

20 The introduction of risk management intention may mean that the bottom layer is not needed as no misalignment when within the risk limits.

*EFRAG TEG discussions – **21 October 2021***

21 The EFRAG Secretariat should try to capture the extent of the use of the carve-out, e.g., it may be used for only a small portion.

22 Use of the carve-out use have increased over time due to the low interest rates.

Questions for EFRAG Board

23 Does EFRAG Board have comments on the summary above?

Next steps

24 The EFRAG Secretariat will update EFRAG Board on the IASB's discussions.

25 At previous meetings of EFRAG TEG, the EFRAG Secretariat was tasked to investigate the perception of auditors and regulators of the current carve out and investigate the prevalence of those banks that do not use the carve out.

26 The EFRAG Secretariat is planning workshops with auditors, and regulators to discuss the EFRAG Board's questions around the carve-out in early December.

27 A similar process with a survey and video is planned to understand user perceptions and needs with respect to the carve-out/dynamic risk management.

Questions for EFRAG Board

28 Does EFRAG Board have comments on the proposed next steps above?