DRM: proposed changes with respect to risk limits
Issues Paper

Objective

1 The objective of the session is to provide EFRAG TEG with an update on the IASB staff proposals for changes to the DRM core model, including feedback from EFRAG FIWG about their operationality. These proposals deal specifically with the concerns heard during the outreach relating to risk limits.

Background information

2 For further information about the model as previously discussed with EFRAG TEG, please see Appendix 1.

3 As highlighted in the feedback provided by the EFRAG Secretariat at the May TEG meeting and the IASB staff, all participants to the DRM core model outreach were concerned about the current single target profile. They considered that such a single proposed outcome does not reflect their risk management strategies or the business model. The use of risk limits means that rather than one ideal outcome, the risk management strategies allow a range of possible outcomes after executing risk management decisions. The participants argued that a similar range should be implemented for purposes of DRM as well to easy operational burdens related to the model.

4 Challenges with the current description of the target profile in the core model:

(a) it assumes a single outcome. This single outcome then represents a key element in the measurement of ineffectiveness in profit or loss. This contradicts the use of risk limits that imply a range of acceptable outcomes through the risk limits;

(b) it considers the assets and liabilities of the entity as two separate elements, but from a risk management perspective, assets and liabilities are considered in combination to determine the net open risk position;

and

(c) although an entity's risk management strategy (or risk limits) is not expected to change frequently, the extent to which the entity decides to carry out further risk mitigation activities within the risk limits, such as using derivatives, may change frequently including several times daily. These changes in risk mitigation activities may relate to numerous factors.

5 The IASB Staff prepared agenda paper 4A for the IASB's September 2021 meeting and suggested the following refinements for the DRM model to better reflect an entity's interest rate risk management strategy and activities in the financial statements. These are as follows:

(a) the definition and objective of the target profile;

(b) the inclusion of a risk mitigation intention; and

(c) the construction of the benchmark derivative.

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

6 This then results in retrospective performance assessments that are also discussed below. However, the other elements of the DRM model are not affected by these proposals.

Current definitions

7 The ***target profile*** represents both *what* risk the entity wants to manage (risk management strategy) and *how* (i.e., the extent to which) the entity wants to mitigate the risk (risk management objective). It is currently based on the following principles:

(a) The target profile represents management's objective for a given asset profile;

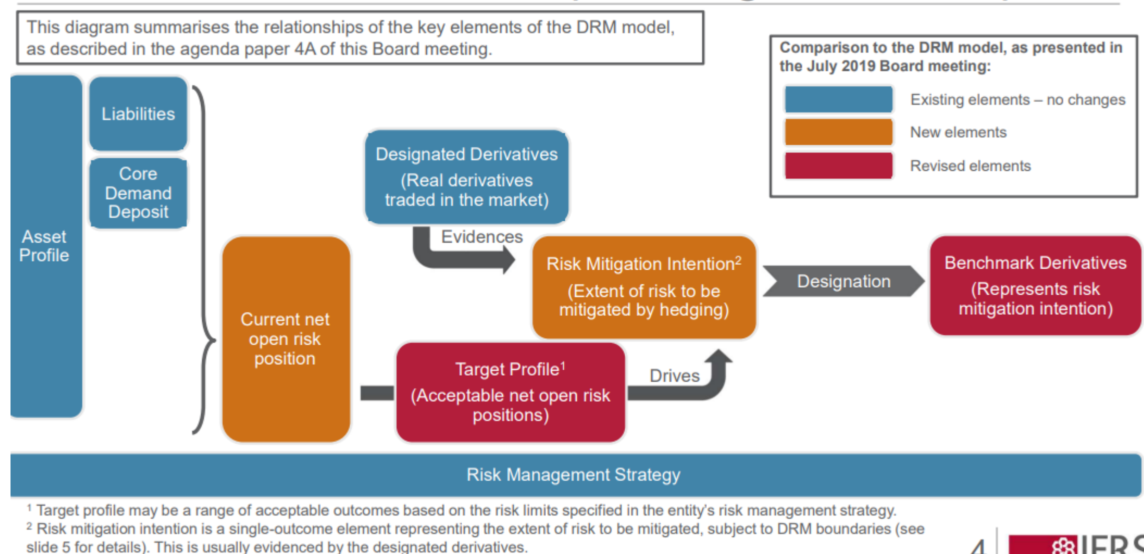
(b) The bank's risk management strategy defines the target profile considering: (i) the contractual terms of financial liabilities; and (ii) the bank's approach to core demand deposits where present.

(c) The notionals of the asset profile and the target profile are required to be the same but not the tenors;

(d) The DRM model would not permit negative balances to be designated within the target profile; and

(e) The time horizon of the target profile is the period of time over which the bank is managing interest rate risk.

Proposed amendments in the IASB Staff paper



From IASB agenda paper 4B, September 2021

Definition and objective of the target profile

8 Under IFRS 9, the designation of hedges needs to set out both the entity's risk management strategy and objective for undertaking the hedge. The former is established at the highest level of risk management, but the risk management objective applies at the level of the specific hedging relationship. The risk management objective describes how the hedging instruments hedge a particular risk exposure. As the IASB Staff summarises the risk management strategy may include many hedging relationships to execute such strategy. The objective is important to determine the effectiveness of the hedging relationship as it sets out the extent to which the risk will be managed.

9 The IASB staff indicates that the current definition of the target profile includes both these elements and consider that it would be clearer if the target profile only represents the risk management strategy element. A new element should be included in the model to represent the risk management objective element.

10 A new definition of the target risk profile therefore could be: "the acceptable open risk position given an entity's risk management strategy". The acceptable open risk position would reflect the acceptable range as reflected by the risk limits, while still complying with the entity's overall risk management strategy.

11 The IASB Staff is of the view that such a change is consistent with the IASB's original intention that the target profile represents the entity's objective for a given asset profile. They also have identified the following benefits:

(a) The revised definition is more intuitive and aligned with risk management practices; and

(b) This would mean that the DRM model is closer aligned to the general hedge accounting model in IFRS 9, which will improve the understandability and operability of the DRM model.

The risk mitigation intention

12 The IASB Staff suggests that the risk mitigation intention could be a new element to be incorporated into the DRM model. The risk mitigation intention could assist to relate as to how the particular derivatives are used to mitigate the portion of risk exposure the entity wants to mitigate. This would be similar to the role that the risk management objective under the general hedge accounting model of IFRS 9 is playing.

13 However, such a risk mitigation intention would be subject to certain boundaries (DRM boundaries):

(a) the risk mitigation intention cannot create new risks[2]; and

(b) the risk mitigation intention shall transform the current net open risk position to a residual risk position that is within the target profile.

14 The DRM boundaries are intended to limit DRM hedge accounting so that an accounting exception is not allowed where an entity creates a synthetic risk position that does not arise from its assets and liabilities. This is in line with the current restrictions to the target profile that do not permit negative balances in the target profile.

15 This risk mitigation intention is therefore the single-outcome element representing the extent of risk mitigation through derivatives, subject to the DRM boundaries. It can be expressed as the portion of the current net open position that the entity wants to mitigate (as expressed in PV01 or nominal terms) through the use of derivatives.

16 However, unlike under the general hedging model, changes in management objective would not affect continuation of the DRM model.

17 The IASB Staff considers that the risk mitigation intention might be evidenced by the designated derivative available relating to a specific interest risk point or benchmark interest rate risk. The IASB Staff argues that the actual externalisation (i.e., the actual derivatives traded with third parties outside the group) is directly linked to an entity's target profile which mandates the risk the entity accepts.

[2] Defined as "the cumulative amount of risk to be mitigated through derivatives must reduce the interest rate risk by bucket of the current net open risk position by time bucket and cannot exceed the total amount of risk by time bucket (an entity cannot over hedge its current net open risk position)".

18 Therefore, while the updated target profile definition relates to a range of acceptable outcomes, the risk mitigation intention is a fixed amount of risk to be mitigated through derivatives for a set period of time. The period would depend on the frequency of changes to the underlying portfolio. The plan is that changes in the risk mitigation intention will impact a retrospective assessment of performance which then may lead to measurement of misalignment (currently called ineffectiveness) in the financial statements.

The construction of the benchmark derivative

19 The current definition of the benchmark derivative, based on the IASB's tentative decisions, is the theoretical derivative that would perfectly transform the asset profile into the target profile. The IASB Staff considers that in the context of the above-mentioned changes, the construction of the benchmark derivative must be based on the risk mitigation intention rather than the target profile.

20 As explained above, the target profile would represent the acceptable open risk position given the entity's risk management strategy, but it does not specify the extent to which the entity decides to mitigate the risk. The extent to which such risk mitigation takes place is determined through the risk mitigation intention. Once constructed, the benchmark derivative is used as the theoretical single outcome derivative which then can be the anchor point for measurement purposes.

21 The IASB Staff acknowledges that in practice the risk mitigation intention, which the benchmark derivative is based on, might often be evidenced through the traded designated derivatives. Therefore, the question arises whether there would be ever any misalignment recognised in the financial statements because the benchmark derivative would equal the designated derivates.

22 The IASB Staff considers this unlikely for the following reasons:

(a) The benchmark rate referenced in the designated derivative may not match the designated hedge risk in the DRM model (due to basis mismatch such as a SONIA derivative traded to hedge a 3-month Euribor benchmark risk);

(b) The tenor might similarly not match, e.g., trading a 6-month Euribor to hedge a 9-month Euribor risk; and

(c) The designated derivative might not achieve the risk mitigation intention due to a maturity or volume mismatch for example if one has an open risk position of 200 and then take out a derivative with a notional of 205. In this case, the designated derivative will be limited to a notional of 200 as the derivative of 205 would increase risk.

23 Overall, the benchmark derivative cannot impute terms of the designated derivatives which do not reflect the risk mitigation intention, i.e., the characteristics in the hedged item.

Retrospective performance assessments

24 These refinements to the DRM model also contemplate the following retrospective performance assessments to determine the effect of unexpected changes to the current net open risk position. These include assessing whether:

(a) The entity has mitigated interest rate risk; and

(b) The target profile has been achieved.

Mitigation of interest rate risk

25 As described in paragraphs 13 and 14 the DRM boundaries are intended to prevent hedge accounting for synthetically creating risk positions. This remains true even if the entity's residual risk position falls within its target profile.

26 This requires a retrospective test whether the entity was over-hedged. Such a test would compare the current net open risk position at the end of the period with the risk mitigation intention.

Period 1

Step 4

Accountants consider the unexpected changes to the current net open risk position based on latest ALM information, and compare that against the risk mitigation intention.

This step covers the effect from unexpected changes to the underlying assets and liabilities considered in the previous period (ie Period 0). Other changes (such as additional new businesses) are only considered in prospective steps (Step 4). One possible way to reflect the impact of unexpected changes is by amending the benchmark derivatives if one of the DRM boundaries is breached.

In this example, we assume there was a change in the expected repayment date for the prepayable assets, and thus part of the PV01 in year 5 bucket had moved to year 4 bucket unexpectedly.

	bucket (yrs)	1	2	3	4	5	
	Prepayable Assets (PV01)				160	940	+60 of PV01 moved from Y5 to Y4
	Term Liabilities (PV01)				-100	-500	
A	**Current Net Open Risk Position (updated)**	**0**	**0**	**0**	**60**	**440**	Excluding new business
B	**Risk Mitigation Intention (for Period 0)**				**0**	**-490**	
C	Total of A and B	0	0	0	60	-50	
D	Target profile	50	50	50	50	50	
	Check for risk mitigation (A vs B)	OK	OK	OK	OK	Over	
	Check within target profile (C vs D)	OK	OK	OK	Over	OK	
	Amendment Required?	No	No	No	Yes	Yes	

Amendments are needed as the residual open risk position falls outside of the risk limits in Year 4 bucket and does not satisfy the risk mitigation requirement in Year 5 bucket.

9 IFRS

From the IASB Staff paper 4B, September 2021

27 Where the entity is deemed to be over-hedged, this would result in misalignment that would be recognised in profit or loss. However, if the effect of unexpected changes to the current net open risk position means that the risk mitigation intention is lower than the current net open risk position (under-hedge?) at the end of the period under assessment, that would not give rise to misalignment.

Has the target profile been achieved?

28 An additional test is necessary to ensure that the current net open risk position falls within the target profile. To the extent this is true, there will be no misalignment, however, where the residual risk position falls outside the target profile this would be recognised in the profit or loss. Please see slide 9 of the IASB agenda paper 4B for an example.

29 The IASB Staff argues that this would provide useful information to users and would be consistent with the risk management view and how risk managers evaluate performance of risk management actions. The EFRAG Secretariat notes that misalignment here means a breach in limits which are currently quite rare and which would raise internal and regulatory concerns.

Operability of the DRM model

30 The IASB Staff highlighted that as many participants indicated that if an entity sets one overall risk limit rather than identifying risk limits for each maturity bucket, this may have implications for the robustness of the model. Therefore, the Staff plan to do further research and analysis on this matter.

31 The following require further inputs as to feasibility are:

(a) Conversion of various risk metrics into a target profile by maturity buckets; and

(b) Capability to distinguish existing positions from new business.

The IASB discussions

32 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 and questions:

(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 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) Therefore, disclosures would be essential for purposes of understandability and comparability. One member asked the staff not to dismiss disclosure of the risk limits and another suggested that prudential reporting may be useful;

(e) Some suggestions for changes to terminology used;

(f) Would the model be applied at entity or portfolio level? The 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;

(g) Some cautioned that the model may be becoming too complex;

(h) Should the model continue to be voluntary and how does this fit with classification and measurement under IFRS 9;

33 The IASB Staff confirmed that the discussion on P&L versus OCI recognition would be brought back to the IASB for further discussion at a later stage. They also commented that this reflects the mechanics of the hedge accounting and these decisions about the model would not impact the later decision on the location of these amounts.

34 The IASB Staff expect to incorporate the comments received from today's meeting and bring back for a tentative vote at the next IASB meeting.

EFRAG FIWG discussions

35 EFRAG FIWG met on 4 October 2021 and commented as follows on the IASB's discussions:

(a) this is a step in the right direction as being closer aligned to risk management and/or the carve out;

(b) before being able to express an informed view on the changes, a test of these proposals is needed, similar as was done with core model;

(c) differences in risk management practices may mean that a common model may be hard to find;

(d) increased complexity given the double testing and possible frequent benchmark derivative changes (this may also have cost implications). Furthermore, tracking of limits by time bucket may be difficult and add an artificial allocation step (i.e., transforming a PV01 measure into a measure based of a repricing gap analysis);

(e) share concern of some IASB members that the model may incentivise counter-intuitive actions around risk limits which may require robust disclosures as counterbalance or another way to mitigate that;

(f) 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;

(g) focus should be whether disclosures/financial statements would be able to provide more useful information than currently;

(h) 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).

Questions for EFRAG TEG

36 Does EFRAG TEG consider that the proposed IASB Staff approach will address the challenges presented in paragraph 4 above?

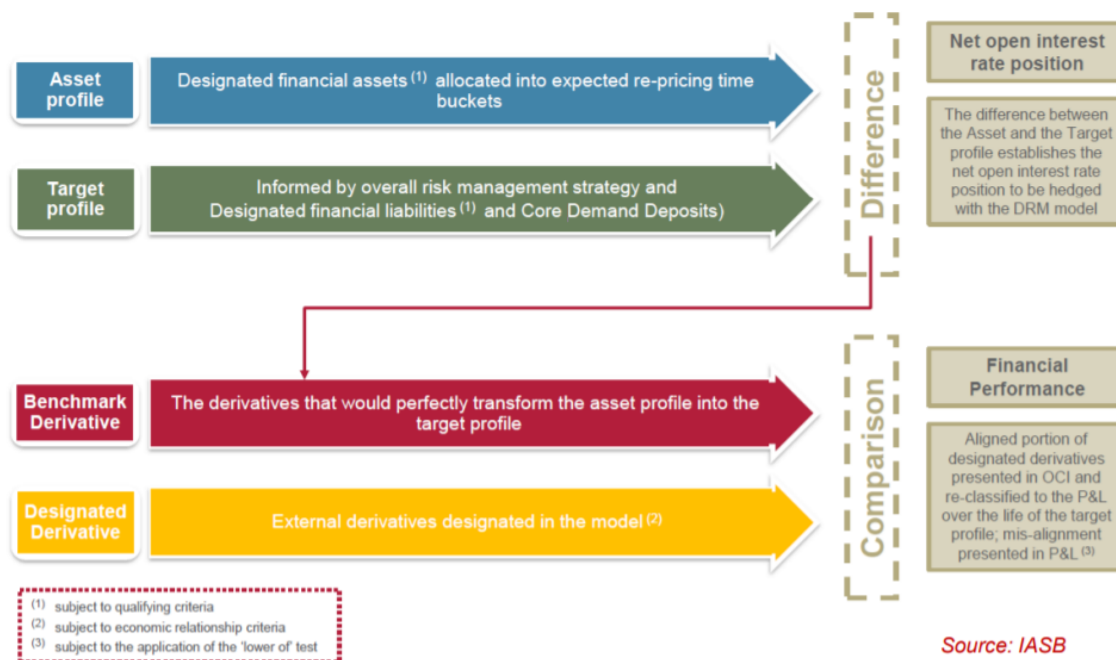
37 Does EFRAG TEG have comments or questions on the IASB Staff paper, the IASB's discussions or EFRAG FIWG comments?

Appendix 1: Background information on the DRM model

1 This appendix serves as a reminder to EFRAG TEG members about the main concepts of the core DRM model before the IASB's discussions in September.

2 The basis for this appendix is slides 16 to 23 of Paper 06-04 of EFRAG TEG May 2021 meeting. For further information please refer to paper 4A of the EFRAG TEG May 2021 meeting which is a demonstration of the model under various scenarios.

DRM model overview



Source: IASB

Asset profile

- The asset profile allocates designated financial assets (FA) into time buckets based on their re-pricing dates
- At a minimum, portfolios should comprise of FA of the same currency and with similar prepayment features.
- Qualifying criteria:
  - FA are measured at amortised cost under IFRS 9
  - Future transactions are highly probable and will result in FA measured at amortised cost
  - Items within the asset profile are managed on a portfolio basis for interest rate risk
  - Items already designated in a hedge accounting relationship for interest rate risk are not eligible under the DRM model (cannot double hedge) *
  - The effect of credit risk does not dominate the value changes.

* It is not clear how de-designation under IAS 39/IFRS 9 and designation under the DRM model would work as this forms part of transition which will be considered later.

Target profile

- The target profile could be described as the funding profile adjusted for the entity's risk management strategy and approach regarding core deposits.

- At a minimum, portfolios should comprise of liabilities of the same currency and core deposits are separated from other liabilities.
- Qualifying criteria:
  - Financial Liabilities (FL) are measured at amortised cost
  - Financial Transactions that are highly probable and result in FL measured at amortised cost
  - These items are managed on a portfolio basis for interest rate risk; and
  - These items are not designated in a hedge accounting relationship for interest rate risk.

The DRM model allows the target profile to be flexible to reflect the risk management strategy of the entity

Core demand deposits

Stabilising the Net Interest Income (NII) when the asset profile is entirely funded by core demand deposits raises complications as core demand deposits represent perpetual funding

Key features of core demand deposits

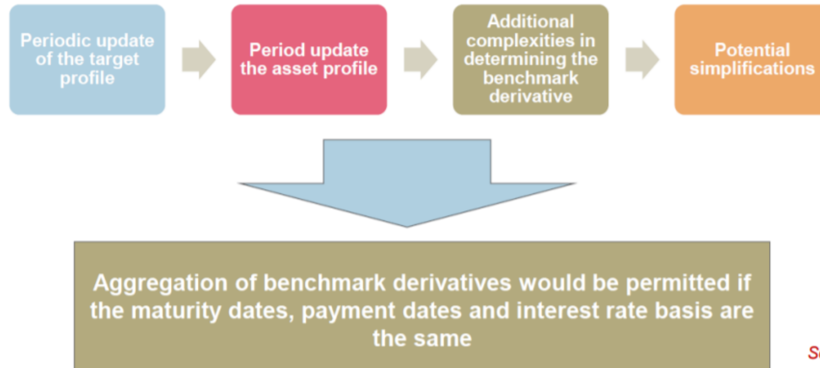
- Demand feature
- The notional of demand deposits treated as core and the associated tenor must be based on reasonable and supportable information
- The interest rate paid can only change at the discretion of the deposit issuer. The entity cannot be contractually obligated to change the interest rate paid when market interest rates change

Benchmark vs designated derivatives

- Benchmark derivative is the theoretical derivative that would perfectly transform the asset profile into the target profile
- Designated derivatives within the DRM model are expected to be successful in meeting the same alignment target
- Qualifying criteria:
  - There is an **economic relationship** between the target profile, the asset profile and the derivatives designated within the DRM model
  - Any designation **does not reflect an imbalance** that would create misalignment that could result in an accounting outcome inconsistent with the purpose of the DRM accounting model.

Benchmark and designated derivatives continued.

- As the DRM model allows for designation of open portfolios, the portfolio of derivatives required for alignment will also change.
- The benchmark derivative will become a portfolio of derivatives over time due to the dynamic nature of open portfolios.



Source: IASB

Performance reporting

- The aim of the DRM model is to faithfully represent the impact of a financial institution's risk management activities
- An entity perfectly achieves its risk management strategy. The model should reflect its risk, in the statement of profit or loss

Perfect Alignment

- *Achieved when the asset profile, in conjunction with the designated derivatives, equal the target profile*
- *These derivatives are called the benchmark derivative in the model*

Imperfect Alignment

- *Achieved when the designated derivatives are different from the benchmark derivative*
- *The effects of imperfect alignment on the entity's current and future economic resources*