

## **DRM – Issues in relation to the carve-out Issues Paper**

### **Objective**

- 1 The objective of this paper is to provide an overview of the IASB's reasoning on requirements of IAS 39 that were at the origin of the EU carve-out<sup>1</sup> and whether these are still relevant, as requested by EFRAG Board at its meeting on 9 June 2021.

### **Description of the issue(s)**

- 2 The following issues have been identified:
  - (a) The use of core demand deposits as a hedged item;
  - (b) Hedged items with a sub-benchmark interest rate; and
  - (c) Bottom-layer approach.

#### *The use of core demand deposits as a hedged item*

- 3 The fair value of a financial liability with a demand feature (e.g., a demand deposit) cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. (IFRS 13, paragraph 47)
- 4 So, for accounting purposes, liabilities that are callable on demand (such as non-term deposits) are measured at the nominal or demand amount. These therefore are assumed to have no fair value risk with regard to interest rate changes, because they can be withdrawn immediately. In addition, demand deposits are ineligible for cash flow hedge accounting as their associated interest cash flows, if any, do not vary with interest rates. (IAS 39 BC 182-192)

#### *EFRAG Secretariat analysis*

- 5 Under the 2014 DP detailing the **Portfolio Revaluation Approach**<sup>2</sup> (the PRA), the IASB had decided to include behaviouralised core demand deposits as it is consistent with the risk management activities of banks. (2014 DP paragraph 3.9.10)
- 6 The IASB tentatively decided at its April 2018 meeting that the **Dynamic Risk Management (DRM<sup>3</sup>) model** will allow for inclusion of core demand deposits in its target profile based on a bank's risk management strategy. This is conditional on the deposits having a demand feature and that they will not reprice with a change in market interest rates. The interest rate paid can change only at discretion of the issuer (i.e., the bank) and the bank is not contractually obligated to change the interest rate paid when market interest rates change. Furthermore, the notional amount of core demand deposits and their tenor must be based on reasonable and supportable information. For those deposits that do not meet the proposed requirements would be included as part of other liabilities under the model.

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<sup>1</sup> For further information about the carve-out please refer to Appendix 2 of this document.

<sup>2</sup> While respondents rejected this approach, it is important to note that it reflected the use of a fair value hedge accounting mechanism similar to the current IAS 39 portfolio hedging model.

<sup>3</sup> As discussed previously, this model currently under development uses a cash flow hedge accounting mechanism.

- 7 Therefore, the EFRAG Secretariat considers that from an overarching perspective this issue has been resolved and is not aware of any further concerns on this topic based on the outreach.

*Sub-benchmark interest rate issue*

- 8 This issue arises when an entity uses a hedging instrument that is based on a benchmark risk to hedge an item with total cash flows that are less than those associated with that benchmark, e.g., an interest rate swap derivative based on Euribor to hedge an asset paying Euribor less 20 basis points (bps).
- 9 IFRS requires that if an entity wants to designate a component (such as interest rate risk relating to Euribor) of the cash flows of a financial or a non-financial item as the hedged item, that component must be less than or equal to the total cash flows of the entire item (IFRS 9, B6.3.21/IAS 39, AG99C). This requirement was carved out to allow hedging of the interest rate component of core deposits remunerated at zero or below market interest rate.
- 10 While re-deliberating the requirement during the development of IFRS 9, the IASB concluded that in various scenarios, allowing such designations would result in outcomes that are inconsistent with the economics of the instrument being hedged. The example based on BC 6.226 is included in Appendix 1. Other examples separately from the one in Appendix 1 relating to a zero floor was considered in the following [paper](#).
- 11 However, IFRS 9 allows the designation of all of the cash flows of the entire item as the hedged item and hedged for only one risk such as interest rate risk relating to Euribor. In such a case, an entity may adjust the hedge ratio to a ratio other than a one-to-one to improve hedge effectiveness. (IAS 39 paragraph AG99C; IFRS 9, B 6.3.23). Also, where a fixed-rate item is hedged only after its origination (and benchmark rates have changed), the entity can designate a risk component equal to a benchmark rate that exceeds the contractual rate. This is only possible where the benchmark rate is still lower than the effective interest rate calculated as if the entity purchased the instrument on the date of the designation. (IFRS 9, B 6.3.23)

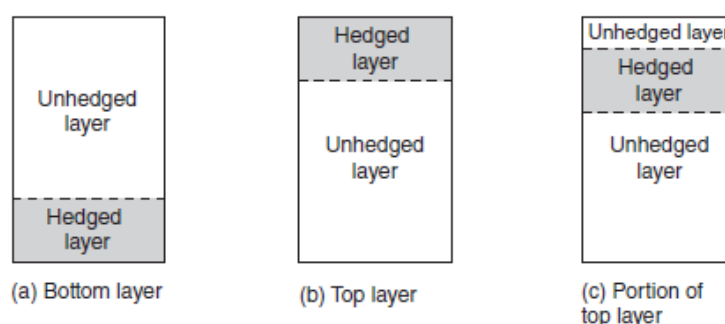
*EFRAG Secretariat analysis*

- 12 The EFRAG Secretariat notes that the current economic environment means that previous 'uneconomic' outcomes such as negative interest rates are now part of the economic landscape.
- 13 In the 2014 DP, it was indicated that the **PRA model** is not a modification to hedge accounting, but rather "a new approach for accounting to be more aligned with dynamic risk management". Feedback was requested on the topic especially in the context of transfer pricing where below-benchmark rates may be relevant. (Paragraph 3.10.13 of the 2014 DP)
- 14 There was broad support that sub-benchmark instruments should be included within the managed portfolio as benchmark instruments if it is consistent with an entity's DRM in the feedback.
- 15 The **DRM model** currently does not deal specifically with this issue. The topic was not prevalent during the outreach on the core model, however, the EFRAG Secretariat considers that it is probably still relevant also in the context of transfer pricing as per the feedback on the PRA model.
- 16 In conclusion, the issue is still relevant. However, it is unclear whether this issue will be resolved by the current proposals or whether this will form part of a later phase.

*Bottom-layer approach<sup>4</sup>*

- 17 Typically, many of the assets that are included in a portfolio hedge are prepayable (e.g., mortgage loans may be repaid before the maturity date). Such assets contain a prepayment option whose fair value changes as interest rates change (for a fixed rate loan the option becomes more valuable as interest rates decrease as you can refinance at a lower rate). However, the hedging derivative typically do not have such a prepayment option. This asymmetry means that when interest rates change, the resulting change in the fair value of the mortgage book (due to the disappearance of the prepaid loans) would differ from the change in fair value of the hedging derivative which would result in ineffectiveness (and a possible knock-on effect on the effectiveness tests). To recognise possible prepayments, banks may choose to only hedge a portion (or layer) of the mortgage book and then the question arises how this should be designated to avoid problems around ineffectiveness. (IAS 39 BC 176 a). There are three possibilities:

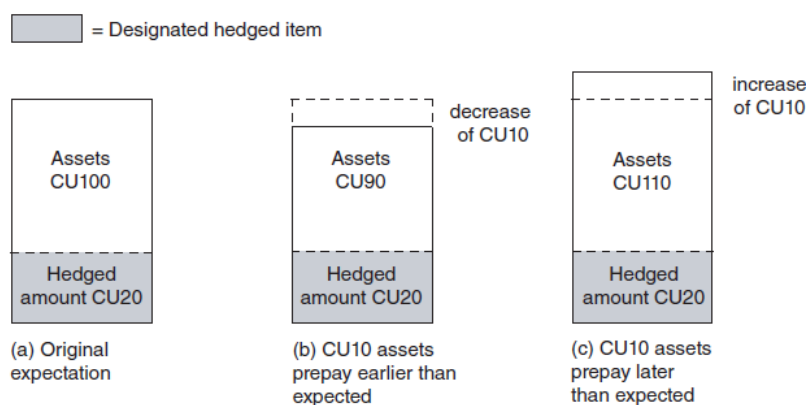
**Figure 1: Illustrating the designation of an amount of assets as a layer**



**IAS 39 BC 196**

- 18 In the bottom layer approach, if some assets prepay earlier than expected, such reductions are assumed to be from the unhedged layer, rather than across the whole portfolio. The IASB is concerned that the bottom layer approach, not all ineffectiveness is recognised.

**Figure 2: Illustrating the effect on changes in prepayments in a bottom layer approach**

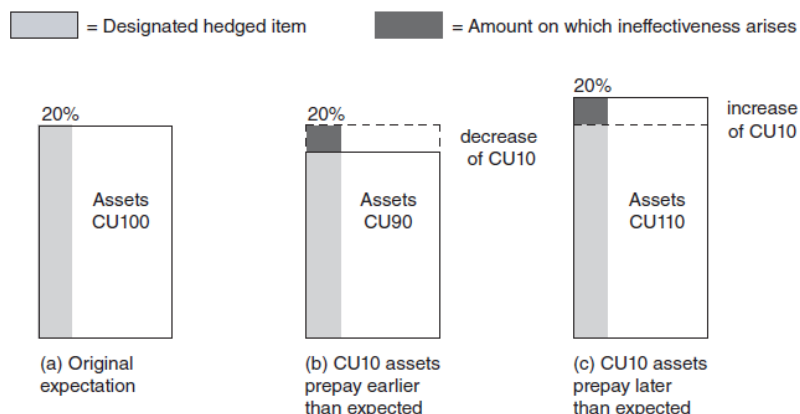


**IAS 39 BC 197**

<sup>4</sup> IFRS 9 allows a bottom layer designation where the layer meets the definition of risk component that can be separately identified and reliably measured. IAS 39 allows the same with respect to financial risks.

- 19 IAS 39 allows the percentage approach where a percentage of the mortgage book in our example is designated as the hedged item. Therefore, prepayments earlier or later than expected give rise to ineffectiveness as shown in Figure 4 below.

Figure 4: Illustrating the designation of an amount of assets as a percentage



**IAS 39 BC 199**

- 20 When issuing IAS 39 the IASB rejected layer approaches and concluded the hedged item should be designated in such a way that where expectations about repayments change, there should be ineffectiveness (IAS 39 BC 202 based on BC 200 and BC 201).
- 21 The carve out follows the view that under-hedging should not lead to ineffectiveness and allows a bottom layer approach. Therefore, those banks using the carve out are less likely to recognise ineffectiveness relating to prepayments than those using IAS 39. The reason is that variations in expected cash flows (except when impacting the bottom layer) have been carved out from the effectiveness test and do not impact profit or loss.
- 22 In the [PRA DP](#), the following example was provided: 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 and therefore, €65 million is 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. The question then arises as to whether the hedged item is the €100m or €65m or €60m. A bottom layer approach would assume the hedged item is €60m whereas under IAS 39 the most effective designation possible would be €65m of the portfolio. (Paragraph 3.7.1 of the DP, CU changed to euros).
- 23 In particular, the carve out has deleted the last sentence of paragraph 81A of IAS 39: *'Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.'*
- 24 The EFRAG Secretariat notes that the carve out has deleted paragraphs of IAS 39 (as detailed in Appendix 2) without adding specific guidance to accompany the resulting requirements. Furthermore, some have the following concerns about the bottom layer approach per the carve out:
- (a) the basis on which an under-hedge is determined (volume like notional amounts, cash flows, fair values or present values);
  - (b) the consequences of a breach of the bottom layer; and

- (c) the treatment of changes to the defined bottom layer and whether this results in a moving bottom layer.

Furthermore, there is a concern that the carve out assumes a homogeneous portfolio as potential differences in the cash flow pattern of the hedged items are not addressed.

- 25 The EFRAG Secretariat also notes that in feedback received recently from auditors there was an indication that the carve out requires banks to track by generation whether the bottom layer has been breached. Furthermore, European banks using the carve out, have recognised ineffectiveness in profit or loss on their hedged fixed rate loan books when decreases in interest rates resulted in higher prepayments than expected in recent years. This could include cases where the fixed interest rates differ based on vintage of the loan assets.
- 26 The IASB staff has indicated that a further paper on the Designation of a proportion of prepayable assets will be brought to the IASB for discussion in Q4 2021.

*EFRAG Secretariat analysis*

- 27 Feedback was requested on a bottom layer approach under the **PRA model** and many respondents commented that such an approach should be included as it is consistent with a risk mitigation view in that it avoids profit or loss volatility arising from unhedged risk positions.
- 28 In the **DRM model** as currently formulated there is no bottom layer. As highlighted in the IASB feedback on the outreach, some participants indicated that the designation of a bottom layer would represent their risk management view. However, others indicated that this is purely for accounting purposes and did not assert that such an approach would reflect their risk management view.
- 29 The EFRAG Secretariat notes that in this case the differences in approach between risk management and accounting become clear. Risk managers consider interest risk as fungible (i.e., irrespective of which individual financial instruments generates the risk) and decide what volume to hedge based on risk limits and risk appetite. From an accounting perspective it is important to identify which financial instrument generates the risk and whether that individual instrument belongs to the top or bottom layer.
- 30 The EFRAG Secretariat notes that this may be seen as a unit of account issue. A higher unit of account of hedged items (e.g.: a portfolio of hedged items with similar risks and characteristics) could allow identification of interest rate risk independent of the individual financial instrument that generates it. This is especially relevant as the outreach confirmed that banks do not manage interest rate risk in portfolios (that share similar risk characteristics) but from an entire balance sheet perspective, such as all interest rate exposures. The question is then whether for risk management (and DRM purposes) a bank could define several portfolios (each with different characteristics) and combine these. The question of determining the pertinent characteristics when aggregating portfolios could thus also be important. However, for purposes of the DRM model, the focus is on repricing gaps rather than the achieving of a specific interest rate for the portfolio.
- 31 However, as pointed out by an EFRAG FIWG member, with the changes to the DRM model, there is no misalignment while the hedged position is within the risk limits. There may be ineffectiveness for aspects in the hedging derivative that does not reflect the risks in the hedged position as highlighted in paragraph 21 of agenda paper 09-02. However, the EFRAG Secretariat notes that the mechanics of establishing such mismatches for a net position is not clear.
- 32 However, beside it being seen as a unit of account issue, the fungibility of risk exposure may also be seen as relating to a different issue. In particular, interest rate risk is subject to different sensitivity to a change in market interest rates (and thus

fair value of the underlying derivative) depending on which point of the interest curve it relates to. Accordingly, items in a portfolio may not be fully fungible when it comes to measuring their exposure to interest rate risk. A future change in interest rates in 3 years-time has a different sensitivity than one in 5-years' time. The EFRAG Secretariat notes that risk limits are linked to the time-buckets being used.

- 33 However, fungibility exists within each time bucket (i.e., having similar risk characteristics) and not across time buckets for the reason mentioned in above.
- 34 In conclusion, the issue is still relevant but, subject to the operability of the changes now proposed to the DRM model, the adoption of risk limits may offer an alternative approach to (or in combination with) the bottom layer approach. The IASB will discuss the issue of the designation of a proportion of prepayable assets later this year. Accordingly, a final assessment is not feasible at this stage.

#### **EFRAG FIWG – 4 October 2021**

35. EFRAG FIWG members commented as follows on this paper:

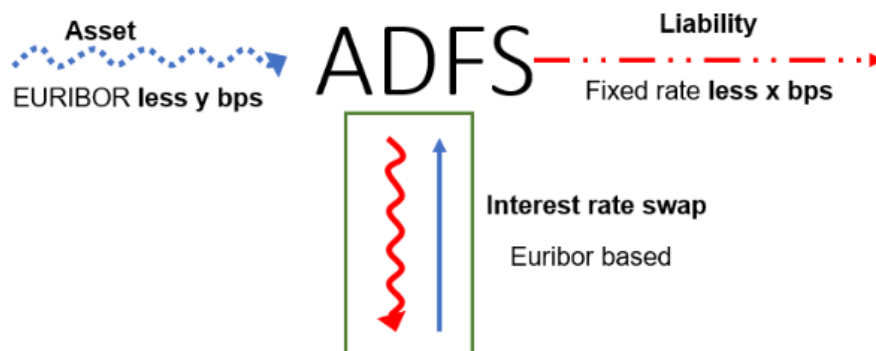
- a. Agreement that customer demand deposits have been resolved under both systems;
- b. On sub-libor issue: The issue is still relevant. these exposures should be treated the same as those above benchmark rates;
- c. The issue is still relevant. However, if the changes proposed by the IASB staff are finally operable, there is a possibility that the risk management intention would mean that the bottom layer may not be longer needed as there would be no misalignment as long as you are within the limits. However, the issue has to be reassessed after the IASB foreseen deliberations on the designation of a proportion of prepayable assets.

#### **Question to EFRAG TEG**

- 36 Do EFRAG TEG have further comments or suggestions on the issues covered by this paper or the discussions of EFRAG FIWG?

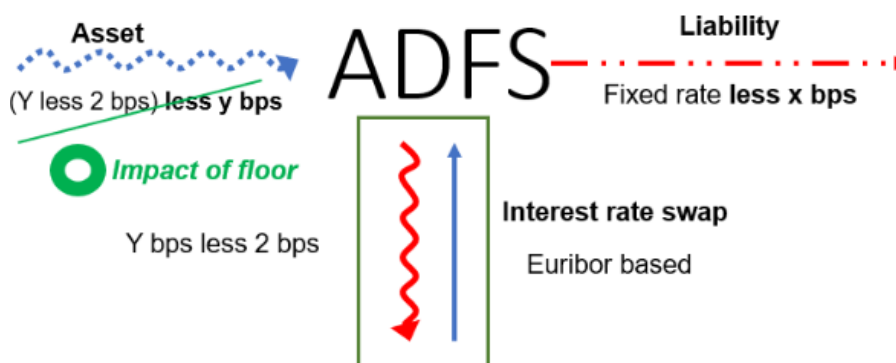
## Appendix 1: the sub-benchmark rate issue

- 1 The following example provides insights into the sub-benchmark rate prohibition in IAS 39 and IFRS 9 on the basis for conclusion paragraph 225 of IFRS 9.
- 2 Entity with a liability that pays a fixed rate and a loan at a floating rate at below benchmark interest rates.
- 3 The entity enters into a benchmark-based interest rate swap to lock in the margin on the combined position. This can be visually represented as follows:



- 4 The net return on the asset including the floating rate leg of the interest rate swap is negative y bps. Imagine a starting position of Euribor at 1% and y = 15 bps. ADFS will receive 85 bps from the asset but pay 1% on the variable leg in the swap.
- 5 Where the asset has a zero-rate floor and EURIBOR declines to below y bps, the return on the asset will be higher than negative y bps as the IRS does not have a floor. In the example of the previous paragraph, when Euribor becomes 14 bps, then the margin becomes negative 14 bps rather than the starting position of 15 negative bps.

### Euribor = y less 2bps:



- 6 Therefore, where Euribor is below y, the margin could become variable instead of being locked. The IASB considers that in this case there is an economic mismatch between the changes in cash flows on the floating-rate asset and the swap that should result in hedge ineffectiveness to be recognised in profit or loss. Therefore, designating the hedge as being of cash flows would be inappropriate in the IASB's view. (IFRS 9, BC6.226)

## Appendix 2: Background to the carve out

- 1 The objective of this appendix is to provide background on the EU carve-out from IAS 39.

### Paragraphs affected and reasons:

- 2 The overall intention of the carve-out was to enable hedge accounting for risk management activities related to core deposits and to alleviate the impact of hedge ineffectiveness when actual scheduled cash flows in a specific time bucket turns out to differ from expectations. The carved-out standard is available [here](#).
- 3 The carve-out affects the following paragraphs in IAS 39 *Financial Instruments: Recognition and Measurement*: 81A, AG99C, AG99D, AG107A, AG114, AG118, AG119, AG121, AG122, AG124, AG126, AG127, AG129 and AG130.

Para	Change	Reason
81A	Deletion of last sentence.	Relaxation of effectiveness testing, so underhedging does not lead to ineffectiveness.
AG99C	Deletion of first two sentences	To allow hedging of interest rate component of core deposits remunerated at zero interest rate or below market interest rate.
AG99D	Deletion in middle of paragraph	As for previous paragraph
AG107A	Deleted in full	As for paragraph 81A
AG114(c)	Deletion of last sentence	Consequential amendment of withdrawal of AG 126.
AG114(g)	Deletion of phrase in paragraph	Relaxation of effectiveness test.
AG118	Deletion of paragraph b	To allow hedging of a portfolio of core deposits.
AG119	Deletions in paragraphs d, e, f	Consequential amendments related to withdrawal of AG 126.
AG121	Deletion of second part of paragraph	Relaxation of effectiveness test (adoption of a layer approach)
AG 122	Deletion of sentence in paragraph	To allow hedging of a portfolio of core deposits (linked also to the measurement of effectiveness when core deposits are remunerated at below market interest rates.
AG124	Delete paragraph a and explanation in paragraph d	To relax the effectiveness test for fair value hedging of portfolio of financial instruments including core deposits.
AG126	Delete almost whole paragraph	As for AG124
AG127	Delete second and last sentences.	To relax the effectiveness test for fair value hedging of portfolio of financial instruments including core deposits and allow banks to



		continue their present risk management practice.
AG129	Deletion of example	Illustration related to the percentage method
AG130	Deletion in full.	As for AG129

**What is the issue?**

- 4 Core deposits are customer deposits (either on demand or term deposits) that remain on deposit for a relatively long period and for which banks typically pay negligible interest. The stability arise as withdrawals are mostly offset by additional deposits. Some banks consider core deposits to have economic characteristics of a zero-coupon bond and they regard each new deposit at its discounted value, considering its expected future date of repayment. The discounted value of these liabilities can be sensitive to interest rate movements, so banks mitigate this risk. However, the accounting for these transactions creates the problem.
- 5 In order to hedge the related interest rate risk and apply fair value hedge accounting, then the core deposits must be fair valued in contrast to IFRS 13 *Fair Value Measurement*, that states that fair value of a demand deposit equals its face value. However, banks argue that it is the discounted value associated with its face value.<sup>5</sup>
- 6 According to the EC<sup>6</sup>, the carve out of certain hedging accounting provisions reflects criticism by many European banks that the current version of IAS 39 poses a major problem for operating their risk management practises. According to these banks, the limitation of hedges to either cash flow hedges or fair value hedges and the strict requirements on the effectiveness of those hedges, prevent the continuation of risk management techniques, such as hedging a portfolio of core deposits, which are currently accepted by banking supervisors. Many European banks argue that IAS 39 in its current form would force them to carry out disproportionate and costly changes both to their asset/liability management and to their accounting systems and that it produces unwarranted volatility

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<sup>5</sup> Christopher Armstrong and Alan Jagolinzer, 2007, *The IAS 39 “carve-out”: How the European Union hedged its exposure to the international standard on derivatives and hedging*. Stanford Graduate School of Business.

<sup>6</sup> [https://europa.eu/rapid/press-release\\_MEMO-04-265\\_en.htm?locale=en](https://europa.eu/rapid/press-release_MEMO-04-265_en.htm?locale=en)