

Dynamic risk management: Update of November IASB meeting Issues Paper

Objective

- 1 The objective of the session is to update EFRAG TEG about the recent IASB decisions on the dynamic risk management project especially those relating to the risk mitigation intention and other changes to the core model.

Background information

- 2 As highlighted at the October 2021 EFRAG FIWG meeting, 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.
- 3 The IASB Staff had presented some proposals to the IASB at its September 2021 meeting and have returned with further updates for decision making by the IASB.

Staff recommendations

- 4 As summarised in paragraph 4 of the [IASB Staff agenda paper 4A](#), the IASB staff asked the IASB whether they “agree with the staff recommendation to make the following refinements to the DRM model for the purpose of incorporating risk limits:
 - (a) revising the definition of the target profile 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;
 - (b) introducing the risk mitigation intention as a new single-outcome element to the DRM model, representing the extent of risk to be mitigated through the use of derivatives, i.e., the portion of the current net open risk position the entity intends to mitigate through the use of derivatives;
 - (c) revising the construction of benchmark derivatives so that they represent the risk mitigation intention; and
 - (d) introducing prospective assessments to ensure the DRM model is used to mitigate interest rate risk and achieves the target profile, supplemented by similar retrospective assessments designed to capture the potential misalignment arising from unexpected changes.”
- 5 Other important aspects to note:
 - (a) The target profile will have to be linked to the entity’s risk management strategy and documented at initial designation of the hedge.
 - (b) Any changes to the target profile would result in discontinuation of the hedge.
 - (c) The benchmark derivatives will be based on the risk mitigation intention and will be used to measure the performance or effectiveness of the strategy (similarly to hypothetical derivatives in IFRS 9).
 - (d) The intention with the assessments is to ensure that the DRM model is used to mitigate the interest rate risk, that the target profile is achieved and that any misalignment that is driven by the effect of unexpected changes is captured in the financial statements.

- (e) As the recognition of the misalignment will be determined based on the ‘lower of’ test, it may not always lead to the recognition of a gain or loss in the P&L (i.e., the entity only recognises gains and losses in the P&L on the over-hedged position similarly to IFRS 9).

IASB Board Discussion

- 6 At its meeting on 19 November 2021, the IASB tentatively agreed with the proposals in paragraph 4 and the discussion covered the aspects below.

Clarifications

- 7 Can other hedge accounting models be applied while applying the DRM model? The same item cannot be designated twice for the same risk, i.e., under both the DRM and IFRS 9 requirements. However, the risk item, like today, may be hedged for more than one risk such as DRM for the interest rate risk and micro-hedging for the FX risk. Once in the DRM model, items cannot be designated on a gross basis.
- 8 Is the concept of ‘unexpected changes’ clear? The current net open risk position reflects the expected changes and repricing, the rest are ‘unexpected’. These can include higher prepayments than expected, or slower growth in the book.
- 9 Board members had wording recommendations around clarity or definitions such as ‘current net open risk position’; ‘trading derivatives’; ‘adjust’ versus ‘amend’ or ‘period’ vs ‘reporting period’ or ‘risk management period’. Clarity of requirements were also emphasised such as ‘reducing re-pricing risk due to interest rate changes’, and the net open risk position should be specific to the population hedged.
- 10 The DRM model is for external hedging using external derivatives.
- 11 Consequences of increases in risk in a bucket was discussed. There may be situations where the bank cannot do anything, but most often the banks act to bring the exposure within the limits. When should such a reassessment take place i.e. (i) when the entity decided to act and change the derivatives position, bring the risk back below the line, or (ii) at the end of period?
- 12 Furthermore, ‘buckets’ are not static but are everchanging with time.

Effectiveness testing

- 13 The IASB Staff reiterated that there would need to be a distinction between effectiveness assessment which is performed via a bucket-by-bucket and period-on-period comparison and measurement that is based on a cumulative basis as is currently done. However, banks would need to know what was in the bucket at the beginning and at the end of the period to compare and determine the retrospective assessment. Each bucket will be assessed.
- 14 Will misalignment be visible? Given that there are different types of misalignment and because the ‘lower of’ test will be used, not all will be recorded in profit or loss. Therefore, the staff will further explore the disclosures when the ineffectiveness is not recognised in profit or loss due to mechanics of the ‘lower of’ test. It was confirmed that such information about the misalignment is still very important and useful to the users of financial statements.
- 15 Would the changes that happen during the period will be captured as the testing suggests comparison between the beginning of the period and the end of the period? For example, during the period there can be unexpected prepayments and increases on the portfolio. It follows that overall, at the end, the position may not change. It was asked how such a misalignment that happened during the period will then be captured.
- 16 Why is there a proposal to have two retrospective tests (i.e., testing the target profile and risk management intention) if the consequences are the same? The Staff

commented that the risk management intention is to be within bands and due to unexpected changes, the entity may fall outside the bands. That is what one of the tests is trying to capture.

- 17 The focus should not only be on the backwards tests but also prospectively. However, entities are sometimes over-hedging in particular time buckets, but not overall, and this is likely to provoke discussion.

Designation of a proportion of prepayable assets

- 18 The IASB was scheduled to discuss the issue around designation of a proportion of prepayable assets and specifically whether a bottom layer of such prepayable assets can be designated as the hedged item under the model.
- 19 In [agenda paper 4B](#) (November meeting), it is argued that the introduction of the risk mitigation intention to the DRM also addresses this issue and recommended no refinements with respect to this issue. The IASB tentatively agreed.

EFRAG FIWG discussions

- 20 Overall, the elements as approved by the IASB are very encouraging that the model will be much closer aligned to the risk management practices of banks.
- 21 There was agreement that the bottom layer is not be required given how radically different the DRM approach is compared to today's approach. Some thought it may still be needed in future as the whole discussion has not yet been completed and others questioned how the bottom layer approach fits into a net position model like DRM compared to the current gross hedge accounting approach.
- 22 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?
 - (b) The frequency of the effectiveness tests would impact operational feasibility.
 - (c) The transposition to cases where banks do not use time buckets for repricing gaps 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 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.
- 23 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.

Questions for EFRAG TEG

- 24 Does EFRAG TEG have comments on the IASB paper, the IASB discussions or the EFRAG FIWG comments?
- 25 Does EFRAG TEG have any further questions to EFRAG FIWG?

¹ PV01 is the present value change of 1 basis point move in interest rates.

² Value at risk. This is a measure of the risk of loss. It estimates how much a portfolio might lose, given normal market conditions, in a set time period such as a day and depending on a specific confidence interval.

Appendix 1: Extracts from IASB September 2021 meeting Agenda paper 4B

Introduction

- Some of the slides from the IASB are reproduced here for the convenience of EFRAG FIWG members in their preparation.

Example of DRM hedge accounting


Period 0

Not applicable – No retrospective steps required for the first period.

Step 1 Risk managers calculate the current net open risk per bucket and decide to what extent the current net open risk position shall be mitigated prospectively through the use of derivatives.

Risk managers decided to mitigate the current net open risk from +500 to +10, by trading an interest rate swap that has PV01 of -490 in the 5-year bucket.

bucket (yrs)	1	2	3	4	5
Prepayable Assets (PV01)				100	1,000
Term Liabilities (PV01)				-100	-500
Current Net Open Risk Position				0	500
Designated Derivatives				0	-490
Residual open risk position				0	10

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Example of DRM hedge accounting

Period 0


Step 2 Accountants determine the risk mitigation intention based on the designated derivatives and the current net open risk position, subject to DRM boundaries.

bucket (yrs)	1	2	3	4	5
A Current Net Open Risk Position				0	500
Designated Derivatives				0	-490
B Risk Mitigation Intention				0	-490
C Total of A and B				0	10
D Target Profile	50	50	50	50	50
Check for risk mitigation (A vs B)	OK	OK	OK	OK	OK
Check within target profile (C vs D)	OK	OK	OK	OK	OK

To work out risk mitigation intention that meets the DRM boundaries prospectively

Step 3 Accountants construct and designate the new benchmark derivatives based on the risk mitigation intention and any existing benchmark derivatives.

bucket (yrs)	1	2	3	4	5
Risk Mitigation Intention	0	0	0	0	-490
Benchmark Derivatives	0	0	0	0	-490 @ T0 Rates

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Example of DRM hedge accounting

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
Term Liabilities (PV01)				-100	-500
A Current Net Open Risk Position (updated)	0	0	0	60	440
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

+60 of PV01 moved from Y5 to Y4

Excluding new business

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.

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Example of DRM hedge accounting

Period 1

Step 5 Accountants calculate the resulting misalignment due to unexpected changes.

One possible way to do this is to amend the benchmark derivatives by the minimum amount to satisfy the DRM boundaries (as per slide 5). The misalignment could be represented by designating additional benchmark derivatives using the prevailing benchmark interest rates at previous period end when the performance of DRM hedge was last assessed.

	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
Previous Benchmark Derivatives		0	0	0	0	-490	@T0 Rates
Additional Benchmark Derivatives					-10	50	@T0 Rates
B Total revised Benchmark		0	0	0	-10	-440	
C Total of A and B		0	0	0	50	0	
D Target profile		50	50	50	50	50	
Check for risk mitigation (A vs B)		OK	OK	OK	OK	OK	
Check within target profile (C vs D)		OK	OK	OK	OK	OK	

At Y4 bucket, an additional benchmark derivative of -10 PV01 is needed to bring the residual risk within risk limits.

At Y5 bucket, additional benchmark derivative of +50 PV01 is needed to ensure the benchmark derivatives reflect the unexpected change.

10 | IFRS

Example of DRM hedge accounting

Period 1

Step 6 Accountants work out the hedge accounting adjustments (using the 'lower-of test').

Accountants calculate the present value movements of the designated derivatives and the benchmark derivatives, and recognise the lower of the two in OCI.

	bucket (yrs)	1	2	3	4	5	
Designated Derivatives		0	0	0	0	-490	
Previous Benchmark Derivatives		0	0	0	0	-490	@T0 Rates
Additional Benchmark Derivatives		0	0	0	-10	50	@T0 Rates
Total Benchmark Derivatives		0	0	0	-10	-440	

In this example, between period 0 and period 1, the present value movements in designated derivatives are driven by the -490 PV01 in Y5 bucket, while the present value movements in the benchmark derivatives are driven by -440 PV01 in Y5 bucket, and -10 PV01 in Y4 bucket, which lead to misalignment.

11 | IFRS

Source: IASB