Dynamic Risk Management: Project update

Objective

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

(a) the results of the outreach done by the EFRAG Secretariat on perceptions about the carve-out; and

(b) the IASB's discussions on the DRM model in February 2022.

Background

2 IFRS 9 *Financial Instruments* has not changed the hedge accounting requirements for portfolio hedging and IAS 39 still applies. The IASB is considering a new model to replace these requirements. Such a 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 an improvement to the current model.

3 The re-deliberations on phase 1 of the model development is coming to an end with the determination of the project direction at the May 2022 IASB meeting. If the IASB decides to continue, the IASB Staff will focus on phase 2 of the research on items such as instruments carried at fair value through OCI, hedging with options, etc.

IASB project (2015 to now)

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

Project stage	Further details/links	Reference
IASB Core Model outreach and feedback 2015 – 2021	• IASB development of the Core Model • EFRAG TEG/CFSS and EFRAG FIWG • IASB outreach (2020/2021) • EFRAG Board meeting: June 2021	• Paper 06-04 of May 2021 TEG meeting • Paper 05-02 and 05-03
Re-deliberations H2 2021	• October 2021 IASB decisions • EFRAG Board meeting: November 2021	Agenda paper
This meeting	• **February 2022 IASB discussions** • **Feedback from carve out outreach**	This paper
Next steps	• The IASB will continue its deliberations and decide on project direction in May 2022.	

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
Q2 2022	Recognising changes in fair value of derivatives in OCI
	Decide on project direction

EFRAG's previous discussions on the IASB re-deliberations

6 The IASB's re-deliberations have been discussed at the following EFRAG meetings:

	FIWG	FR TEG	FR Board
Interaction between risk limits and target profile	4 October 2021	20 October 2021	18 November 2021
Designation of a proportion of prepayable assets	8 December 2021	22 December 2021	
Recognising changes in fair value of derivatives in OCI	15 March 2022	23 March 2022	4 April 2022

7 On the basis of the above EFRAG discussions, the IASB decisions are considered to be a positive development. EFRAG FIWG has indicated that the IASB's decisions on the risk mitigation intention have solved the concerns around the use of risk limits as compared to the single outcome as originally envisaged by the IASB.

8 As part of these discussions, members have considered to what extent the model direction would allow to address the issues that were at the origin of the European carve out in 2004. These issues were the following:

(a) The use of core demand deposits as a hedged item;

(b) Hedged items with a sub-benchmark interest rate; and

(c) The use of a bottom-layer approach in hedge designation.

9 EFRAG FIWG has agreed the following:

(a) The issue around customer demand deposits have been resolved under both the PRA and the DRM core model.

(b) The sub-LIBOR issue has not yet been resolved under DRM and requires further work by the IASB. The IASB requested feedback on the topic in the PRA DP in 2014; and

(c) The introduction of the risk mitigation intention per the IASB discussions in November 2021 means that the bottom layer is not needed because the DRM model focuses on alignment with the risk management strategy. The quantum of the hedged item is derived from the hedging derivative. There would be no misalignment when within the risk limits.

10 This session today focusses on the deliberations undertaken by the IASB after the last EFRAG FR Board update, in particular on the hedge accounting mechanism.

Hedge accounting mechanism

11 Participants in the DRM outreach shared the concern that the IASB's model would cause volatility in equity as it defers the fair value changes of the hedging derivative in equity similarly to cash flow hedge accounting.

12 Managing interest rate repricing risk has a dual purpose – to manage both:

(a) changes in fair value of the fixed rate exposure; and

(b) changes in variability of the cash flows.

13 Risk management operates within a target range, not as a single outcome. Therefore, neither fair value nor cash flow hedge accounting fit this dual purpose. The IASB Staff put forward two alternative approaches for the DRM mechanics:

14 Approach A (similar to current portfolio fair value hedging):

	What is valued?	**What is recognised in the BS?**	**What is recognised in the IS?**
Hedged item	Risk mitigation intention	Fair value of the risk mitigation intention	Changes in fair value of the risk mitigation intention
Hedging instrument	Designated derivatives	Fair value of the designated derivatives	Changes in fair value of designated derivatives

15 Approach B (includes characteristics of both fair value and cash flow hedging):

	What is valued?	**What is recognised in the BS?**	**What is recognised in the IS?**
Hedged item	Risk mitigation intention	n/a	n/a
Hedging instrument	Designated derivatives	Fair value of the designated derivatives	Misaligned portion resulting from the lower of test
DRM adjustment[1]	The lower of the above (see paragraph 17(b))	Aligned portion resulting from the lower of test as a separate line item	

Approach A

16 Approach A is a symmetrical approach and would account for DRM as follows:

(a) designated derivatives would be recognised in the balance sheet at fair value.

(b) the risk mitigation intention would be recognised at fair value[2] as a separate line item in the balance sheet and gains or losses in statement of profit or loss.

Approach B

17 Approach B is asymmetrical and here DRM would be accounted for as follows:

(a) designated derivatives would be recognised as for Approach A.

(b) the DRM adjustment would be recognised in the balance sheet as the lower of the cumulative gains or losses on the designated derivatives and the cumulative change in fair value of the risk mitigation intention (using the benchmark derivative as a proxy).

(c) the DRM adjustment therefore represents the aligned portion of the designated derivatives that offsets the gain or loss on the risk mitigation intention. Any remaining gain or loss on the designated derivates (misaligned portion or ineffective part) will be recognised in the statement of profit or loss.

18 Advantages and disadvantages of the two approaches are discussed in paragraphs 24-25, 33-34 respectively of IASB Staff paper 4B. Appendix A of the same paper also provides illustrative examples of how the different approaches would impact the financial statements.

---

[1] The difference between the DRM adjustment and the hedged item in Approach A in the context of a portfolio hedge is not clear.

[2] This would be for the hedged risk, i.e., normally interest rate risk

19 The IASB met on 21 February 2022 in an education session to discuss these possible modifications. The IASB raised the following comments:

(a) An option of the two approaches was discussed but rejected.

(b) Conceptual framework concerns raised by the approaches in the paper.

(c) Disclosures should be used to inform users about the entity's DRM activities.

(d) The IASB staff should investigate mandatory application of the DRM model. It was pointed out that this would require strong preparer acceptance.

EFRAG FIWG – 15 March 2022

20 EFRAG FIWG commented on the IASB discussions as follows:

(a) Most members preferred these approaches compared to the original proposal. Some proposed that both approaches should be subject to a field test[3].

(b) Approach B was favoured as providing more useful information compared to Approach A.

(c) A few members doubted the usefulness of applying a 'lower of' test as it has been designed in the context of micro-hedging with a different objective.

(d) The tracking of the adjustment was also discussed with some questioning what the DRM adjustment reflects and what the adjusted NIM represents. Some were concerned about the outcomes from significant interest rate decreases.

21 The EFRAG Secretariat commented that the tracking concern may relate to the mechanics of the current hedge accounting framework which is not truly a portfolio hedging solution. Under the DRM mechanics, the accounting would follow the risk management approach.

EFRAG TEG – 22 March 2022

22 EFRAG TEG members raised the following points:

(a) There was, in general, agreement with the direction of the project.

(b) As Approach A is consistent with the EU carve-out, some were unclear as to why EFRAG FIWG members favoured Approach B.

(c) Input from French banks indicated that the direction of the project is positive and that both approaches are acceptable with no preference.

(d) Question whether Approach B provided useful information as the adjustment is not linked to an item on the statement of financial position. Approach B may result in changes to systems which could be costly to implement.

(e) Missing a complete picture of the model, including on the designation/de-designation/discontinuation and documentation, a view on whether the DRM model should be mandatorily applied was not possible at this stage.

(f) Members also reiterated the need to consider a field test after Phase 2 of the project.

Question for EFRAG FR Board

23 Does EFRAG FR Board have comments on the summary above?

[3] The EFRAG Secretariat notes that the outcome from phase 2 will probably require significant testing in the context of the difficult nature of the intended hedged items and that this has not been subject to such testing previously. Therefore, we do not propose field tests at this stage of the project to reduce the burden on preparers.

Feedback on carve out outreach

24 At previous meetings of EFRAG Board, the EFRAG Secretariat was asked to provide feedback from various stakeholders on the perceptions of the IAS 39 EU carve out after 15 years of continued practice.

25 The EFRAG Secretariat has performed outreach with auditors/accountants, regulators and users.

26 The following provides an overview of the feedback received and the EFRAG Secretariat's conclusions on the outreach. For further information please refer to EFRAG FR TEG March 2022 paper 03-03.

EFRAG Secretariat's conclusions of the outreach exercise

27 The outreach confirmed that the carve-out is widely used in many European countries, mostly for consolidated groups but in some cases, such as in Italy also for the separate accounts of banks. The carve out is not used in Greece or Portugal due to differences in products available to the market.

28 While specific application guidance is absent, practices have been established and have commonalities mainly at country level. The EFRAG Secretariat understands that France has the most detailed guidance with requirements to track the notional of hedged items by vintage.

29 In the absence of specific disclosure requirements, disclosures about the use of the carve out is not uniform and unclear. Only part of the banks disclose that they use the carve-out. In addition, detailed information about the hedging accounting practices is not often presented. However, the use of carve-out is not an area of focus in the communication to the market or an area that raises questions from users. Some possible additions to consider in terms of disclosures are described in the paper referenced in paragraph 26 above.

30 The EFRAG Secretariat collected quantitative data aimed at assessing the extent of use of the carve out. As an illustration, some banks manage their assets and liabilities on a net basis, i.e., they use hedging derivatives to reduce the risk of the residual net position (assets less liabilities). As the designation of a net position as hedged item is not allowed under IAS 39, hedging liabilities are designated in a 'proxy hedge' choosing a gross position (e.g., a specified group of assets) as a hedged item for hedge accounting purposes. As a result, the data collected (which generally refer to the asset designated in the hedge accounting and not to the overall asset/liability management) are not meaningful.

EFRAG FIWG discussions - 15 March 2022

31 EFRAG FIWG commented as follows:

(a) Debt analysts may have a stronger understanding of risk management aspects and users would only be interested in the after-hedging outcomes, not the accounting technicalities of hedge accounting.

(b) Additional factors as to why hedge accounting is only a small part of interest rate management were supplied:

(i) difference between risk management focus compared to IAS 39 requirements (i.e., net vs gross and internal vs external derivatives);

(ii) some risk exposures are intended to be transferred out by way of securitisation; and

(iii) micro hedges (including of groups of items) may be sufficient to achieve the entity's objectives.

(c) Members also noted proposals to improve disclosures on the carve-out or the interest rate position.

EFRAG FR TEG discussions – 22 March 2022

32 Members considered that the outreach did not identify major areas of concerns. Some concluded that the carve-out was working well in practice.

33 It was noted that not many banks currently disclose, as part of their accounting policies, that they use the EU carve-out in the absence of any specific requirements to do so.

Question for EFRAG FR Board

34 Does EFRAG FR Board have comments on the summary above?

Next steps

35 Two of the three main preparer concerns on Phase 1 of the model have been resolved by the re-deliberations. For the remaining concern, while no decision has been made, the IASB Staff proposals resolve the issue. The EFRAG Secretariat will continue to update the EFRAG FR Board on the IASB's discussions.

36 Other issues raised during the discussions that the EFRAG Secretariat will continue to monitor are as follows:

(a) Sub-libor issue as discussed at the November 2021 meeting;

(b) Mandatory application;

(c) Effective disclosures and

(d) Transition.

Question for EFRAG FR Board

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