Dynamic Risk Management: Project update

Objective

1 The objective of the session on DRM is to update the EFRAG FR Board on the IASB's discussions on the DRM project in May and July 2022 as well as the reactions from EFRAG FIWG and FR TEG.

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 was coming to an end with the determination of the project direction at the May 2022 IASB meeting. The IASB decided to add the DRM project to its standard-setting programme which means that the next step in the process will be an exposure draft. However, this will only be issued on the conclusion of phase 2 of the IASB's work. During phase 2, the focus will be on items carried at fair value through OCI, hedging with options, etc.

4 EFRAG Secretariat has conducted interviews with various categories of stakeholders to investigate the perceptions of the market on the carve-out of IAS 39 after more than 15 years of continuous use. The conclusions can be found here. No significant issues emerged from this research and some of improvements on disclosure were identified, to enhance transparency.

IASB project (2015 to now)

5 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 and EFRAG discussions • IASB outreach (2020/2021)	• Paper 06-04 of May 2021 FR TEG meeting • Paper 05-02 and 05-03 of June 2021 FR Board meeting
Re-deliberations H2 2021	• IASB decisions discussed in by EFRAG FR Board • Feedback from carve out outreach	• Paper 05-01 of April 2022 FR Board meeting

Mechanics of DRM model and project plan	• **IASB discussions in May and July 2022**	• **This paper**
Next steps	The IASB will continue its deliberations focussing on phase 2.	

The IASB's indicative timeline

6 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

7 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

8 On the basis of the above EFRAG discussions, the IASB decisions are considered to be a positive development and decisions on the risk mitigation intention have solved the concerns around the use of risk limits.

9 This session today focusses on the deliberations undertaken by the IASB after the last EFRAG FR Board update, in particular on mechanics of the DRM model (May 2022 IASB discussions) and on project plan (July 2022 IASB discussions).

IASB discussion in May 2022 about hedge accounting mechanism

10 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.

11 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.

12 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.

13 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

14 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 15(b))	Aligned portion resulting from the lower of test as a separate line item	

Approach A

15 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

16 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.

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

18 The IASB met on 23 May 2022 to discuss these possible modifications and decided tentatively to change the mechanics of the DRM model to require Approach B.

19 IASB members raised the following comments during the meeting:

(a) Agreed with the IASB Staff's arguments as to why the mechanics of Approach B provide more faithful and more relevant information than Approach A.

(b) The "lower of" test gives a faithful representation on the effectiveness of the designated derivatives and hedge strategies and better represents the link between the risk management framework applied by entities and the underlying items.

---

[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

(c) In respect of departure from the Conceptual Framework, IASB members accepted that, in the end, it would provide more transparent information for the users of financial statements. However, it was reiterated that such a departure could only be applied to the DRM model and cannot be analogised to as the IASB wants to avoid degradation of usefulness of the Conceptual Framework in the long term.

(d) Disclosure requirements should be developed to inform stakeholders about the DRM activities of entities with a focus on: (i) the full fair value size of the risk management intention and related changes, (ii) the description of the underlying items and, (iii) the characteristics of designated derivatives. A starting point could be the disclosures provided by European banks on EU carve-out from IAS 39 on a regulatory basis.

(e) In the following stages of the project, more users of financial statements should be appropriately involved, also considering the development of educational sessions and materials.

EFRAG FIWG – 6 September 2022

20 EFRAG FIWG commented on the IASB discussions as follows:

(a) At the previous meeting, they had indicated a preference for Approach B, but they still also considered that both approaches have to be field tested. However, the choice of mechanics is less important than the hedging of net positions or equity envisaged under DRM compared to today.

(b) The same numbers are required for both approaches and, therefore, this is more a presentation issue. However, explanation of the 'lower of' test may be more complicated even if this captures the impact of risk mitigation.

(c) The carve-out may have been the best solution for banks in the context of IAS 39 but not necessarily what they would drafted if they had the choice (i.e., a compromise). So even if Approach B is not aligned with the carve out per se, it would not be considered problematic. It is more important that the risk management strategies that can today be reflected by using the carve are also captured by the new model.

(d) It is unclear how prudential disclosures may be helpful in the DRM project.

EFRAG FR TEG – 14 September 2022

21 EFRAG FR TEG members raised the following points:

(a) Many members agreed with the IASB tentative decision of selecting Approach B. One member indicated that if there was under-hedging (i.e., the target range not being met) then there would be no profit or loss impact under Approach B.

(b) Another member indicated that the project is moving in the right direction. He welcomed the introduction of the DRM adjustment even if it does not meet the definition of an asset or liability under the Conceptual Framework. However, there are still practical questions remaining and the DRM model should be aligned as much as possible to the risk management practices.

(c) One member noted that Approach B was preferred by the IASB for two conceptual reasons: (i) it reflects the dual objective of the DRM model (maintaining the economic value of the balance sheet and stabilisation of the interest margin) and (ii) the "lower of" test makes it possible to consider highly probable future transactions included in the net open risk position.

(d) Another member highlighted the importance of involving users in field tests to check the usefulness and their understanding of the numbers.

IASB discussion in July about project plan

IASB Staff proposal

22 In the AP 4 of the July 2022 meeting, the IASB Staff set out the areas and topics that need to be further considered in order to complete the developments of the DRM model together with a proposed order of future discussions for the next stage of the project.

23 The areas and topics identified are the following (the order of the list also represents the proposed order in which the IASB will discuss them):

(a) Eligible items and the determination of the current net open risk position.

(b) Target profile[3] and its alignment with an entity's risk management strategy.

(c) Designated derivatives.

(d) Risk mitigation intention[4] and the construction of benchmark derivatives.

(e) Performance assessment and subsequent unwinding of DRM adjustments.

(f) Other considerations such as qualifying risk management strategies and whether more than one DRM model could exist for different business units or for different currencies. It also includes the transition requirements.

(g) Presentation and disclosure requirements.

24 The IASB Staff emphasised that a transparent discussion on these areas and topics would be the most efficient approach and that an exposure draft will be published once the discussion of these areas and topics has been completed. The IASB Staff noted that there may be cases where it will not be possible to fully reflect the risk management in order to maintain the robustness of the DRM model and ensure useful information is provided. The Staff also indicated that it is important to firstly focus on developing a viable DRM model for interest rate risk for financial institutions before exploring whether il could apply to other industries or other types of risk.

July 2022 IASB meeting discussions

25 The IASB met on 20 July 2022 in an education session to discuss the proposed project plan. The IASB members were overall supportive to the approach and direction of the project and made the following comments:

(a) Future developments on DRM should focus on model robustness rather than a complete reflection of risk management practices.

(b) The IASB staff should focus on developing a model for interest rate risk only.

(c) An illustrative example of the functionality of the entire core model was requested as currently tentatively deliberated.

(d) It was suggested to consider as early as possible in the process whether the DRM model should be applied on a voluntary or mandatory basis.

EFRAG FIWG – 6 September 2022

26 EFRAG FIWG commented on the IASB discussions and considered the list of topics of the IASB Staff to be exhaustive.

---

[3] The target profile is defined 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. In other words, it is the amount of the risk the entity is willing to tolerate, which is clearly documented in its risk management strategy.

[4] The risk mitigation intention id described as the extent to which an entity intends to mitigate the current net open risk position through the use of derivatives. In other words, the risk mitigation intention is a single-outcome element and could be determined based on an entity's preferred risk metrics.

27 However, one member considered that the impact of unexpected changes (i.e., should this offset interest income or expense as envisaged at point of designation or as it is now) should be considered before considering eligible hedged items.

EFRAG FR TEG – 14 September 2022

28 EFRAG FR TEG members raised the following points:

(a) Some members indicated that it was important to understand what was meant by the term 'mandatory' when discussing whether the DRM model must be applied if the application criteria are met. One member asked that if the model was mandatory only in one direction – i.e., once designated, it cannot be de-designated voluntarily.

(b) One member also emphasised that the important aspects where guidance was required, include:

(i) Eligible items such as FVOCI and equity;

(ii) Construction of the benchmark derivative; and

(iii) Application to foreign currency risk management (and other risks).

(c) However, another member considered that interest rate is a good starting point from a practical perspective.

Question for EFRAG FR Board

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

Next steps

30 The EFRAG Secretariat will continue to update the EFRAG FR Board on the IASB's discussions and deliberations after discussions with EFRAG FIWG and FR TEG.

31 The IASB's next step will be the issuance of the ED.

32 A crucial step will be the field test of the model, where EFRAG Secretariat considers that significant involvement of European banks will be needed, as well as of auditors and users. The most opportune timing of such testing is still to be confirmed with EFRAG FIWG, however, it is anticipated to be later during the process.

33 Should a final standard be issued, as part of the endorsement advice, EFRAG will have to compare the two scenarios: IAS 39 carve out compared to DRM model. It would be the first time that as part of an endorsement advice EFRAG assesses the elimination of a carve out.

Question for EFRAG FR Board

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