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DRM – update on February 2022 IASB meeting
Issues Paper

Objective

1 The objective of this paper is to discuss the alternative approaches to the DRM mechanics put forward by the IASB Staff during the IASB February 2022 meeting. The papers of this IASB meeting can be found here.

Introduction

2 Managing interest rate repricing risk has a dual purpose: the aim is addressing both:

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

(b) changes in variability of the cash flows.

3 This is done to achieve an outcome within a target range, not a single outcome.

4 Neither fair value hedge nor cash flow hedge accounting can technically fit this dual purpose for reasons explained in the IASB staff papers.

Previous EFRAG discussions on the issue of hedge accounting mechanism

High-level outreach feedback

5 The core model envisaged the use of a cash flow hedge mechanism with changes in the fair value of the derivative being recognised in OCI.

6 This was universally opposed by participants in the outreach and by some more strongly than others. While the strongest concern related to the impact on CET1 and whether a filter would be possible, there were also some concerns for the implications of the IFRS equity. For the detailed feedback reported to EFRAG TEG, please consult Appendix 1.

EFRAG FIWG – 15 October 2019

7 EFRAG FIWG members expressed concerns about the additional material volatility resulting in OCI from revaluation of the risk-mitigating derivatives. This would be difficult to explain and its treatment for prudential purposes uncertain.

EFRAG FIWG – 7 May 2021

8 EFRAG FIWG members were asked for reasons for the change in views[1] around the preferred hedge accounting mechanism (fair value vs cash flow).

(a) The feedback on the PRA has to be seen in the specific context of the concern at the time that the PRA would lead to full or nearly full fair value accounting of the banking book.

(b) Furthermore, while cash flow hedging mechanism may have been mentioned as a solution, it was not the top choice of preparers and was one of many possibilities.

[1] During the PRA project in 2014/2015, EFRAG's comment letter supported a cash flow hedging mechanism.

(c) While one may focus on cash flows when considering what needs to be hedged, it does not necessarily translate to a cash flow hedge mechanism.

(d) While hedge accounting is just an accounting concept, OCI volatility would be hard to explain. The volatility in the 'basis adjustment for portfolio fair value hedges' in the context of total assets or total liabilities is not as significant as such adjustments in OCI that forms part of the equity line.

(e) There was a concern that regulators would not be satisfied with a prudential filter if there is a significant excess of CET 1 over IFRS equity.

(f) If the concern is transparency, alternative disclosure solutions could be investigated. For example, users find sensitivity to interest rate changes disclosures in IFRS 7 very useful.

EFRAG FR TEG – 18 May 2021: Hedge accounting mechanics (FVH or CFH)

9 Different members supported FVH mechanism, as being easier to explain to CFH mechanism due to the natural off-setting achieved in profit or loss.

10 It was noted that OCI volatility is a serious concern for French banks even if a prudential filter is agreed and the concern is shared by strongly capitalised entities.

Alternative approaches considered

11 The IASB Staff put forward two alternative approaches for the DRM mechanics:

Approach A

12 Approach A is a symmetrical approach, which is similar to the fair value hedge mechanics, but with some changes to reflect to the characteristics of dynamic risk management. Applying this approach, the DRM model would be accounted for as follows:

(a) the designated derivatives would continue to be recognised at fair value in the statement of financial position, with gains or losses recognised in statement of profit or loss.

(b) the risk mitigation intention would be recognised at fair value as a separate line item in the statement of financial position, with gains or losses recognised in statement of profit or loss.

13 The following table illustrates Approach A:

	What is valued?	**What is recognised in the statement of financial position?**	**What is recognised in statement of profit or loss?**
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 Advantages and disadvantages of this approach are discussed in paragraphs 24-25 of IASB Staff paper 4B.

Approach B

15 Approach B is based on mechanics that are a combination of cash flow and fair value hedging mechanics. Applying this approach, the DRM model would be accounted for as follows:

(a) the designated derivatives would be recognised in the statement of financial position at fair value.

(b) the DRM adjustment would be recognised in the statement of financial position, determined as the lower of:

(i) the cumulative gains or losses on the designated derivatives from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the risk mitigation intention from inception of the hedge (measured by using the benchmark derivative as a proxy).

(c) the DRM adjustment therefore represents the portion of the gain or loss on the designated derivatives that offsets the gain or loss on the risk mitigation intention (the aligned portion). Any remaining gain or loss on the designated derivates, including any changes to the DRM adjustment calculated in accordance with (b) would be recognised in the statement of profit or loss.

16 The following table illustrates Approach B

	What is valued?	**What is recognised in the statement of financial position?**	**What is recognised in statement of profit or loss?**
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[2]	The lower of the above (see paragraph 15(b))	Aligned portion resulting from the lower of test as a separate line item	

17 Advantages and disadvantages of this approach are discussed in paragraphs 33-34 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.

Key points of discussion IASB Board discussion 21 February 2022

18 This was an educational session with no decisions made. However, approach B was preferred by most IASB Board members, an option between both approaches was discussed but rejected.

19 Concern was raised that accounting for the DRM adjustment on the statement of financial position creates conceptual issues. While these should not be taken lightly, good reasons were required to justify such a step. For some, the concern relates in particular to the representation of forecast transactions and more importantly, the inclusion of equity.

20 It was noted that the discussion relates to presentation of the DRM adjustment.

21 One IASB Board member suggested that the DRM adjustment should reflect:

(a) the lower of accumulated changes in fair value of designated derivatives and combination of fair value changes of benchmark derivatives; and

(b) effects of unexpected changes from current net open position.

22 Disclosures should be used to inform users about the DRM activities of entities. In particular:

(a) Disclosure about what the DRM adjustment represents;

(b) Disclosure not limited to the “lower of” end of the test but also the higher end.

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

23 The DRM model should be mandatory, not voluntary application such as general hedge accounting.

EFRAG Secretariat analysis

Conceptual concerns

24 The EFRAG Secretariat does not share these concerns and notes that there are strict requirements to achieve hedge accounting as it amends the normal recognition and measurement requirements. There is therefore an in-built recognition of the impact on the framework in the relevant standards. Furthermore, the DRM model is not introducing further breaches of the framework, it continues what is currently allowed by hedge accounting under IFRS 9 albeit with separate presentation due to the nature of the hedge item. The EFRAG Secretariat would support further disclosures for users to understand the nature of these items as it is not clear how these are currently interpreted.

DRM adjustment

25 The EFRAG Secretariat notes that the DRM adjustment will play a pivotal role in the DRM project, with a specific informative value for users of financial statements. Hence, it is worth to think about the decomposition of the adjustment and its roll-over as well as the disclosure of the different components:

(a) Addition or reduction of (net) hedged items (new production, change in volume of deposits assigned as hedged item; prepayments, maturing items, ….);

(b) Amount recognised in the profit or loss account;

(c) Effect of currency exchange differences (while the EFRAG Secretariat expects the DRM adjustment(s) to be based per currency, questions arise on translation differences coming from exposures held by subsidiaries in a different currency and the effect of cross-currency swaps);

(d) Changes in the net open position;

(e) …

Mandatory application

26 The EFRAG Secretariat understands the request to make the DRM model mandatory. Nevertheless, further clarification could be useful whether this is valid per currency, or for all currencies and similarly for different portfolios?

27 The other question is whether such a decision would have any unintended consequences for reporting. As one IASB member noted, compulsory application of the model would require a high level of acceptance by preparers.

Questions for EFRAG FR TEG

28 Do EFRAG FR TEG members agree that Approach B brings more useful information than Approach A? Please explain.

29 Does EFRAG FR TEG members have comments on the other IASB proposals and the EFRAG Secretariat analysis?

Appendix 1: Feedback during the outreach

Introduction

1 The appendix provides the feedback[3] on the hedge accounting mechanism received during the DRM outreach November 2020 to February 2021 as per EFRAG FR TEG paper 06-02 at the May 2021 meeting.

The details

2 Many participants noted that revaluation through OCI (and the volatility that it would bring) was their biggest issue. In contrast to a fair value hedge where any movement of the hedged item would be offset by an opposite movement of the derivative in the opposite direction in profit or loss, this would not be the case when using a cash flow hedge. Here the movement of the hedging derivative would be recorded in OCI with no offsetting of the hedged item. This would create volatility.

3 Two participants emphasized that an accounting mismatch existed between the book value of derivatives (fair value) and the book value of hedged items (amortised cost). This could be avoided using a fair value hedge mechanic but would not be avoided using a cash flow hedge mechanic.

4 The participants noted that the accounting of derivative's fair value in OCI, which is 'asymmetrical', would be a key challenge both in terms of financial communication towards the users of financial statements, and in terms of its potential impact on regulatory capital. Furthermore, the public disclosure requirement on deviation from a theoretical target profile would not provide valuable information. As the proposed DRM model is not aligned with actual risk management practices.

5 For one of the participants concerned the impact on OCI would be 10% of their OCI balance.

6 One participant suggested to record the change in fair value of the derivatives as a single line item in the balance sheet (asset or liability) instead of in equity. It was noted that the fair value amount would not have to be tracked down to individual financial instruments, it would work as ‘fair value balance’ on a higher level of aggregation [not specified]. While it was noted such ‘a fair value balance’ may not bring much information about the entity’s hedging of a net open risk position (which may include off-balance sheet positions), the detailed mechanics of this approach were not explored in the interview. This solution would also resolve the difference in accounting treatment between under hedges and over hedges. Information on the potential future impact of over-hedging or under-hedging on the net interest income could be provided in the disclosures.

7 Various participants mentioned the impact of the use of a cash flow hedge mechanism on Core Equity Tier 1 under CRR2 and that a filter similar to that for cash flow hedges currently available would be required. It is noted that this does not imply a different risk management strategy (hedging the fair value versus hedging the cash flows) but rather the destination to where the fair value of the hedging instrument is booked, either in OCI (without revaluation of the hedged item) or in profit or loss (with revaluation of the hedged item).

8 Views were mixed as to the importance of the impact on equity even if such a filter has been obtained with some regarding the impact on equity as unacceptable and others not being that concerned.

9 Several participants noted that they would prefer a fair value hedge approach instead of using the cash flow hedge mechanics. They note that displaying volatility

[3] Paper 6-02 available here.

in equity does not faithfully represent an activity which purpose is to reduce the sensitivity of NII/EVE to interest rate risk.

10 Several participants asked why a model based a FVH mechanism with a valuation of the hedged risk on a net basis by analogy to IFRS 13.48 52 has not been considered? Those participants also noted that to consider gains or losses representing the portion of the hedged risk of a portfolio do not meet the definition of an asset or a liability and therefore to reject fair value hedge mechanics is questionable.

11 This because the conceptual framework acknowledges the possibility to select one unit of account for recognition and a different unit of account for measurement (cf. Conceptual framework §4.49). Accordingly, IFRS 13.48-52 exemption allows for groups of financial assets and liabilities managed on a net basis to be measured based on their net position under certain criteria (1/ the valuation process is the result of a documented strategy, 2/ fair value information is disclosed to management on this basis, 3/ the use of the exception corresponds to an accounting policy choice), while presentation has to be made on a gross basis.