Risk mitigation intention and construction of the benchmark derivatives: Issues Paper

Objective

1 The objective is to receive comments from EFRAG FR TEG members on IASB Staff paper 4B to the IASB April 2023 meeting (the SP) on the above topic.

Overview of the paper

2 The IASB Staff in the SP recommends that the IASB requires the following (paragraphs 6 of the SP):

(a) the managed risk to be consistent with the entity's risk management strategy and risk limits; and

(b) the benchmark derivative to be calibrated to current market rates of the managed risk (to achieve a fair value of zero using the risk mitigation intention (RMI) by repricing period – the EFRAG Secretariat assumes this excludes the possible use of non-linear derivatives).

3 The IASB Staff also recommends that the following tentative decisions of the IASB is reconfirmed (paragraphs 7 of the SP):

(a) the RMI is evidenced by the amount of interest rate risk transferred to an external party; and

(b) the repricing time periods of the available risk to mitigate are aligned with the entity's risk management strategy.

4 In the SP the IASB Staff summarises the current tentative decisions in paragraphs 8 to 14 and a summary of informal outreach feedback in paragraphs 15 to 19. The analysis is set out in paragraphs 20 to 37 of the SP.

IASB discussions

5 IASB members discussed the example in the SP in paragraph 17 where an undertaking has a current net open risk position (CNOP) at the nine-year repricing period. To hedge this would be very expensive due to lack of liquidity, and so the entity may choose to hedge with a ten-year swap. The RMI would reflect the nine years in the CNOP even though evidenced by a ten-year swap.

6 There was a question as to whether an entity can have more than one CNOP. The staff confirmed that there is one CNOP per DRM, so there could be several within the reporting entity.

7 The IASB members agreed with the staff recommendations in paragraph 2 and 3 above.

EFRAG FIWG discussions

8 One member noted an inconsistency between the definition of portfolio which refers to similar risk characteristics and the highest level of management (which will often include different risk characteristics such as types of credit risk but also currencies).

9 On internal derivatives, the concern is not so much that internal derivatives should be qualifying hedging derivatives, but these may be relevant to consider when identifying the CNOP and not only for foreign exchange impacts.

10 Another member had some concerns about the final drafting for internal derivatives as well and how that could impact cases where the trading book has such low risk limits that substantively the internal derivatives reflect the external derivatives. This is usually an inexpensive way to trade whereas fully back-to-back is usually expensive and not used by that many entities.

EFRAG Secretariat analysis

11 The EFRAG Secretariat notes the following should alleviate practical issues around application of the DRM model:

(a) The expectation that the managed risk would be clearly identifiable through the entity's risk management strategy (paragraph 23 of the SP) and how that would work on a consolidated basis (with reference to paragraph 20 of the SP).

(b) The acknowledgement that the RMI would not need to be documented before execution of the external derivatives (paragraph 27 of the SP).

(c) Using the same front office system for designated and benchmark derivatives (paragraph 37 of the SP).

12 The EFRAG Secretariat notes that the principles in paragraph 35 of the SP would be familiar to practitioners as these apply to hypothetical derivatives as well. The EFRAG Secretariat notes that while it is clearly stated that the benchmark derivative shall be constructed to be on-market at designation it is not clear whether this also applies to each of the repricing time periods.

Questions for EFRAG FR TEG

13 What are the comments of EFRAG FR TEG members on the following aspects:

(a) That the managed risk seems to refer to one type of benchmark interest rate in local currency (paragraph 20 of the SP)?

(b) The explanation in paragraph 32 of the SP around the mechanics when using a designated derivative with a tenor exceeding the CNOP tenor?

(c) The difficulty or ease in determining the benchmark derivative in practice?

14 Does EFRAG FR TEG have further comments on the IASB Staff paper and related discussions or the EFRAG Secretariat analysis as set out above?