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Dynamic Risk Management – Eligible items Issues Paper

Objective

- 1 The objective of this paper is to update EFRAG FR TEG and obtain views on the February 2023 IASB tentative decisions on the Dynamic Risk Management (DRM) project related to the discussion on whether financial assets measured at fair value through other comprehensive income (FVOCI) or at fair value through profit or loss (FVPL) are eligible for inclusion in the current net open position (CNOP).

Summary of the IASB tentative decisions to date

- 2 When developing the core DRM model, the IASB tentatively decided what the qualifying criteria would be for financial assets and liabilities to be eligible for designation in the DRM model, which are:
 - (a) financial assets or financial liabilities must be measured at amortised cost under IFRS 9;
 - (b) the effect of credit risk does not dominate the changes in expected future cash flows;
 - (c) future transactions must be highly probable;
 - (d) future transactions must result in financial assets or financial liabilities that are classified as subsequently measured at amortised cost under IFRS 9;
 - (e) items already designated in a hedge accounting relationship are not eligible under the DRM accounting model; and
 - (f) items must be managed on a portfolio basis for interest rate risk management purpose.
- 3 In the July 2022 project plan (IASB Staff paper [AP4](#)), the IASB considered that further analysis might be necessary to consider whether other items could be eligible for inclusion in the DRM model as part of the current net open risk position, including:
 - (a) own equity balances (such as, equity reserves and equity instruments with characteristics of debt);
 - (b) financial assets classified as fair value through other comprehensive income (FVOCI items); and
 - (c) other financial assets that are classified as fair value through profit or loss (FVPL) as a result of not having contractual cash flows that are solely payments of principal and interest (SPPI), but nevertheless have contractual payments for interest.
- 4 In November 2022 (IASB Staff paper [AP4A](#)), the IASB discussed the inclusion of own equity in the CNOP and concluded that it is not necessary to achieve the

objective of the DRM model, and therefore tentatively decided that equity is not eligible for designation in the CNOP.

- 5 The following paragraphs summarise the IASB Staff's considerations and recommendations regarding the eligibility of financial assets measured at FVOCI or FVPL for the February 2023 IASB meeting (IASB Staff paper [AP4A](#)).

Financial assets measured at FVPL

- 6 According to the requirements of IFRS 9, financial assets are measured at FVPL if they are not held in a business model whose objective is to hold financial assets in order to collect contractual cash flows or both collecting contractual cash flows and selling financial assets or if they do not have SPPI cash flows even if they are held in a business model whose objective is achieved by collecting contractual cash flow (and selling financial assets).
- 7 For financial assets held exclusively for sale, the IASB Staff considered that the DRM model is not relevant as the entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. Therefore, from an earning perspective, net interest income (NII) is not relevant.
- 8 In the case of financial assets without SPPI cash flows but with certain exposure to interest rate risk, the IASB Staff noted that the general accounting requirements already achieve faithful representation of both economic value and earnings perspective.
- 9 To simplify the underlying conceptual arguments, the IASB Staff considered an inverse floating-rate asset and the related interest rate derivative used to mitigate the changes in the benchmark interest rate.
- 10 From an accounting perspective, the fair value movements on the item and on the derivative offset each other in the statement of profit and loss for the fair value changes related to changes in the benchmark interest rate. This offset is done in the same period in profit or loss. Therefore, there is no accounting mismatch that exists from an economic value perspective.
- 11 Furthermore, neither the gains or losses of the underlying asset nor the designated derivative are recognised in interest income or expense – calculated using the effective interest method – and the entity is therefore not exposed to earnings variability in NII¹.
- 12 Therefore, for an accounting point of view, the DRM adjustment would not add any advantage in form of reduced variability both from an economic value and an earnings (NII) perspective. Consistently, the IASB Staff recommended that financial assets measured at FVPL are not eligible for designation in CNOP.

Financial assets measured at FVOCI







- 13 Applying IFRS 9, for financial assets measured at FVOCI, interest is recognised in profit or loss using the effective interest rate method (in the same way as for financial assets measured at amortised cost) and the cumulative gain or loss in OCI is reclassified to profit or loss only when the financial asset is derecognised.
- 14 Considering a fixed rate bond at FVOCI and an interest rate derivative used to mitigate the interest rate risk as simplifying example, the IASB Staff noted that both instruments are measured at fair value in the statement of financial position. However, in profit and loss, the entity still has an accounting mismatch as the fair value of the financial assets are recognised in OCI while the gains and losses on the derivative are recognised in profit and loss.

¹ The earnings perspective of the DRM model focuses on NII.

- 15 Therefore, the IASB Staff considered that the DRM adjustment would reduce this accounting mismatch as the fair value changes of the derivatives would be recognised in future periods when the changes in economic value inherent in the underlying items are realised (to the extent the designated derivatives have been effective in achieving the risk mitigation intention).
- 16 In addition, the IASB Staff noted that the DRM adjustment would also reduce the variability in earnings (NII). The unwinding over time of the DRM adjustments, recognised in NII, would fill the gap existing in profit or loss between interest recognised using the effective interest method on the financial asset and the gains or losses on the derivative used to mitigate interest rate risk.
- 17 Lastly, the IASB Staff noted that the application of the DRM model to financial assets measured at FVOCI would not achieve a reduction in total fair value variability in the statement of financial position. In fact, the DRM model is not a fair value hedge and does not affect the measurement of the underlying items. This means that the cumulative fair value changes of financial assets in OCI would not be offset by the DRM adjustment.
- 18 Nevertheless, the IASB Staff considered that the inclusion of financial assets at FVOCI in the CNOP achieves the dual objective of the DRM model (e.g., stabilising the net interest income and protecting the fair value of assets, liabilities and future transactions). Consistently, the IASB Staff recommended that financial asset measured at FVOCI are eligible for designation in CNOP.

Summary of the IASB Staff recommendations

- 19 This table summarises the IASB Staff considerations on eligible items:

	Assets at FVOCI	Assets at FVPL
Can the DRM adjustment reduce variability in NII (earnings perspective)?	 Because of the accounting mismatch between the underlying items and the derivatives (interest recognised on the asset in NII using the EIR method vs gains or losses not in NII)	 Because gains or losses of both the underlying items and the derivatives are not recognised in NII (no exposure to earnings variability)
Can the DRM adjustment protect the fair value of assets, liabilities and future transactions (economic value perspective)?	 Because of the accounting mismatch between the underlying items and the derivatives (FV changes of asset recognised in OCI and only recognised in PL when the asset is derecognised vs FV changes of derivative recognised in PL)	 Because FV changes of underlying assets and derivatives recognised in the same period (no accounting mismatch)
Are they eligible for designation in the CNOP?		

February 2023 IASB tentative decisions

- 20 The IASB tentatively decided that, when an entity determines its current net open risk position under the DRM model, financial assets measured at FVOCI are eligible for designation in the DRM model, but financial assets measured at FVPL are not. The IASB's rationale for its tentative decision is that financial assets measured at FVOCI have the same exposure to variability in future net interest income and fair value as financial assets measured at amortised cost.
- 21 All 12 IASB members agreed with this decision.

EFRAG FIWG discussion

- 22 Members highlighted that the IASB's tentative decision not to allow the inclusion of financial assets at FVPL in the current net open risk position represents a departure from current risk management practices.
- 23 Members noted that the objective of the DRM model was and is to reflect, as the extent possible, risk management practices and questioned the IASB Staff's approach which considers only the reduction of an accounting mismatch in terms of PL volatility; such an approach does not properly reflect the economics of risk management activities.
- 24 Members provided several examples of financial instruments measured at FVPL (since they do not have SPPI cash flows) which are instead considered part of the banking book portfolio for interest rate risk management (e.g., certain Hungarian loans and sustainability-linked loans). One member specified that risk management looked at the portfolio in a holistic way, without distinguishing assets from different accounting categories.
- 25 Members also noted that these types of instruments could have an impact on earnings similar to financial assets measured at amortised cost (at least on an accrual basis). Therefore, members noted that the example used by the IASB Staff to illustrate the absence of an impact on earnings is extreme and does not fairly represent the fact that these instruments could be considered in an overall interest rate risk management strategy. One member noted that the IASB Staff focused the earnings perspective on net income interest only and therefore financial assets at FVPL have no direct impact on it.
- 26 It was noted the DRM model highlights an implicit tension between the mitigation of the variability of the net interest income (e.g., cash flow perspective) and the variability of the economic value (e.g., fair value perspective). However, the IASB Staff's solutions proposed both for assets at FVPL and for retrospective assessments seem to favour a fair value perspective.
- 27 Some members considered that a perfect alignment between risk management practices and the accounting rules is not possible due to differences in terms of objectives, timescales and perspectives, therefore some compromises need to be considered.
- 28 One member shared a concern on the presentation of the DRM adjustment for financial assets at FVOCI: some stakeholders had raised concerns that there could be a double-counting arising from the measurement of the underlying asset and the DRM adjustment. Members noted that even if this were not the case (e.g., the DRM adjustment represents a deferral of the fair value changes of the designed derivatives), the IASB should clarify the underlying mechanism better to ensure that this aspect does not constitute an obstacle to the development of the model.

EFRAG Secretariat analysis

- 29 The EFRAG Secretariat notes the IASB's tentative decision on FVPL instruments creates a difference between the definition of the portfolio of interest rate exposures

managed by risk management and the portfolio of interest rate exposures included in the DRM model and a similar difference between derivatives used by risk management and designated derivatives in the DRM model.

- 30 The EFRAG Secretariat shares the IASB Staff's considerations according to which, from an accounting point of view, the inclusion in the DRM model of financial assets measured at FVOCI would reduce variability both in term of economic value and an earnings value. Furthermore, the EFRAG Secretariat agrees with the conclusion that financial assets at FVPL should be not included in the DRM model, due to the absence of accounting mismatch between the underlying items and the designed derivatives.
- 31 Therefore, the EFRAG Secretariat agrees with the IASB Staff's recommendations.

Questions for EFRAG FR TEG

- 32 Does EFRAG FR TEG agree with the IASB's tentative decision that financial assets at FVOCI are eligible for designation in the CNOP, while financial assets at FVPL are not eligible for designation in CNOP?
- 33 Does EFRAG FR TEG have any other comments on the IASB's tentative decision?