Dynamic Risk Management – Unexpected changes 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 how unexpected changes could be reflected in the assessment and measurement of performance in the DRM model.

IASB Staff's recommendations

2 The IASB Staff recommends:

(a) not to require the retrospective assessment against an entity's target profile; but

(b) introduces another retrospective assessment based on the entity's capacity to realise the expected benefits.

Retrospective assessment against an entity's target profile

3 In November 2021 (AP4A), the IASB tentatively decided to introduce two retrospective assessments to reflect misalignment arising from unexpected changes in the DRM model. The retrospective assessments should be performed at the end of the period under assessment in order to assess whether:

(a) the entity has mitigated interest rate risk (that is, assessing whether the effect of unexpected changes to the current net open risk position (CNOP) during the period, resulted in the entity creating risk. In other words, the entity was over-hedged)[1] ; and

(b) the target profile has been achieved (to determine whether the difference between the current net open risk position at the end of the period and the risk mitigation intention for each time bucket falls within the target profile).

4 While the retrospective assessment against risk mitigation criteria fails when the entity has over-mitigated the risk and the DRM adjustment should be adjusted accordingly, the IASB Staff considered that the fact that the risk mitigation intention has achieved the target profile or not, should not have direct effect on the measurement of the DRM results in the financial statements.

5 In particular, the IASB Staff noted that the failure in the retrospective assessment against the target profile would usually happen when there are unexpected increases in the current net open risk position during the period under assessment. If that happen, an entity would be required to recognise a DRM misalignment to

[1] If the effect of unexpected changes on current net open risk position at the end of the period is such that the risk mitigation intention is greater than the updated net open risk position, that would mean that risk is created rather than mitigated (e.g., the outcome would be over-hedging).

reflect the minimum additional risks it needs to mitigate in order to achieve its target profile.

6 The IASB Staff considered that the inclusion of such minimum additional risks in the DRM adjustment may lead to a counter-intuitive accounting result.

7 Considering that the measurement of the DRM adjustment is based on the "lower of" test[2], the effect of such unexpected changes could result in a higher (rather than lower) DRM adjustment in the statement of financial position, and therefore offset more (rather than less) of the designated derivatives profit or loss, with the result that the entity would report less (rather than more) in misalignment profit or loss.

8 If the entity's CNOP has increased unexpectedly, the total fair value changes of the risk mitigation intention after including the effect of unexpected changes (e.g., capturing the effect of such unexpected changes) would probably increase as the effect of the unexpected changes would be in the same direction as the changes in the value of the benchmark derivatives.

9 The IASB Staff considered that the retrospective assessment against an entity's target profile would not provide useful information and it could even confuse or mislead users of the financial statements in some circumstance. Therefore, the IASB Staff recommended not requiring such a retrospective assessment and maintaining only the one that assesses whether the entity has mitigated interest rate risk (over-hedge).

Retrospective assessment based on the entity's capacity to realise the expected benefits

10 The IASB Staff noted that:

(a) The DRM adjustment represents the extent to which the designated derivatives mitigated the variability in the fair value of the risk mitigation intention. Subsequently, the DRM adjustment unwinds to profit or loss to 'offset' the net interest income from the underlying items.

(b) the risk mitigation intention is a portion of a net open risk position derived from underlying items that are dynamically changing. In an undisputable manner it is not possible to attribute the DRM adjustment to changes in the individual underlying items as the risk management is performed holistically based on the overall risk exposures from all [qualifying] underlying items;

(c) large prepayments or other unexpected changes to the underlying items may significantly change the fair value or future net interest income within the underlying items that were caused by market movements in previous DRM assessment periods. It is not straightforward to reflect the economic effects of such unexpected changes in the financial statements; and

(d) there is a risk that the DRM adjustment may no longer represent the future benefit to be realised due to unexpected changes (e.g., if most of the underlying items have prepaid earlier that initially expected).

11 As an alternative, the IASB Staff considered that an assessment of the capacity to realise the expected future benefits is the most appropriate approach. The IASB Staff had also considered two other potential solutions but did not support them. These are described in the Appendix to this paper.

12 The alternative based on the entity's capacity to realise the expected benefits is an assessment of the fair value of the CNOP at the assessment date, assuming no

[2] The DRM adjustment is recognised in the statement of financial position, as the lower of (in absolute amounts):

- the cumulative gain or loss on the designated derivatives from the inception of the DRM model; and
- the cumulative change in the fair value of the risk mitigation intention attributable to repricing risk from inception of the DRM model. This would be calculated using the benchmark derivatives as a proxy.

further increases or decreases in the CNOP until the end of the time horizon. The assessment will ensure that the DRM adjustment is not recognised at an amount higher that the expected benefit of reduce variability to be realised in future (e.g., the fair value of the CNOP at the assessment date) and any excess of the DRM adjustment is written off via profit or loss in the period of the assessment.

13 The IASB Staff considered that this method would have the following advantages:

(a) it is consistent with the holistic risk management view upon which the DRM model is based, avoiding identifying the individual underlying items;

(b) it is a natural and easy extension of the retrospective assessment based on whether the entity has mitigated interest rate risk (over-hedge);

(c) it will ensure that the DRM adjustment represents the extent to which the derivatives will mitigate the future variability in both the fair value of and the net interest income from the risk mitigation intention;

(d) it will make sure that the amount of the DRM adjustment recognised in the statement of financial position corresponds to (or is not higher than) the economic benefit in the existing underlying items.

February 2023 IASB tentative decisions

14 The IASB tentatively decided not to require an entity to make a retrospective assessment against its target profile because such an assessment would not provide useful information to users of financial statements. However, the IASB tentatively decided to require an entity to assess whether the current net open risk position at the end of the DRM assessment period can realise the expected benefits (in the form of reduced variability in earnings or economic value) represented by the DRM adjustment.

15 All 12 IASB members agreed with this decision.

EFRAG FIWG discussion

16 One member questioned whether an entity should disclose information on unexpected changes rather than performing the assessment relating to unexpected changes. Some members agreed with the IASB's tentative decision to perform this assessment and indicated that a 'disclosures only' approach was not adequate and an assessment was needed to check, for example, what has been accumulated in the DRM adjustment still makes sense.

17 Some reasons for support of the IASB's tentative decisions included that, based on the other solutions proposed by the IASB Staff, the assessment of capacity to realise the expected benefits was simpler as it did not require the tracking and the operational burden required by the other proposed solutions. For one member, the reasoning was based on a logic similar to that in cash flow hedging to match what is accumulated in the OCI reserve with future transactions. Also, if a portfolio has dramatically changed (e.g., due to early prepayments or disposal of part of the portfolio), then one would need to question the DRM adjustment which is on the balance sheet and is to be amortised over time.

18 A few members requested more guidance and illustrative examples. It was expected that the IASB Staff would have a paper further explaining how the assessment would work in practice.

19 The EFRAG FIWG Chair indicated that once all the key decisions have been taken, it would be useful to have an overview of the comprehensive model and discuss on that basis.

EFRAG Secretariat analysis

20 In a dynamic risk management setting, the occurrence of unexpected outcomes is to be expected and modifications of positions are a constant element. Retrospective assessment is thus either a continuous action or an action providing random outcomes depending upon the time period elected.

21 The EFRAG Secretariat shares the views considered by the IASB Staff to conclude that a retrospective assessment against an entity's target profile would not provide useful information as well as the IASB Staff's analysis on two other potential solutions not ultimately supported.

22 The EFRAG Secretariat understands that the retrospective assessment based on the entity's capacity to realise the expected benefits is intended to capture the effects of any over-hedging not captured by the retrospective assessment against risk mitigation criteria. If there are significant unexpected changes, for example, significant early prepayments, the EFRAG Secretariat considers that a test is needed to assess whether the DRM adjustment on the statement of financial position still represents the extent to which designated derivatives are successful in mitigating repricing risk. In addition, the EFRAG Secretariat agrees with the advantages identified by the IASB Staff regarding this assessment.

23 However, the EFRAG Secretariat is of the opinion that more clarity on how the retrospective assessments would be applied in practice is needed to conclude on the appropriateness of the method proposed by the IASB Staff (how the retrospective assessments would be applied in practice is one of the elements that, in July 2022, the IASB tentatively decided to discuss further).

24 The EFRAG Secretariat notes that the fair value of the CNOP at the assessment date cannot be calculated directly, as the CNOP is a combination of non-identified assets and liabilities. Thus, a different wording, instead of 'the fair value of the CNOP' may better represent the retrospective assessment on whether the entity has a capacity to realise the expected benefits.

Questions for EFRAG FR TEG

25 Does EFRAG FR TEG agree with the IASB tentative decision not to require the retrospective assessment against an entity's target profile, but introduces another retrospective assessment based on the entity's capacity to realise the expected benefits?

26 Does EFRAG FR TEG agree with the EFRAG Secretariat's analysis?

27 Does EFRAG FR TEG have any other comments on the IASB's tentative decision?

Appendix: Summary of other methods considered and not supported by the IASB

1 The IASB Staff considered the following solutions for the challenge indicated above in paragraph 10 but did not support them:

(a) Tracking the changes in the fair value of the underlying positions; and

(b) Extending retrospective assessment against risk mitigation to multiple periods.

Tracking the changes in the fair value of the underlying positions

2 This alternative would be similar to the existing requirements in IAS 39 for a portfolio fair value hedge of interest rate risk, where an entity may use a 'percentage approach' to calculate the impact of any early repayments or other unexpected changes, based on the changes to the fair value of the underlying positions.

3 For example, assuming an entity had a cumulative fair value change of CU100 in its underlying positions driven by interest rate risks, and a DRM adjustment of CU60 (because it has on average mitigated 60% of the total interest rate risk). When there is an early repayment which reduces the total fair value change of the underlying position by 30% to CU70, applying this alternative, the entity would reduce the DRM adjustment by 30% to CU42 accordingly.

4 However, the IASB Staff did not consider this method appropriate for the following reasons:

(a) tracking the fair value changes of individual items would be inconsistent with the actual risk management which considers the effects of all underlying items holistically based on the aggregated risk position instead of individual underlying items.

(b) both the current net open risk position and the risk mitigation intention may change frequently from period-to-period, and thus it is not possible to determine the appropriate write-off in the DRM adjustment based merely on the fair value changes in the underlying items.

Extending retrospective assessment against risk mitigation to multiple periods

5 This alternative would entail extending the retrospective assessment against the risk mitigation to multiple DRM assessment periods, so that the assessment is done for each of the periods since the start of the DRM model, based on the latest current net open risk position. Using this method, the entity would be required to keep a record of the underlying items that were used to calculate the CNOP and risk mitigation intention for each of the past DRM periods.

6 This alternative is consistent with the holistic risk management view underlying the DRM model, as it does not require the entity to attribute the DRM adjustment to individual underlying assets or liabilities.

7 However, such a method is significantly complex and could have potential high implementation cost as an entity would need to track the details of the underlying positions and the risk management intention in each of the DRM assessment periods for the whole life of the DRM model.

8 The IASB Staff therefore considers that the incremental benefit of this approach to the users of financial statements is limited and is unlikely to outweigh the cost of application.