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Dynamic Risk Management Webcast

Walkthrough of illustrative example

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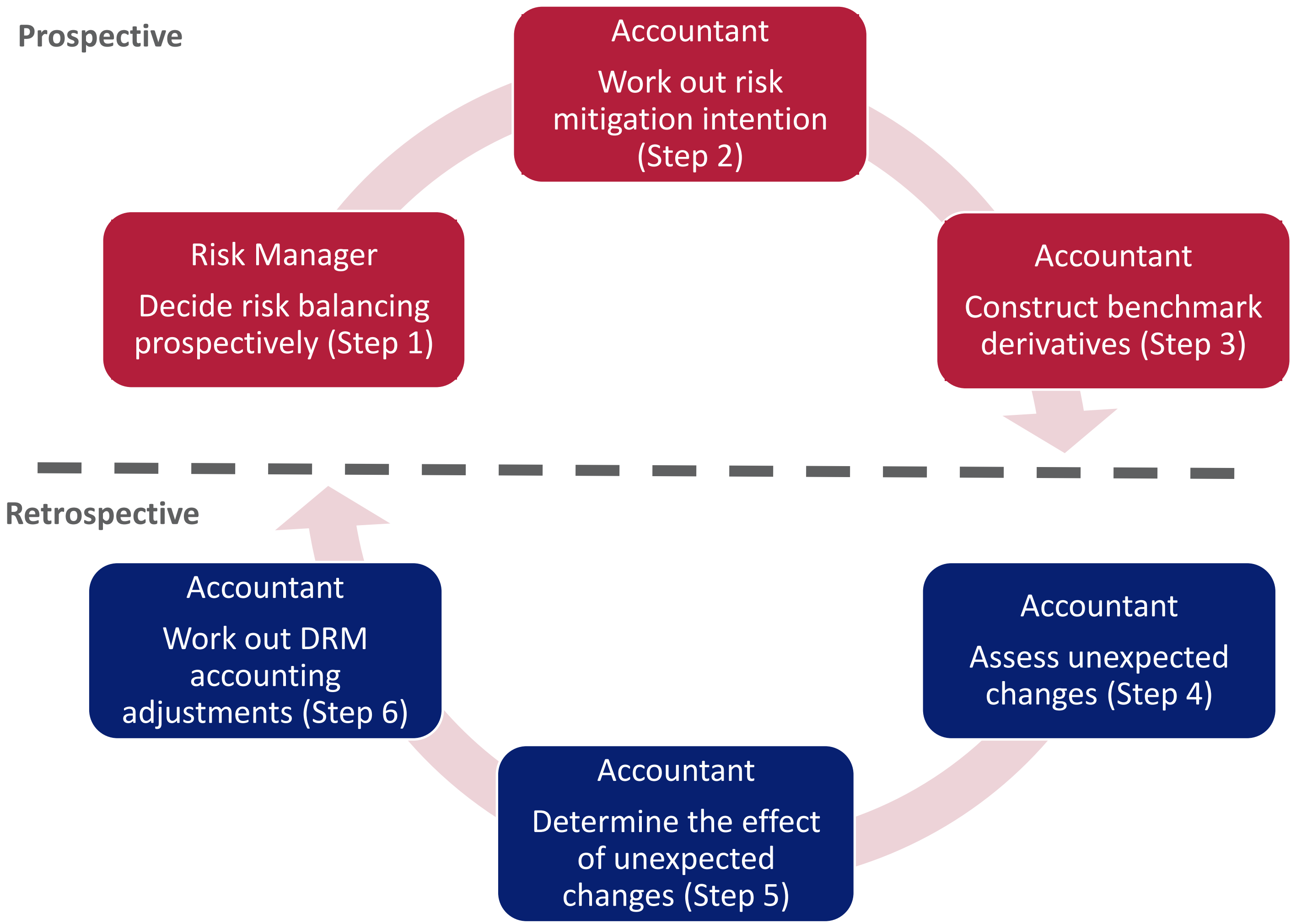
Risk Management Strategy (RMS)

Key components documented in the entity’s RMS:

- Manages its entity-level interest rate risk exposure for a 5-year time horizon
- Uses PV01 as the key risk metrics, splitting into 5 yearly time buckets
- Sets the risk limit as a PV01 of -50 to +50 in each of the time bucket (target profile)
- Manages the changes in risks monthly
- Includes expected cash flows based on internal models.



Walkthrough—prospective steps for Period 1

Beginning of Period 1 (ie T_0)

Step 1 Risk managers decide on the use of derivatives

Risk Manager View - No restriction from DRM model

bucket (yrs)	1	2	3	4	5
Prepayable Assets (PV01)				100	1,000
Term Liabilities (PV01)				-100	-500
Total Interst Rate Risk Exposure (PV01)				0	500
Traded Derivatives				0	-490
Residual open risk position				0	10

Step 2 Accountants determine current net open risk position and risk mitigation intention

DRM Model View

	bucket (yrs)	1	2	3	4	5
A	Current Net Open Risk Position				0	500
	Designated Derivatives				0	-490
B	**Risk Mitigation Intention**				**0**	**490**
C	Net of A and B				0	10
D	Target Profile	50	50	50	50	50
	Check for risk mitigation (A vs B)	OK	OK	OK	OK	OK
	Check within target profile (C vs D)	OK	OK	OK	OK	OK

Prospective assessments

Step 3 Accountants construct benchmark derivatives

DRM Model View

bucket (yrs)	1	2	3	4	5	
Risk Mitigation Intention				**0**	**490**	
Benchmark Derivatives	**0**	**0**	**0**	**0**	**490**	@ T0 rate (prevailing rate at the beginning of first period)

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Walkthrough—retrospective steps for Period 1

End of Period 1 (ie T_1)

Step 4

Accountants consider the unexpected changes to the current net open risk position based on latest ALM information, and compare that against the risk mitigation intention.

60 of PV01 risk shifts from yr 5 to yr 4

	bucket (yrs)	1	2	3	4	5
	Prepayable Assets (PV01)				160	940
	Term Liabilities (PV01)				-100	-500
A	**Current Net Open Risk Position (EOP)**	**0**	**0**	**0**	**60**	**440**
B	**Risk Mitigation Intention (for Period 1)**				**0**	**490**
C	Net of A and B	0	0	0	60	-50
D	Target profile	50	50	50	50	50
	Check for risk mitigation (A vs B)	OK	OK	OK	OK	Over
	Check within target profile (C vs D)	OK	OK	OK	Over	OK

Retrospective assessments

Comparison

There is no need to measure the effects of unexpected changes if such changes do not cause breaches to retrospective assessments

5 of PV01 risk shifts from yr 5 to yr 4

	bucket (yrs)	1	2	3	4	5
	Prepayable Assets (PV01)				105	995
	Term Liabilities (PV01)				-100	-500
A	**Current Net Open Risk Position (EOP)**	**0**	**0**	**0**	**5**	**495**
B	**Risk Mitigation Intention (for Period 1)**				**0**	**490**
C	Net of A and B	0	0	0	5	5
D	Target profile	50	50	50	50	50
	Check for risk mitigation (A vs B)	OK	OK	OK	OK	OK
	Check within target profile (C vs D)	OK	OK	OK	OK	OK

Walkthrough—retrospective steps for Period 1

End of Period 1 (ie T_1)

Step 5 Accountants determine the effect of unexpected changes

	bucket (yrs)	1	2	3	4	5
	Prepayable Assets (PV01)				160	940
	Term Liabilities (PV01)				-100	-500
A	**Current Net Open Risk Position (EOP)**	**0**	**0**	**0**	**60**	**440**
	Risk Mitigation Intention (PV01 of BD)	0	0	0	0	490
	Determine the effect of unexpected change				10	-50
B	**Total basis for measurment**	**0**	**0**	**0**	**10**	**440**
C	**Net of A and B**	**0**	**0**	**0**	**50**	**0**
D	Target profile	50	50	50	50	50
	Check for risk mitigation (A vs B)	OK	OK	OK	OK	OK
	Check within target profile (C vs D)	OK	OK	OK	OK	OK

- The effect of unexpected changes are expressed in risk terms here. An entity needs to measure the changes in fair values driven by these unexpected changes during the period.
- One of the possible ways is to construct additional hypothetical derivatives similar to benchmark derivatives for measurement purposes.

Walkthrough—retrospective steps for Period 1

End of Period 1 (ie T_1)

Step 6 Accountants work out the DRM adjustments (using the 'lower-of test').

	bucket (yrs)	1	2	3	4	5	Total FV
A	**Designated Derivatives**	**0**	**0**	**0**	**0**	**-490**	
	Existing Benchmark Derivatives	0	0	0	0	490	
	Effects of unexpected changes	0	0	0	10	-50	
B	**Benchmark Derivatives + Effects of Unexpected Changes**	**0**	**0**	**0**	**10**	**440**	
	Market interest rate changes during the period:						
C	Interest rate changes in bps	-2	-2	-2	-2	-2	
A*C	**Changes in FV of the designated derivatives**	0	0	0	0	980	980
B*C	**Change in FV of RMI and unexpected changes**	0	0	0	-20	-880	-900

Account balances:

Dr Derivatives B/S	980
Cr DRM adjustment	(900)
Cr Misalignment P&L	(80)

Comparison

If the market interest rate change was -2 bps at Year 5 but -10 bps at Year 4

	bucket (yrs)	1	2	3	4	5	Total FV
A	**Designated Derivatives**	**0**	**0**	**0**	**0**	**-490**	
B	**Benchmark Derivatives + Unexpected Changes**	**0**	**0**	**0**	**10**	**440**	
	Market interest rate changes during the period:						
C	Interest rate changes in bps	-2	-2	-2	-10	-2	
A*C	**Changes in FV of the designated derivatives**	0	0	0	0	980	980
B*C	**Change in FV of RMI and unexpected changes**	0	0	0	-100	-880	-980

Account balances:

Dr Derivatives B/S	980
Cr DRM adjustment	(980)
Cr Misalignment P&L	0

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