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Introduction

1. The objective of this paper is to seek the Board's feedback on a proposed outline of a model for accounting for Dynamic Risk Management (DRM). The staff would like to note that the paper presents an outline of the proposed solution along with the critical decisions that the Board will need to consider if the Board decides to proceed in the manner proposed in the paper. More specifically the paper:
 - (a) discusses the objective of the proposed model;
 - (b) discusses two alternatives for the proposed model;
 - (c) highlights the critical decisions required to develop an accounting model for DRM regardless of the preferred approach; and
 - (d) provides a staff recommendation.

Background

2. Financial institutions manage interest rate risk through frequent monitoring of net interest rate risk positions. With an aim to better reflect this business activity in

financial reporting, the IASB published the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach for Macro Hedging* (the '2014 DP'). The objective was to seek views so that the IASB could evaluate how the proposed model would enhance the usefulness of financial statements.

3. The Board obtained feedback on the accounting proposals in the 2014 DP from investors, analysts, preparers, accounting practitioners, as well as others, in comment letters and public roundtable discussions. Many constituents agreed that the 2014 DP had correctly identified the current accounting challenges when risk management is dynamic in nature. More specifically, these issues relate to the dynamic nature of some hedged portfolios and a financial institution's inability to designate demand deposits as hedged items. Constituents also believed that there was a need for a project to address these challenges. Comments received also clarified that only a small number of non-financial entities manage risk dynamically and some were of the view that the requirements in *IFRS 9: Financial Instruments* (IFRS 9) were sufficient.
4. Constituents highlighted that IFRS 9 requires that the majority of banking book assets (eg loans) and liabilities (eg deposits) be measured at amortised cost, regardless of any net open risk positions between assets and liabilities. Consequently, under IFRS 9, any impact arising from net open risk positions is presented in profit or loss on an accrual basis. Respondents did not think that all the banking book exposures should be remeasured at current value (ie fair value with respect to the hedged risk) – as proposed by the Portfolio Revaluation Approach (PRA) in the 2014 DP – only because they are managed dynamically.
5. The PRA proposed to revalue managed net open risk position(s) for changes in interest rate risk the risk being managed dynamically. The PRA provided two alternatives regarding scope – specifically, one approach with a focus on risk mitigation and the other a focus on DRM. The risk mitigation focused approach would revalue portfolios where risk-mitigating activities had been undertaken whereas the DRM would revalue all dynamically managed portfolios.
6. Overall, many constituents did not support the PRA, but did highlight the need for an accounting model which better reflects DRM in financial statements.

Unfortunately, constituents did not provide specific suggestions to accomplish that goal.

Business activity

7. The core economic activity of some financial institutions can be described as raising funds to provide longer-term loans to customers. The difference between yield on loans (interest revenue) and cost of funding (interest expense) represents the financial institution's net interest margin (NIM).
8. An adverse change in market factors, such as interest rates, can negatively impact NIM and thus the performance of the financial institution. DRM is the process that involves understanding and managing how and when a change in market factors can impact NIM. As NIM is the net of cash inflows (interest revenue) and cash outflows (interest expense), a change in market factor that has an equal impact on both inflows and outflows would have no impact on NIM. If an increase in cash inflows is offset by an equal increase in cash outflows the difference between inflows and outflows would remain unchanged, implying NIM should be unchanged. Consequently, one of the best ways to ensure cash inflows and outflows react in a similar manner to a change in market factors is to align the timing of when those cash inflows and outflows are contracted. In the context of financial institutions, matching re-pricing dates of cash inflows and outflows is a common approach used to mitigate the impact that changes in market factors can have on NIM.
9. Some sources of funding, specifically demand deposits, can be insensitive to changes in market factors. Demand deposits are funds placed with the financial institution that can be withdrawn with little or short notice and pay little or no interest. Nonetheless, it is very common for deposit accounts to be maintained for an extended period of time. This implies that a significant portion of financial institution deposit funding is non-rate sensitive for an indeterminate period. Consequently, as interest expense (cash outflows) will remain stable regardless of changes in market rates for an extended period of time, these deposits effectively represent perpetual fixed rate funding.

10. In order to implement a strategy of aligning cash inflows and outflows, the financial institution would need an asset with an indefinite life to match the indefinite life of the deposits. As fixed rate perpetual life loans do not exist in sufficient quantity to match the quantum of deposits, aligning the re-pricing of loans and deposits is difficult and perfect alignment may not be possible. This implies NIM will change over time and that changes in loan yields (cash inflows) will dominate changes in NIM over time. In this situation, while the financial institution cannot eliminate the impact of market factors on NIM, it can influence the speed at which those changes impact NIM. More specifically, while a financial institution cannot prevent cash inflows from re-pricing over time, it has the ability to accelerate or delay the speed at which such inflows re-price.
11. The ability to accelerate or delay re-pricing, but not eliminate, forces management to decide whether they will be proactive and take action altering the re-pricing of NIM or if they will accept NIM re-pricing based upon the originated loans. As discussed during the Board education session on DRM, a passive approach can lead to an uneven distribution of re-pricing over time that may not be in the financial institution's best interest. It is important to note that the decision to take no action, ie accept the changes in cash inflows over time, is a decision nonetheless and will affect the future economic resources of the financial institution. Furthermore, specifically within the realm of financial institutions, the prudential regulator can and often does mandate some form of active management in order to limit potential risk.
12. If the financial institution decides, or is required, to proactively manage NIM, it must decide how changes in market factors should influence NIM. This decision reflects management's target profile. In practice, as management cannot force customers to originate loans that are convenient from a re-pricing perspective, derivatives are used to influence the speed of re-pricing. The derivatives transform loans such that the financial institution's cash inflows will react to changes in market factors based on management's target profile rather than the profile based on the loans originated by the financial institution.

What are the objectives of the proposed model?

13. The objective of developing a new model is to improve information provided regarding risk management and how risk management activities affect the financial institution's current and future economic resources. A perfect and complete reflection of all risk management in financial reporting is an aspirational objective as 'financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need.'¹ The aim of the model is to faithfully represent, in the financial statements, the impact of risk management activities of a financial institution in the area of dynamic risk management rather than perfectly capture every aspect of the risk management activity. The staff believe that to achieve the aim above, the model needs to focus on the challenges outlined in paragraphs 14 through 20 below.

Transparency

14. The objective of 'financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity'². In the context of DRM, conveying how the risk management actions will affect the financial institution's current and future economic resources is relevant for economic decision-making. Users understand the difference between cash inflows (interest income) and cash outflows (interest expense) is a key value driver for financial institutions but also recognise the different re-pricing sensitivities of cash inflows and outflows. Transparency on management's approach for managing re-pricing of those cash flows will help users with their assessment of the above mentioned key value driver.
15. Financial institutions select an approach when managing interest rate risk based upon their evaluation of advantages and disadvantages inherent with a longer (slower) or shorter (faster) re-pricing profile. Adding transparency to the financial statements about the profile would better enable users to evaluate management's approach and rationale for their decisions. Furthermore, such transparency would

¹ Paragraph OB6 of the Conceptual Framework.

² Paragraph OB2 of the Conceptual Framework.

better enable the comparison of management's approach, both amongst the peer group and over time, enhancing the usefulness of information. Clarity on management's target profile and implications for future cash flows is largely absent from financial reporting today.

Eligible Items

16. When developing the hedge accounting requirements in IFRS 9, the Board decided an entity could only apply hedge accounting, if it met certain qualifying criteria. One such criterion is that the hedging relationship consists only of eligible hedging instruments and eligible hedged items. Demand deposits, whose nature is described in paragraph 9, are ineligible for cash flow hedge accounting as their associated interest cash flows, if any, do not vary with interest rates. Furthermore, such demand deposits do not have any fair value risk arising from movements in interest rates³. Therefore, entities are unable to apply hedge accounting when demand deposits are the hedged item as they are not exposed to either variability in cash flows or to changes in fair value arising from interest rate risk. This creates tensions when certain financial institutions try and reflect their risk management activities, as described in paragraph 7 through 12, in the financial statements.
17. If customers have a preference for fixed-rate loans, aligning those loans with management's target profile often requires two derivatives. Assuming a financial institution uses interest rate swaps to manage re-pricing risk, the first derivative would convert the loans' fixed cash flows into floating, while the second derivative would transform the floating cash flows to the management's target profile. Currently, only the first derivative would be eligible in a highly effective hedge accounting relationship. The second interest rate swap cannot be designated against demand deposits thereby creating a 'capacity' issue for preparers. There are various ways in which entities attempt address this capacity issue. For example, entities identify alternative eligible hedged items on the statement of financial position – such as variable interest rate assets for which cash flow hedge

³ Paragraph 47 of IFRS 13 states that the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

accounting can be applied. However, this can result in risk management not being properly captured in the financial statements.

Dynamic Nature

18. Assets and liabilities managed by DRM are not static. On a daily basis, events alter the composition of the assets of any financial institutions. Some events, such as product maturities, are inherently considered by DRM. However, other events, such as growth, often require additional DRM actions. These additional mitigating actions result in frequent additions of hedging instrument leading to frequent de-designations and rebalancing of hedge designations as IFRS 9 requires one-to-one designation between eligible hedged items and hedging instruments. In addition, such changes often require the amortisation of the associated cash flow or fair value hedge accounting adjustments. Consequently, the processes required to manage the constant designation, de-designation, re-designation of hedge accounting relationships and the associated amortisations arising from DRM become inherently complex, costly and prone to operational error.

Performance Measurement

19. Finally, any model has to facilitate the users' assessment of how 'efficiently and effectively the entity's management have discharged their responsibility to use the entity's resources'⁴. While assessing the merits of management's strategy is one aspect of performance measurement, in the context of DRM, determining if management has successfully achieved their target profile is also important. A simple, understandable and reliable metric demonstrating if management was successful in transforming the asset profile as desired would be relevant information for economic decision-making. Current financial reporting provides some information regarding the effectiveness of hedging programs. However, the current measures are designed to reflect the performance of one-to-one relationships and are also coloured by the hedge designations as discussed in paragraphs 16 and 17. Consequently, one of the key objectives of any chosen model would be also to provide such a metric for users of financial statements.

⁴ Paragraph OB4 of the Conceptual Framework.

20. To summarise, the model aims to increase transparency on management's target profile. Furthermore, it aims to address the 'capacity issue' and the operational challenges identified in paragraph 18. Finally, the model aims to provide a performance metric more closely aligned with the business activity.

Proposed approaches

21. Before we can outline any proposed model to address the above objective, it is important to define certain terms that are used in articulating the model:
- (a) The asset profile: Composed of all existing financial assets measured at amortised cost plus highly probable forecast transactions, for example, reinvestments of maturing assets that result in a future financial asset that will also be measured at amortised cost. Items in the profile must be managed on a group basis for risk management purposes. The reason being that items in the profile must impact interest income given the risk management focus on NIM.
 - (b) The target profile: The desired profile of cash flows arising from the above assets as determined by management to manage interest rate risk (refer to paragraphs 7 through 12 for additional details).
 - (c) DRM derivative instruments: Derivatives that align or bring closer (ie transform) the financial institution's asset profile to the target profile.
22. The model proposes that if the derivative instruments are successful in aligning the asset profile with the target profile, and the target profile is realised through the collection of cash flows over the life of profile (ie it impacts NIM), the change in fair value of the derivatives should be accounted for as outlined in paragraph 26. Portrayed differently, the model proposes that if the DRM derivative instruments (C) are successful in aligning the defined asset profile (A) with management's target profile (B), the fair value changes of such derivatives will be accounted for as outlined in paragraph 26.
23. When developing the outline of the model the staff have prioritised the consideration of interest rate risk consistent with the Board's May 2015 decision.

24. Under current IFRS Standards, there are two alternatives for designating an interest rate hedge accounting relationship. Those methods are:
- (a) Fair value hedge accounting of eligible fixed rate assets and liabilities;
or
 - (b) Cash flow hedge accounting of the cash flow variability arising from eligible floating-rate assets and liabilities.
25. In essence, the difference between the above two methods is that a fair value hedge relationship partially alters the measurement basis of a hedged item otherwise measured at amortised cost. Conversely, in a cash flow hedge relationship changes in fair value of the hedging instrument is recognised in Other Comprehensive Income instead of profit or loss.
26. Using the above, the staff have identified two methods for consideration in developing the outline of a model for DRM activities along the lines of hedge accounting:
- (a) *Approach 1 – Using Cash flow hedge mechanics:* If DRM derivative instruments (C) are successful in aligning the asset profile (A) with the target profile (B), changes in fair value of the effective portion of such derivative instruments would be deferred in Other Comprehensive Income. Expressed differently, if $A + C = B$, then perfect alignment has been achieved and the change in fair value of the DRM derivative instruments should be deferred. The amount deferred will be recycled to the statement of profit or loss in the period or periods during which the hedged cash flows arising from the asset profile affects profit or loss. In doing so, interest income recognised in profit or loss would be aligned with the target profile. Recycling is discussed further in paragraphs 33 through 36. The model would require demonstration that the DRM derivative instruments are successful in aligning the asset profile with the target profile on a prospective and retrospective basis. Furthermore, it must be demonstrated that the target profile has and will be realised through the collection of cash flows.
- Approach 2 – Using Fair value hedge mechanics:* The mechanics of fair value hedge accounting effectively represents the risk management

objective when the change in fair value of the hedged item attributable to the hedged risk is offset by the change in fair value of the hedging instrument. Analogising to the terms in the proposed model, simply using the fair value hedge accounting mechanics whereby the change in fair value of the asset profile attributable to the hedged risk (A) is offset by the DRM derivative instruments (C) would not be effective in representing the activities of DRM. The risk management objective is not to eliminate fair value risk but attain the fair value risk inherent in the target profile (B). Consequently, in order to capture this objective the change in fair value of the DRM derivative instruments (C) in combination with the change in fair value of the asset profile (A) should equal the change in fair value of the target profile (B). Expressed differently, assuming perfect alignment, the statement of profit or loss must recognise changes in fair value of the target profile attributable to the hedged risk in addition to the asset profile and DRM derivative instruments to provide a faithful representation of performance ie the statement of profit or loss should reflect $A + C - B = 0$. Consequently, under such an approach the change in fair value of the asset profile and target profile would need to be recognised in the statement of financial positions and amortised to the statement of profit or loss in the period or periods in a manner that aligns interest income with the target profile. This approach would also require demonstrating: i) the DRM derivative instruments are successful in aligning on a prospective and retrospective basis changes in fair value of the asset profile with changes in fair value of the target profile; and ii) the target profile has and will be realised through the collection of cash flows.

How do the proposals achieve the objectives?

27. The proposed model considers designations based on asset and target profiles determined on a portfolio basis with derivatives used for such transformation. This essentially allows for the designation of the second derivative required for asset transformation. This implies firstly, the hedged item in such designations would be a fixed rate financial asset, and in some cases, a highly probable forecast

transactions representing the reinvestment of the fixed rate financial asset. Secondly, it effectively creates a new type of relationship. Asset transformation is neither ‘a hedge of the exposure to changes in fair value of a recognised asset or liability, or component thereof’⁵, nor is asset transformation ‘a hedge of the exposure to variability in cash flows that are attributable to a particular risk associated with all, or a component of, a recognised asset or liability’⁶. By expanding hedged items and creating a new type of hedge relationship, asset transformation will address the capacity issue.

28. Furthermore, replacing the one-to-one designation requirements will also reduce the operational burden required to document and measure the effectiveness of individual relationships considering the dynamic nature of DRM. Aligning the level of designation with the risk management perspective will facilitate a more representative recognition and presentation of DRM activities.
29. The staff would highlight that removing the impetus on managing designations (ie capacity) should reduce the need for de-designation and re-designation (rebalancing). This will reduce, but not eliminate, the need for amortisations of hedge accounting adjustments, regardless of if the adjustment relates to a cash flow or fair value hedge.
30. Finally, focusing performance on the equation described above will provide a direct link performance metric based on management’s ability to align the asset profile with the target profile. This will provide users with a more meaningful and reliable metric directly related to the risk management objective.
32. In totality, the staff believe, addressing the root cause of the capacity issue and providing a more reliable performance metric will result in a more faithful representation of the economics of DRM in the financial statements. Both approaches would be accompanied with disclosures regarding the target and asset profiles such that users can understand and evaluate the rationale and incorporate the implications into projections of future cash flows. These disclosures should

⁵ Paragraph 6.5.2(a) of IFRS 9.

⁶ Paragraph 6.5.2(b) of IFRS 9.

add transparency in financial reporting enhancing the information provided to users about risk management and the impact for future economic resources.

Advantages and disadvantages of Approach 1 and Approach 2

Amortisation

33. There are usually two concerns that arise when considering a model based on cash flow hedge accounting mechanics and it pertains to the information content about the balance deferred in Other Comprehensive Income. Firstly, the information it purports to represent is not clear to many users and secondly, how this balance is recycled to the statement of profit or loss can often be unclear and situation dependant. In addition, this can be further exacerbated given the dynamic nature of the activities that the model is trying to capture. Consequently, the mechanics associated with both deferral and recycling will be an essential element of the model. For example, the implications for and mechanics of recycling when a DRM derivative instrument is no longer required for alignment, and thus settled, should be considered.
34. The staff would highlight a similar requirement arises from fair value hedge accounting mechanics. In the proposed model, the change in fair value of the DRM derivative instruments will be offset in the statement of profit or loss by measuring the change in fair value attributable to the hedged risk in the statement of profit or loss and the statement of financial position for both the asset profile and the target profile. Similarly, in the fair value approach as described, if a DRM derivative instrument is settled to maintain alignment, amortisation of the accumulated change in fair value of the asset profile and of the target profile will be required.
35. The staff recognise that if DRM derivative instruments are held to maturity then the need for amortisations is reduced in both scenarios, as they will naturally reverse through the settlement of interest cash flows. However, the staff also believe that there will be instances when the above will not be the case and thereby require amortisation.
36. The staff recognise additional guidance is required clarifying the information content of these adjustments on the statement of financial position and how those

adjustments should impact the statement of profit or loss. While the guidance will be critical when developing the proposed accounting model, it is important to note that these challenges exist regardless of the selected approach.

Approach 1 – Cash flow hedge mechanics

37. In a cash flow hedge relationship, the hedged exposure is the variability in future cash flows attributable to a particular risk. As discussed in paragraphs 7 through 12, DRM essentially is a process that involves understanding and managing how and when a change in market factors will affect cash inflows (interest revenue) and outflows (interest expense). Consequently, the staff believe that a model leveraging cash flow hedge mechanics has a stronger conceptual alignment considering how entities manage interest rate risk. Furthermore, based on the analysis of the comment letters received on the 2014 DP, constituents also noted that banks usually manage their interest rate risk on a cash flow basis rather than on a fair value basis.
38. As noted in paragraph 21 of the paper, the designated profiles contain not only existing financial asset but also highly probable forecast transactions. Consequently, using cash flow hedge mechanics prevents the recognition of the revaluation of forecast transactions for the hedged risk being recognised on the statement of financial position. This is also the reason for having the ‘lower of test’ ie if a cash flow hedge meets the qualifying criteria, the cash flow hedge reserve is adjusted to the lower of the cumulative gain or loss on the hedging instrument or the cumulative gain or loss on the hedged item. The rationale for the same is explained in paragraph 6.372 of the Basis for Conclusions of IFRS 9,

For cash flow hedges, recognising in profit or loss gains and losses arising on the hedged item in excess of the gains and losses on the hedging instrument is problematic because many hedged items of cash flow hedges are highly probable forecast transactions. Those hedged items do not yet exist although they are expected to occur in the future. Hence, recognising gains and losses on those items in excess of the gains and losses on items that do not yet exist (instead of a deferral of the gain or loss on the hedging instrument).

39. The staff recognise the rationale for the 'lower of test' and the need to consider this when determining the performance objective of the model.
40. In addition, the staff acknowledge that an accounting model based on cash flow mechanics will need to provide specific guidance regarding the hedge reserve deferral in Other Comprehensive Income and associated recycling. Specifically, what does the amount deferred purport to represent and how should it recycle to the statement of profit or loss. However, as described in paragraph 34, Approach 2 would require similar guidance.

Approach 2 – Fair value hedge mechanics

41. In a fair value hedge relationship, the hedged exposure is the variability in fair value of the hedged item attributable to the hedged risk. Consequently, in the staff view it is less amenable to DRM given the objective of DRM is to manage cash flows rather than eliminate fair value risk. Nonetheless, the main advantage of Approach 2 is that a financial institution would eliminate the impact of the measurement mismatch from the statement of financial position as well as the statement of profit or loss and also not have volatility in Other Comprehensive Income as compared to cash flow hedge accounting.
42. In addition, Approach 2 has another advantage when considering performance. Changes in fair value of the hedged item attributable to the hedged risk and changes in fair value of the hedging instrument are both recognised in the statement of profit or loss. Consequently, any difference is automatically recognised in the statement of profit or loss. Accordingly, there is a clear performance link between performance and the hedge objective to eliminate fair value risk as any residual fair value risk between the hedged item and hedging instrument will be recognised in the statement of profit or loss. Any difference recognised indicates the hedge objective was not achieved. The 'lower of test' is also not applicable to fair value hedge accounting. In contrast, the recognition of any difference when the hedge objective is not met is not automatic but must be calculated for Approach 1.
43. The staff's main concern under Approach 2 is that in the change in fair value of the target profile attributable to the hedged risk must be recognised in the statement of profit or loss and on the statement of financial position. As the target

profile is the desired profile of cash flows as determined by management to manage interest rate risk, the staff are concerned that the target profile would not meet the definition of an asset or liability in the Conceptual Framework.

44. Similarly, as elaborated in paragraph 21 the asset profile is the combination of existing assets and highly probable forecast transactions. Consequently, Approach 2 would require the recognition of changes in the fair value arising from a highly probable forecast transaction as an asset or liability on the statement of financial position. The staff note similar concerns have been raised by the Board in previous discussions, as stated in paragraph BC148 of the Basis for Conclusions of *IAS 39: Financial Instruments: Recognition and Measurement*.

The Board also noted that treating a hedge of a forecast transaction as a fair value hedge is not appropriate for the following reasons: (a) it would result in the recognition of an asset or liability before the entity has become a party to the contract; (b) amounts would be recognised in the balance sheet that do not meet the definitions of assets and liabilities in the *Framework*; and (c) transactions in which there is no fair value exposure would be treated as if there were a fair value exposure.

Staff recommendation

45. As the business activity of DRM, as described, is more directly related to the concepts of cash flow hedge accounting than fair value hedge accounting, the staff support an accounting model as outlined in Approach 1. Furthermore, while the staff acknowledge the challenge to provide complete picture of performance given the requirements of the 'lower of test', recognition of the target profile's change in fair value attributable to the hedged risk on the statement of financial position is considered a greater challenge. The staff believe an accounting model for DRM based on cash flow hedge mechanics will address the concerns as described while using, as best as possible concepts and principles within IFRS Standards.

What are the key decisions?

46. Regardless of the approach selected, decisions on a number of key issues will be required going forward before the Board can decide whether or not the model outlined above meets the stated objectives.
47. As discussed in previous sections of this paper, the proposed outline of the accounting model for DRM is based on existing hedge accounting requirements. Mapping the requirements for hedge accounting with the proposed model, the staff believe the following to be the critical areas that need consideration for the development of the proposed model. The table below summarises key terms from the proposed model and aligns them with terminology from IFRS 9.

Proposed DRM model	IFRS 9 hedge accounting
a) Asset profile	i) Hedged item
b) Target profile	ii) Risk management objective
c) DRM derivative instrument	iii) Hedging instrument
d) Performance assessment	iv) Effectiveness requirements
e) Criteria for designating a relationship	v) Criteria for designating a relationship
f) Disclosures	vi) Disclosures

Asset profile

48. The staff believe that the asset profile should comprise existing financial assets measured at amortised cost plus highly probable forecast transactions, for example, reinvestments of maturing assets that result in a future financial asset that will also be measured at amortised cost. The staff believe that decisions regarding the asset profile will be critical for the model, because the definition of asset profile and related eligibility criteria will determine the boundaries of the proposed model and ensure consistency with the model's objective.
49. While the definition of an asset profile will be discussed further at future Board meetings, the staff believe that leveraging existing concepts and definitions within IFRS 9 will ensure internal consistency when developing the asset profile eligibility criteria. Specifically, the staff believe that the requirements for highly

probable forecast transactions and amortised cost measurement can be used as eligibility criteria.

50. Other key decisions related to the asset profile include initial designation and situations requiring de-designation of items within the asset profile. For example, when a financial asset matures as expected, balance sheet derecognition would automatically result in removal of the financial asset from the asset profile. However, in other circumstances a financial asset could be removed from the asset profile if a customer exercises a prepayment option. The staff believe that this area will require additional consideration, specifically the interaction between prepayment, performance, recycling or amortisation of accumulated changes in fair value and related disclosures.
51. Additional consideration might also be required in situations where a financial asset becomes credit-impaired and the effect of credit risk dominates the financial asset's changes in fair value. In this scenario, although the financial asset is still recognised on the balance sheet, the staff will consider whether removal of such an asset from the asset profile would be appropriate. Other situations could include forecast transactions that are no longer highly probable of occurring and the related accounting implications resulting from their removal from the asset profile.
52. The examples above illustrate some of the main issues related to the asset profile and which the proposal is expected to address. In summary, the staff believe the key decisions around the asset profile will cover:
 - (a) The definition of asset profile and corresponding eligibility criteria;
 - (b) Designation of items as part of the asset profile; and
 - (c) De-designation of items and the impact on performance and recycling / amortisation.

Target profile

53. The target profile represents management's desired profile of cash flows arising from the items in the asset profile. As discussed earlier in the paper, the target

profile is one of the key elements of the proposed model and, therefore, decisions in this area will be critical for the development of the model.

54. As an overarching principle, the target profile should be achievable and determined on the basis of reasonable and supportable information. The staff acknowledge that these criteria should not interfere in how a financial institution manages risks in practice, because the objective of the model is to represent the effect of risk management decisions in the financial statements and not define guidelines for risk management purposes. However, as the target profile definition will enable accounting which will represent a deviation from the normal accounting for derivative instruments, the staff believe certain qualifying criteria need to be established in this area – for example, criteria concerning leverage in the target profile.
55. Because DRM focuses on NIM, the target profile will consider the nature and timing of the cash outflows associated with the financial liabilities used to fund the asset profile. More specifically, to determine an achievable target profile management should consider funding characteristics, such as: i) whether financial liabilities are interest bearing and have a specific repayment schedule; ii) whether demand deposits are rate sensitive or non-rate sensitive; and iii) management's approach and strategy regarding deposits that are non-rate sensitive with an indeterminate life.
56. Furthermore, the proposed model is focused on risk management activities and as such, the target profile should be consistent with risk management and not reflect trading strategies. While the staff recognise the need for further discussion to delineate trading and risk management activities, IFRS 9 provide some guidance regarding trading activities. Specifically, trading activities are executed 'principally for the purpose of selling or repurchasing it in the near term'⁷ or are focused on short-term profit taking.
57. The staff will consider additional conditions that could preclude trading strategies within the target profile, such as establishing a relationship between the size of the target profile and the size of the asset profile. In some situations, the notional of

⁷ Appendix A of IFRS 9.

DRM derivative instruments required to transform the asset profile can be double the size of the asset profile. This notional requirement gives rise to the ‘capacity’ issue as discussed in paragraph 17. This is one of the critical areas that the proposed model intends to address. The staff will further consider whether restricting the size of the DRM derivative instruments to a particular ceiling (eg maximum twice the size of the asset profile if funded through demand deposits) to avoid trading strategies within the target profile.

58. The staff recognise that a target profile may change from time to time for valid reasons (ie in response to a change in the regulatory environment). However, the staff expect changes in the target profile to be infrequent as frequent changes in the target profile could imply a focus on short-term profit taking and therefore inconsistent with risk management. The impact on performance from changes in the target profile will require further discussion at future Board meetings.
59. Finally, as certain financial institutions also treat equity as a source of funding for DRM purposes, the interaction between equity and the target profile will also need to be considered in due course.
60. In summary, the staff believe the key decisions around the target profile will cover:
 - (a) The definition of target profile and related qualifying criteria;
 - (b) How the target profile is consistent with risk management; and
 - (c) How the model should reflect changes in the target profile.

Performance assessment

61. Needless to say a critical element of the model is the representation, in the financial statements, of the performance of a financial institution’s DRM activities. As DRM activities are focused on using DRM derivative instruments to align the asset profile with the target profile, any event that results in the target profile not being achieved, should, in general, be reflected in performance. However, the manner in which these events are reflected will require discussion. Some events may require an adjustment through profit or loss while others may trigger specific disclosures in addition to recognition and measurement. Furthermore, recognition consistent with amortised cost may be appropriate for

other events. For example, how should performance consider prepayment risk when it comprises a part of the asset profile. While the implications of perfect alignment have been discussed in paragraph 26, discussion is required to determine the nature of information conveyed in the absence of perfect alignment. The staff believe that this will be driven by their causes for example:

- (a) Changes in assumptions related to the asset profile, such as prepayment;
- (b) Changes in assumptions related to the target profile, such as demand deposits;
- (c) De-designation of items in the target profile; and
- (d) Derecognition of DRM derivative instruments, including derivatives that are offset by another derivative.

62. Additional consideration might also be required regarding whether the application of the model should be voluntary or mandatory. If voluntary,, the staff will consider situations where discontinuation of the model is permitted and other circumstances which may require discontinuation of the model. This will also include the corresponding impacts, if any, on performance and recycling or amortisation.

63. In all of the above, one key aspect for consideration will be what information concerning misalignment needs to be portrayed through recognition and measurement and what is better captured through disclosure.

Criteria for designation

64. While the current hedge accounting requirements usually focus on individual hedging relationships, relationships under the proposed model will be designated on a portfolio basis. The designation criteria is a key area for further discussion as the staff believe they are essential for ensuring consistent application of the model. Some examples of designation criteria to be considered include:

- (a) The asset profile consists of eligible items and the target profile meets the related qualifying criteria;
- (b) At the inception of the relationship there is some form of linking and documentation of the relationship and the financial institution's DRM objective and strategy; and

(c) The relationship meets the performance assessment criteria.

65. While items (a) and (c) above have already been discussed in the context of the other critical areas for the development of the DRM accounting model, documentation of the relationship is another critical subject that will require decisions from the Board. The staff believe that these requirements will ensure consistent application of the model and allow financial institutions to clearly identify which derivatives have been used to align the asset profile with the target profile and, therefore, are subject to the DRM proposed accounting treatment. In particular, the staff believe that a formal designation and corresponding documentation would address concerns regarding the identification of the specific derivatives that have been designated in a relationship.

Disclosures

66. As stipulated earlier it is not going to be possible to capture every aspect of risk management through the model nor will it be possible to provide all the necessary information entirely through recognition and measurement. The staff recognise it is likely to be impracticable to communicate certain information through measurement, specifically details of the target profile and the implications on future cash flows. As a result, disclosures will also play a part in each of the critical areas outlined above.
67. It is not objective of this paper to provide a comprehensive list of potential disclosures related to the critical areas of the proposed model. However, as the DRM accounting model is developed and critical areas are discussed with the Board, the staff will consider what information would be better communicated through disclosures versus measurement in order to address user information needs. For example, during the 2014 DP outreach users identified information on both hedged and unhedged positions as useful.

Questions for the Board

Question for the Board

- 1) Does the Board agree with the staff recommendation in paragraph 45?
- 2) Does the Board have any comments on the critical areas discussed in paragraphs 46 to 67 that staff have identified and intend to develop further?