# STAFF PAPER

**December 2018**

REG IASB Meeting

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| **Project** | **Dynamic Risk Management** |
| Paper topic | Minimum performance requirements |


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## Introduction

1. The purpose of this paper is to discuss how the minimum performance requirements discussed at the September 2018 Board meeting would be specifically applied in the context of the Dynamic Risk Management (DRM) model.

2. This paper is structured as follows:

   (a) Summary of staff recommendations (paragraph 3);

   (b) Background (paragraphs 4 – 7); and

   (c) Application of minimum performance requirements (paragraphs 8 – 31).

## Summary of staff recommendations

3. In this paper the staff recommend that an entity can apply the DRM accounting model if all of the following requirements are met:

   (a) there is an economic relationship between the target profile, the asset profile and the derivatives designated within the DRM model; and

   (b) any designation does not reflect an imbalance that would create misalignment (irrespective of whether recognised or not) that could

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result in an accounting outcome inconsistent with the purpose of the DRM accounting model.

## Background

4. The requirement to assess alignment is a qualifying criterion for applying the DRM model where an entity considers the expected behaviour of the asset profile and designated derivatives to demonstrate an economic relationship with the target profile. Assessing alignment aims to ascertain whether financial assets, financial liabilities and derivatives designated within the DRM model can be expected to meet the risk management strategy for which they have been designated. Therefore, the objective of this assessment is to set a minimum level of alignment to apply the DRM accounting model. When an entity fails the assessment, the entity must discontinue prospectively the DRM model from the last date on which the requirement was met. While the DRM model does not specify a single method for assessing alignment, entities could do so by comparing the designated derivatives with the benchmark derivatives.[1]

5. At the June 2018 Board meeting, the staff proposed that, to apply the DRM model, entities should demonstrate the existence of an economic relationship. More specifically, this assessment would focus on whether the designated derivatives will be successful in transforming the designated asset profile such that it is better aligned with the target profile. However, the Board was concerned that this approach may not be sufficiently rigorous. As a result, the Board instructed the staff to further amplify the term 'economic relationship' to specify that the DRM accounting model requires more than 'better alignment' as a minimum level of alignment.

6. Following the Board recommendation, at the September 2018 Board meeting the staff noted that a combination of IFRS 9 requirements amended to reflect the concept of asset transformation in the DRM model (rather than offsetting in IFRS 9) would strengthen the discipline around the application of the DRM model

[1] As discussed in the June 2018 Agenda Paper 4C *Financial Performance,* this same method can be used to *measure* alignment.

without the need for an arbitrary 'bright line test'. In particular, this combination of IFRS 9 requirements would address the concerns expressed by the staff that entities could designate a portfolio of derivatives where the change in fair value will always be less than the benchmark derivatives required to align the asset and target profiles and, therefore, avoid imperfect alignment reported in the statement of profit or loss due to the 'lower of' test. The staff also proposed this would sufficiently amplify the term 'economic relationship' to specify that the DRM accounting model requires more than 'better alignment' as a minimum level of alignment.

7. Consequently, at the same September 2018 meeting, the Board tentatively agreed that the DRM model should require a minimum level of alignment in the form of qualitative thresholds supported by quantitative analysis. The Board tentatively decided to not introduce a 'bright line test' to the DRM model since any chosen threshold might be considered arbitrary and onerous. In addition, the Board instructed the staff to further explore how the combination of IFRS 9 requirements proposed by the staff would be specifically applied in the context of the DRM model. Therefore, the purpose of this paper is to discuss how an entity would apply those minimum performance requirements amended to reflect the concept of asset transformation in the DRM model.

## Application of minimum performance requirements

8. During its deliberations leading to IFRS 9, the Board decided to remove the 80–125 per cent 'bright line test' in IAS 39, because it was considered arbitrary and onerous and could result in a disconnection between risk management and hedge accounting.[2] As IFRS 9 kept the 'lower of' test and removed the retrospective 'bright line test' in IAS 39, the Board decided to explicitly address the potential abuse of the 'lower of' test in IFRS 9 via the following requirements:

    (a) *Economic relationship:* there is an economic relationship between the hedged item and hedging instrument;[3]

[2] Refer to paragraph BC6.237 of the Basis for Conclusions of IFRS 9.

[3] Refer to paragraph 6.4.1(c)(i) of IFRS 9.

(b) *Hedge ratio:* the hedge ratio of the hedging relationship must be the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. Designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting;[4] and

(c) *Rebalancing:* if a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio (see paragraph 8(b)) but the risk management objective for that designated hedging relationship remains the same, an entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again (this is referred to in IFRS 9 as 'rebalancing').[5]

9. At its September 2018 meeting, the Board instructed the staff to evaluate how the above performance requirements would need to be amended in order to apply in the context of the DRM model. At the same meeting, the staff noted that amending these performance requirements to reflect the concept of asset transformation in the DRM model (rather than offsetting in IFRS 9) would also strengthen the discipline around the application of the DRM model without the need for an arbitrary 'bright line test' and prevent designations that intentionally create imperfect alignment not reported in the statement of profit or loss.

10. In the context of DRM, the assessment of whether an economic relationship exists would include an analysis of the possible behaviour of the asset profile and the derivatives designated within the DRM model to ascertain whether they can be expected to achieve the target profile. The objective of this requirement is to ensure a strong link between the cash flows from the asset profile, cash flows from the financial liabilities used when determining the target profile and the

[4] Refer to paragraph 6.4.1(c)(iii) of IFRS 9.

[5] Refer to paragraph 6.5.5 of IFRS 9.

designated derivatives, rather than an accidental or immaterial economic link. This is further discussed in paragraphs 17 – 22 of this paper.

11. The staff also considered whether the hedge ratio requirement could be applied in the context of the DRM model. The objective of this requirement is to address the concerns noted in paragraph 6 that entities could take advantage of the 'lower of' test by intentionally designating derivatives that create imperfect alignment not reported in the statement of profit or loss. However, the staff are concerned that given the dynamic nature of portfolios, a requirement focused on the ratio itself could be ineffective. Therefore, in paragraphs 23 – 25 the staff further consider whether the DRM accounting model should include a requirement regarding designation which would have the same effect as the hedge ratio requirement in IFRS 9.

12. Regarding the rebalancing requirement, when a change in input occurs (ie origination of new loans or issuance of new financial liabilities), an entity would need to execute and designate new derivatives within the DRM model to maintain the strength of the economic relationship.[6] However, as tentatively decided by the Board at previous meetings, designation of new financial assets, financial liabilities and derivatives within the DRM model would represent a continuation of the same relationship and entities must demonstrate the existence of an economic relationship on an on-going basis. Therefore, in paragraphs 26 – 30 the staff further discuss whether there is a need for a specific requirement similar to rebalancing under IFRS 9 or whether this requirement has been indirectly incorporated within the DRM accounting model at previous Board meetings.

13. To illustrate the application of the requirements above in a DRM context, assume an entity that has a portfolio of CU 1,000 3-year floating rate financial assets yielding LIBOR + 1.00% and a portfolio of CU 1,000 of 3-year fixed rate financial liabilities that bear 3.00% interest. Consistent with the entity's risk management policies and procedures, the entity starts applying the DRM

[6] According to paragraph 142 of the September 2018 Agenda Paper 4B *Imperfect Alignment*, an entity should assess imperfect alignment on an on-going basis (ie at a minimum, at each reporting date or upon changes in inputs, changes in assumptions or breach in qualifying criteria). In that paper, the staff noted that assessing alignment with such a frequency would ensure this requirement is met throughout the designation of the DRM accounting model.

accounting model in the beginning of 20X1 and designates the portfolio of financial assets within the asset profile and the portfolio of financial liabilities is used to determine the target profile.

14. As the entity's risk management strategy is to stabilise the net of interest income and expense over a period of 3 years, the target profile is a 3-year fixed rate target profile which is the period over which the entity is managing interest rate risk. The benchmark derivative is a CU 1,000 3-year receive fix, pay float interest rate swap that will transform the 3-year floating rate financial assets to 3-year fixed rate financial assets. The benchmark derivative required for perfect alignment is as follows:

*Chart 1*

| Derivative | Notional | Start date | End date | Fixed rate (*) | Float rate (*) |
|---|---|---|---|---|---|
| Swap 1 | 1,000 | 01/01/X1 | 31/12/X3 | 4.00% | (LIBOR) |

(*) For illustration purposes, we assumed the market rate for the fixed leg of the 3-year interest rate swap is 4.00% and LIBOR for the floating leg.

15. Assuming the entity executes and designates the benchmark derivative, the tenor of the asset profile and the target profile after the designated derivative are as follows:

*Chart 2*

| Scenario 1 | Float | X1 | X2 | X3 | Total |
|---|---|---|---|---|---|
| Asset Profile | 1,000 | | | | 1,000 |
| Target Profile | | | | 1,000 | 1,000 |
| **Initial Difference** | **1,000** | | | **(1,000)** | **0** |
| Swap 1: receive fix, pay float | (1,000) | | | 1,000 | 0 |
| **Final Difference** | **0** | | | **0** | **0** |

16. As demonstrated in Chart 2, by executing and designating the CU 1,000 3-year receive fix, pay float interest rate swap the entity has ~~not~~ achieved perfect

alignment. In the following paragraphs in this paper, we elaborate on the application of the minimum performance requirements in the context of the DRM model.

### *Economic relationship*

17. In the context of DRM, an economic relationship is represented by the interaction between the target profile, asset profile and derivatives designated within the DRM model. The assessment of whether an economic relationship exists includes an analysis of the possible behaviour of the asset profile and the derivatives designated within the DRM model to ascertain whether they can be expected to achieve the target profile. As noted in paragraph 4, while the DRM model does not specify a single method for assessing alignment, entities could do so by comparing the designated derivatives with the benchmark derivatives. In particular, quantitative assessments, such as sensitivity analyses with multiple scenarios of potential changes in market interest rates, could be used to demonstrate the existence of such an economic relationship by comparing the resulting changes in fair value of the benchmark and designated derivatives.

18. Also, as noted in paragraph 10, when cash flows are directly linked, financial statements may not faithfully represent some aspects of the entity's financial position and financial performance if measurement differences exist. In the context of DRM, the asset profile and financial liabilities used to determine the target profile are measured at amortised cost, while derivatives within the DRM model are measured at fair value. Therefore, the objective of this requirement (ie the existence of an economic relationship) is to ensure a strong link between the cash flows from the asset profile, cash flows from the financial liabilities used when determining the target profile and the designated derivatives, rather than an accidental or immaterial economic link. Furthermore, paragraph B6.4.6 of IFRS 9 clarifies that 'the assessment of whether an economic relationship exists includes an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective'.

19. To illustrate, considering the fact pattern described in paragraphs 13 – 16, at inception of the DRM model (ie in the beginning of 20X1), the entity could compare changes in fair value of the benchmark with changes in fair value of

designated derivatives for different types of changes in interest rates (ie parallel shifts and tilts with differing severities). To illustrate, assume the entity considered a fluctuation in interest rates of +/- 50 basis points (bps) with a tilt in the yield curve.[7] A change in 50 bps was considered for illustrative purposes only. The staff highlight that an entity should consider the economic environment in which it operates and the characteristics of the designated portfolios to determine the appropriate impact on yield curves. The following chart shows the economic relationship between the target profile and the asset profile combined with the designated derivative:

*Chart 3*

| **Derivative** | **Date** | **Changes in fair value** (*) | |
|---|---|---|---|
| | | *(+) 50 bps* | *(-) 50 bps* |
| Designated | 01/01/X1 | XX | (YY) |
| Benchmark | 01/01/X1 | XX | (YY) |
| **Economic relationship** | | **100%** | **100%** |

(*) Changes in fair value consider an impact of +/- 50 bps on market interest rates. Figures are estimated for illustrative purposes only.

20. In the fact pattern described in paragraphs 13 – 16, because the entity executed and designated the derivatives required to achieve perfect alignment (ie the benchmark derivative), changes in fair value of the benchmark and designated derivatives are expected to be the same, resulting in an economic relationship of 100% as demonstrated above. As discussed at the September 2018 Board meeting, this is a prospective assessment related to expectations about imperfect alignment and is therefore only forward-looking.

21. The staff think that such prospective assessment would ensure the existence of a strong link between the cash flows from the asset profile, cash flows from the financial liabilities used when determining the target profile and the designated derivatives without the need for an arbitrary ‘bright line test’. The staff propose to

[7] A tilt in the yield curve consists of a change in the slope of the yield curve.

carry forward this requirement from IFRS 9 into the DRM model as this would strengthen the discipline around the application of the DRM model.

22. The staff would highlight that, while the DRM model does not provide a specific threshold, management would define both the appropriate range and appropriate shocks in market interest rates to define whether an economic relationship exists. This is consistent with the existing IFRS 9 requirements and the Board's tentative decision to not introduce a 'bright line test' to the DRM model since any chosen threshold might be considered arbitrary and onerous.[8]

*Hedge ratio*

23. The objective of this requirement is to address the concerns noted in paragraph 6 that entities could take advantage of the 'lower of' test by intentionally designating derivatives that create imperfect alignment not reported in the statement of profit or loss. More specifically, according to paragraph BC 6.251 of the Basis for Conclusions of IFRS 9, the Board decided to address the potential for abuse of the 'lower of' test by precluding an entity to 'designate a hedging relationship in a manner that reflects an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.'

24. At its February and April 2018 meetings, the Board tentatively decided that financial assets and financial liabilities should be designated on a portfolio basis, provided portfolios are defined consistently with the entity's risk management policies and procedures. At the same meetings, the Board tentatively decided that the DRM model should allow for designation of a percentage of portfolios of financial assets and financial liabilities, provided it is consistent with the entity's risk management strategy. The staff think that a similar requirement ensuring consistency between the designation of derivatives and the entity's risk management strategy is also needed. Absent such a requirement, entities would be

[8] Refer to paragraph BC6.237 of the Basis for Conclusions of IFRS 9.for further information on the basis for the Board's decision to remove the 80–125 per cent 'bright line test' in IAS 39. For further information on the Board's tentative decision to not introduce a 'bright line test' to the DRM model, refer to the June 2018 Agenda Paper 4C *Financial Performance*.

able to systematically designate less derivatives than required to achieve perfect alignment and, as a result, avoid reporting imperfect alignment in the statement of profit or loss, assuming the entity is able to establish the existence of an economic relationship as discussed in paragraphs 17 - 22.

25. Therefore, the staff propose to carry forward the rationale in paragraph BC 6.251 of the Basis for Conclusions of IFRS 9 into the DRM model as this would strengthen the discipline around the application of the DRM model. More specifically, the staff think that designation of financial assets, financial liabilities and derivatives should be consistent with an entity's risk management policies and procedures and shall not reflect an imbalance that would create misalignment (irrespective of whether recognised or not) that could result in an accounting outcome inconsistent with the purpose of the DRM accounting model.

*Rebalancing*

26. According to paragraph B6.5.14 of the Application Guidance of IFRS 9, rebalancing means that 'for hedge accounting purposes, after the start of a hedging relationship an entity adjusts the quantities of the hedging instrument or the hedged item in response to changes in circumstances that affect the hedge ratio of that hedging relationship.' Rebalancing is accounted for as a continuation of the hedging relationship.

27. In the context of the DRM model, when a change in input occurs (ie origination of new loans or issuance of new financial liabilities), an entity will likely need to execute and designate new derivatives within the DRM model to accomplish their risk management strategy and also maintain the strength of the economic relationship. For example, considering the fact pattern described in paragraphs 13 – 16, assume the entity issues at the end of 20X1 new CU 500 of 2-year fixed rate financial liabilities that bear 3.00% interest and originates new CU 500 2-year floating rate financial assets yielding LIBOR + 1.00%. Assuming the entity's risk management policies and procedures establish 100% of the portfolios of financial assets and financial liabilities should be hedged, to stabilise the net of interest income and expense over the remaining period of 2 years, the entity needs to execute and designate a CU 500 2-year receive fix, pay float interest rate swap to accomplish their strategy. In doing so, the entity can also demonstrate the

existence of an economic relationship between the target profile and the asset profile combined with the designated derivative.

28. As tentatively decided by the Board at previous meetings, changes to designated portfolios of financial assets and liabilities resulting in updates to the asset and target profiles do not represent a designation or a de-designation event but instead a continuation of the existing relationship.[9] Similarly, designation of new derivatives are treated by the DRM model as a continuation of the existing relationship.[10] In other words, designation of new financial assets, financial liabilities and derivatives within the DRM model, as tentatively decided by the Board at previous meetings, would already represent a continuation of the same relationship.

29. Additionally, as also tentatively decided by the Board at its September 2018 meeting,[11] entities should complete the prospective assessment on an on-going basis (at each reporting date or upon changes in inputs, changes in assumptions or breach in qualifying criteria).

30. Therefore, the staff think that a rebalancing requirement is not needed under the DRM model, because it is already incorporated through previous tentative decisions as discussed in paragraph 28 and 29. Including an additional re-balancing requirement, similar to that in IFRS 9, would be redundant considering the already existing qualifying criteria for the DRM model.

### *Staff Preliminary View*

31. For the reasons stated in paragraphs 17 – 30, the staff are of the preliminary view that an entity can apply the DRM accounting model if all the following requirements are met:

    (a) there is an economic relationship between the target profile the asset profile and the derivatives designated within the DRM model; and

[9] Refer to the February 2018 Agenda Paper 4B *Asset profile* and April 2018 Agenda Paper 4B *Target Profile: Designation and Qualifying Criteria*.

[10] Refer to the June 2018 Agenda Paper 4B *Derivatives used for DRM purposes*.

[11] For further information, refer to the September 2018 Agenda Paper 4B *Imperfect Alignment*.

(b) any designation does not reflect an imbalance that would create misalignment (irrespective of whether recognised or not) that could result in an accounting outcome inconsistent with the purpose of the DRM accounting model.

## Question for the Board

| Question for the Board |
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| 1) Does the Board agree with the staff preliminary view in paragraph 31 that an entity can apply the DRM accounting model if all of the following requirements are met:<br>a) there is an economic relationship between the target profile, the asset profile and the derivatives designated within the DRM model; and<br>b) any designation does not reflect an imbalance that would create misalignment (irrespective of whether recognised or not) that could result in an accounting outcome inconsistent with the purpose of the DRM accounting model. |