# STAFF PAPER

**December 2017**

REG IASB Meeting

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| **Project** | **Dynamic Risk Management** | | |
| Paper topic | Proposed project plan | | |


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| CONTACT(S) | Ross Turner | rturner@ifrs.org | +44 (0) 20 7246 6920 |
| | Fernando Chiqueto | fchiqueto@ifrs.org | +44 (0) 20 7246 6496 |
| | Kumar Dasgupta | kdasgupta@ifrs.org | +44 (0) 20 7246 6902 |


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## Introduction

1. The objective of this paper is to provide an overview of the proposed project plan for the development of an accounting model for dynamic risk management (DRM).

## Background

2. At the November 2017 meeting, the Board tentatively agreed that the staff should focus on further developing an accounting model for DRM based on cash flow hedge mechanics. In summary, the model proposes that, if DRM derivative instruments are successful in aligning the asset profile with the target profile, changes in fair value of such derivative instruments would be deferred in Other Comprehensive Income and recycled to profit or loss as the asset profile affects the statement of profit or loss. In a situation of perfect alignment, the mechanics of the model would allow for the representation of interest income as defined by an entity's target profile.

3. At that same meeting, given the complexity associated with the subject matter, the Board requested the staff to present a project plan before further developing the DRM accounting model.

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## Focus of the project plan

4. A perfect and complete reflection of all risk management in financial reporting is an aspirational objective. As stated in paragraph OB6 of the *Conceptual Framework*, financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. As discussed at the November 2017 Board meeting[1], the objective of the proposed DRM accounting model is to improve information provided regarding risk management and how risk management activities affect an entity's current and future economic resources, rather than capture every aspect of the risk management activities.

5. The staff are proposing to develop the accounting model for DRM in two phases. The first phase will focus on developing the 'core areas' that are central to the model while the second phase will address areas that are extensions of concepts developed during the first phase. These core areas will shape the fundamentals of the proposed DRM accounting model. The staff believe that the core areas capture a significant portion of DRM activities and will provide an adequate basis for an early and thorough assessment before progressing on to the second phase.

6. The staff identified the following areas as requiring decisions from the Board to develop the core of the proposed DRM accounting model:

   (a) Target profile;

   (b) Asset profile;

   (c) DRM derivative instruments; and

   (d) Performance assessment and recycling.

7. The staff believe that the above areas form the critical building blocks of the model because:

   (a) DRM focuses on interest income and interest expense. As such, ensuring the asset profile is comprised of financial assets which impact interest income, specifically those measured at amortised cost, will cover a significant portion of assets managed by the DRM function;

[1] For further information, refer to the November 2017 Agenda Paper 4 *Outline of proposed DRM accounting model and next steps*.

(b) DRM derivative instruments will be interest rate swaps as, in practice, these are the main instruments used to manage interest rate risk; and

(c) Sources of funding for the target profile will be limited to demand deposits and other financial liabilities with a specific repayment schedule as they are the primary sources of funding for financial institutions.

8. Needless to say, the staff will address the non-core areas prior to finalising the project as they influence risk management actions and therefore should be considered in a complete accounting model. However, these areas represent more an extension of the core model rather than a fundamental change. These non-core areas include but are not necessarily limited to:

(a) Financial assets at fair value through Other Comprehensive Income. While interest from such instruments will impact interest income, they represent a smaller proportion of the portfolios managed by the DRM function;

(b) DRM derivative instruments other than interest rate swaps, such as options. The use of such instruments, although not absent, is not widespread due to market constraints and increased complexity when compared with interest rate swaps; and

(c) Equity as a source of funding for the target profile. Again, whilst this is prevalent in certain jurisdictions it is not the key driver for funding the target profile.

9. Accordingly, the staff propose that the project focus on addressing the key areas to develop a core version of the model first and then gather external feedback on that core model. The staff also propose that the decision to progress the model further to cover the non-core areas as identified in paragraph 8 only be made subsequent to obtaining external feedback on the core model. The manner in which external feedback is obtained will be discussed with the Board at a future meeting.

## Question for the Board

| Question for the Board |
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| 1) Does the Board agree with the above approach? |

## Key areas for discussion

10. Assuming the Board agree with the above, this section explores the core areas that will require decisions from the Board and the order of future discussions.

11. One of the main objectives of the model is to represent, in the financial statements, the performance of an entity's DRM activities. As performance assessment will dictate measurement in the statement of profit or loss, performance assessment will be one of the key areas. However, because performance will focus on the entity's ability to align the asset profile with the target profile using DRM derivative instruments, the staff believe the elements subject to performance assessment should be discussed first, rather than performance assessment itself. Therefore, the staff propose to split the discussions into the following blocks:

    (a) *Key elements for determining performance:* this will cover the target profile and asset profile as well as the DRM derivative instruments. These discussions will also include the designation criteria required by the proposed DRM model. The staff believe these areas will provide the basis for the Board's decisions before performance assessment and recycling are further explored.

    (b) *Performance assessment*: this will cover the principles and mechanics of performance assessment and therefore recycling. However, some topics concerning the asset and target profiles are also linked to performance assessment. For example, the implications arising from the dynamic nature of DRM activities, such as prepayments. The staff intend to identify these specific topics when the asset profile and target profile are initially discussed but defer the debate until initial discussions around performance assessment and recycling are complete.

12. Designation requirements will also require further discussion with the Board as the staff believe they are essential for ensuring consistent application of the model. These requirements will be considered as part of the discussions covering the two areas mentioned in paragraph 11. Examples of designation requirements to be considered include:

    (a) The asset profile consists of eligible items and the target profile meets the related qualifying criteria;

    (b) The relationship between asset profile, target profile and DRM derivative instruments meets the performance assessment criteria; and

    (c) At the inception of the relationship, there is a method to link and document the relationship and the financial institution's DRM objective.

13. The above areas are presented in more detail in the following paragraphs 14 to 28.

## Target profile

14. The staff acknowledge the target profile is a new concept under IFRS Standards and therefore any definitions and related qualifying criteria will require careful consideration. The staff identified the following topics as those requiring key decisions from the Board at future meetings:

    (a) The definition of target profile and related qualifying criteria; and

    (b) How the target profile is consistent with risk management.

15. Discussions about qualifying criteria will focus on how to ensure consistent and faithful representation of the target profile within the context of DRM. This will include further consideration on whether the model should require formal documentation demonstrating how a target profile satisfies the qualifying criteria. The staff will also consider conditions that could preclude trading strategies within the target profile.

16. Regarding disclosure, the staff acknowledge that tabular disclosures of the target profile and its implications on future cash flows will provide valuable information to users. However, the staff recognise that such information might be

commercially sensitive. This will require specific consideration when further discussed with the Board.

## Asset profile

17. The asset profile will be one of the critical areas for the model as this represents another element subject to performance assessment. The staff believe the following topics will require further discussion and key decisions from the Board:

    (a) The definition of asset profile and corresponding qualifying criteria; and

    (b) Designation of items as part of the asset profile.

18. The staff expect to develop qualifying criteria applicable to the asset profile along with the designation requirements that will ensure consistent application of the model. Furthermore, the staff believe the Board should discuss the merits of documentation to provide clarity as to which assets have been designated in the model versus which assets are out of scope, thus simplifying performance assessment. Finally, discussions on disclosures will focus on how to add transparency to financial reporting regarding an entity's asset profile.

## DRM derivative instruments

19. Discussions on this area will include: i) whether voluntary de-designation of DRM derivatives should be allowed by the DRM accounting model; and ii) whether qualifying criteria for designation of DRM derivatives should be required.

## Performance assessment and recycling

20. For all areas discussed in paragraphs 21 through 28, the staff intend to supplement the required technical discussions with illustrative examples demonstrating the mechanics and quantitative impacts for the statement of financial position, the statement of profit or loss, and any related disclosures. This will consider not only

application of the concepts being developed to a static portfolio but also evaluate the implications as portfolios evolve over time.

21. As discussed in paragraph 2, when perfect alignment is achieved, the statement of profit or loss should reflect interest income as defined by an entity's target profile. Nonetheless, how an entity determines if they have been successful in achieving perfect alignment in addition to suitable disclosures when perfect alignment is achieved will require further consideration.

22. The staff also intend to explore the implications and performance requirements arising from situations of imperfect alignment. While any event that results in imperfect alignment will be reflected through performance, 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. It will be critical to develop a principle regarding the information content of imperfect alignment when determining which method is most appropriate for a given event. Two specific items which will require consideration when discussing how best to convey imperfect alignment are:

(i) *Target profile defined as a range:* DRM will often accept some variance from the target profile. Consequently, it may be appropriate to consider the target profile as a range. Further consideration will be required regarding the implications of any such definition in the context of performance assessment.

(ii) *The 'lower of' test:* The staff intend to consider the implications of the 'lower of' test on performance assessment.

23. While the above should provide clarity on the principle and mechanics of performance assessment, the staff will also consider whether the model should mandate a minimum threshold for performance. Assuming the existence of such a threshold, the staff will consider whether management could define that threshold. Furthermore, the staff will consider the implications of not achieving such a threshold. Specifically, whether application of the model would be disallowed on a prospective and or retrospective basis and any consequential implications for recycling.

24. 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.

25. With clarity on the above, the staff intend to discuss how performance should incorporate the dynamic nature of DRM activities. Initially, the staff will focus on the passage of time, its impact on the asset profile and target profile and consequently any related DRM actions required for maintaining alignment. The staff will develop illustrative examples to walk through the mechanics of the model demonstrating the impact on the statement of financial position and the statement of profit or loss for scenarios of both perfect and imperfect alignment. The illustrative examples will address the following scenarios:

    (a) Perfect and imperfect alignment excluding dynamic considerations;

    (b) Perfect and imperfect alignment including dynamic considerations assuming DRM derivatives are not de-designated prior to maturity; and

    (c) Perfect and imperfect alignment including dynamic considerations where DRM derivative instruments are de-designated prior to maturity thus requiring amortisation of Other Comprehensive Income.

## Interaction between performance and other key areas

26. As discussed in paragraph 11(b), some topics related to the asset and target profiles are also linked to performance assessment and therefore will require further debate after the initial performance assessment discussions are complete. These topics are related to the dynamic nature of the activities that the model is trying to capture, such as:

    (a) *Highly probable forecast transactions:* Further consideration will be required regarding how the asset profile should reflect highly probable forecast transactions and the impact on performance assessment and disclosure. The staff intend to discuss growth in the profile as part of this section;

(b) *Prepayments:* The discussion will focus on how changes in assumptions related to customers' behaviour should be considered for the purpose of performance assessment;

(c) *De-designation:* The staff will consider how performance and disclosure should reflect de-designation of items within the asset profile or the de-designation of DRM derivative instruments. As certain de-designations may not be voluntary (ie resulting from a significant increase in credit risk), the staff intent to discuss the implications for both voluntary and involuntary de-designations; and

(d) *Changes in target profile:* The staff will consider the implications for performance and related disclosures when an entity changes their target profile.

27. Repeating the exercise described in paragraph 25, with clarity on the above events, the staff intend to develop illustrative examples to facilitate a better understanding of how the model will reflect the above topics.

28. It is important to note that this is not a comprehensive list of topics and as such, other areas interacting with performance assessment may be discussed. The staff expect to identify these topics during initial Board discussions regarding the asset profile and the target profile.

## Completion

29. The staff are proposing to develop the model in sequential stages. When all stages are complete, the staff will aggregate all individual decisions and demonstrate the core model in totality, specifically highlighting how the individual areas come together to form the core model. The staff propose this demonstration be the final step prior to seeking external feedback on the core model.

## Question for the Board

| Question for the Board |
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| 2) Does the Board have any comments on the core areas that the staff have identified and intend to develop further? |

## Appendix A – Key areas for discussion

A1. The table below summarises the discussions that will require decisions from the Board as the staff develop the proposed accounting model for DRM:

| Key areas for discussion |
| --- |
| 1) Target profile |
| 2) Asset profile |
| 3) DRM derivative instruments |
| 4) Performance assessment: Perfect alignment excluding dynamic considerations |
| 5) Performance assessment: Imperfect alignment excluding dynamic considerations |
| 6) Performance assessment: Perfect alignment including dynamic considerations |
| 7) Performance assessment: Imperfect alignment including dynamic considerations |
| 8) Performance assessment: Interactions between performance and other key areas |
| 9) Demonstration of the core model |