

STAFF PAPER

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Project	Dynamic Risk Management		
Paper topic	Summary of discussions to date		
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Introduction

1. The objective of this paper is to summarise the Board's discussions to date related to the Dynamic Risk Management (DRM) project. This paper is structured as follows:
 - (a) Business context (paragraphs 2–4);
 - (b) Objective of the project (paragraph 5);
 - (c) The approach to meet the objective (paragraph 6);
 - (d) The plan to meet the objective (paragraphs 7 – 9); and
 - (e) Tentative decisions to date (paragraphs 10 – 33).

Business context

2. The core economic activity of some financial institutions can be described as raising funds to provide longer-term loans to customers. An adverse change in market factors, such as interest rates, can negatively impact interest income and interest expense 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 interest income and interest expense. 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 interest income and interest expense.

3. Some sources of funding, specifically demand deposits, can be insensitive to changes in market factors, such as market interest rates. Consequently, because interest expense will remain stable regardless of changes in market rates for an extended period of time, these deposits effectively represent perpetual fixed rate funding. 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. In this situation, while the financial institution cannot eliminate the impact of market factors on interest income and interest expense, it can influence the speed at which those changes impact interest income and interest expense. The ability to accelerate or delay re-pricing, but not eliminate, forces management to decide whether they will be proactive and take action altering re-pricing or if they will accept re-pricing based upon the terms of the originated loans. If the financial institution decides, or is required, to proactively manage interest income and interest expense, it must decide how changes in market factors should influence interest income and interest expense. 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.
4. The decision on how interest income and interest expense will re-price with interest rates over time future represents an entity's target profile. For the purpose of the DRM accounting model the target profile must be consistent with an entity's interest rate risk management objectives. As such, if the entity's risk management objective focused on discounted cash flows, the target profile should reflect that objective.

Objective of the project

5. 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 DRM rather than perfectly capture every aspect of the risk management activity. The staff believe that to achieve the above, the model should consider the four pillars outlined below:

- (a) **Transparency:** Details of the company's risk management objective and the implications for current and future economic resources is largely absent from financial reporting today. Increasing transparency would better enable users to evaluate management's approach and rationale for their decisions;
- (b) **Eligible Items:** The interaction between the risk management activities and the existing eligibility criteria for hedge accounting within IFRS Standards can create tension when the derivatives required to accomplish the risk management objective exceed existing eligible hedged items. This has been deemed the '*Capacity Issue*';
- (c) **Dynamic Nature:** On a daily basis, events alter the composition of the assets of financial institutions. These changes often mandate additional DRM actions. As IFRS 9 usually requires one-to-one designations between eligible hedged items and hedging instruments, the additional mitigating actions lead to an overly complex process of frequent de-designations and re-designations of hedge accounting relationships. Such operational challenges result from the application of IFRS 9 hedge accounting requirements to dynamic portfolios;

¹ Paragraph OB6 of the Conceptual Framework.

- (d) Performance Measurement: Current financial reporting provides some information regarding the effectiveness of hedging programs. However, the current measures reflect the performance of one-to-one relationships. Providing a simple and understandable metric demonstrating if management was successful in achieving their risk management objective as desired would be relevant information for economic decision-making.

The approach to meet the objective

6. At the November 2017 Board meeting², the staff presented the outline of the proposed DRM accounting model considering the feedback received on the 2014 DP and the education sessions completed throughout 2017. The Board tentatively decided that the DRM accounting model should be developed based on the cash flow hedge mechanics. In particular, it was tentatively decided that, if 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, interest income would reflect the entity's target profile.

The plan to meet the objective

7. At the December 2017 Board meeting³, the Board tentatively decided the staff should develop the accounting model for DRM in two phases. The Board asked the staff to develop the 'core areas' that are central to the model and then seek external feedback on that core model. The staff would then develop 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 first phase

² For further information, refer to the November 2017 Agenda Paper 4 *Outline of proposed DRM accounting model and next steps*.

³ For further information, refer to the December 2017 Agenda Paper 4 *Proposed project plan*.

should capture a significant portion of DRM activities to provide an adequate basis for an early and thorough assessment.

8. At the same meeting, the Board tentatively decided the following areas require further discussion to develop the core of the DRM accounting model:
 - (a) Asset profile;
 - (b) Target profile;
 - (c) Derivative instruments used for DRM purposes; and
 - (d) Performance assessment and recycling.

9. The non-core areas will be addressed 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.

Asset Profile

10. At the February 2018 Board meeting, the Board discussed the role of the asset profile within the DRM model. In particular, the Board discussed the application of qualifying criteria to the asset profile, as well as designation of items within the asset profile and documentation requirements.

Asset Profile Qualifying criteria

11. Based on the staff analysis the Board identified the following qualifying criteria for financial assets to be eligible for inclusion in the asset profile:
 - (a) Financial assets must be measured at amortised cost under IFRS 9;
 - (b) The effect of credit risk does not dominate the changes in expected future cash flows;
 - (c) Future transactions, which are highly probable forecast transactions and firm commitments, must be highly probable;
 - (d) Future transactions must result in financial assets that are classified as subsequently measured at amortised cost under IFRS 9;
 - (e) Items already designated in a hedge accounting relationship are not eligible under the DRM accounting model; and
 - (f) Items within the asset profile must be managed on a portfolio basis for interest rate risk management purpose.

12. The Board specifically instructed the staff to seek external feedback on the above qualifying criteria during outreach.

Designation of the asset profile on a portfolio basis

13. Based on the staff analysis the Board tentatively agreed that financial assets and future transactions dynamically managed for interest rate risk and meeting the qualifying criteria should be designated as part of the asset profile as a portfolio. The Board also tentatively agreed that portfolios should be defined consistently with the entity's risk management policies and procedures and that portfolios should share similar risk characteristics and at a minimum, an entity should consider different currencies and the existence of prepayment features when defining the portfolios. The Board also tentatively agreed that the application of the DRM model should take effect from the date an entity has completed the necessary documentation to designate a specific portfolio.

Designation and the Dynamic Nature of Portfolios

14. The Board tentatively agreed that an entity should have a choice to designate future transactions to be part of the asset profile but only at initial designation,

provided such designation is consistent with the entity's risk management strategy. In addition, the Board also tentatively agreed that changes to designated portfolios resulting in updates to the asset profile should not represent a designation or a de-designation event but instead a continuation of the existing relationship.

Designation of a percentage of a portfolio

15. The Board tentatively agreed that the DRM accounting model should allow for designation of a percentage of a portfolio, provided that:
 - (a) The designated percentage is consistently applied to all expected cash flows within the portfolio;
 - (b) The same percentage of a portfolio of financial assets is applied to a related portfolio of future transactions; and
 - (c) Designation of a percentage of a portfolio is consistent with an entity's risk management strategy.
16. Regarding growth, the Board tentatively agreed an entity may choose to designate growth as a future transaction. It also tentatively agreed that the requirement for designating a consistent percentage between portfolios of future transactions and other related portfolios should not apply if the future transaction is growth.

De-Designation

17. The staff presented preliminary views not to allow voluntary de-designation of portfolios within the asset profile when the risk management objective remains the same and the financial assets in the portfolio continue to meet the qualifying criterion. In addition, the Board also tentatively agreed that financial assets and future transactions should be de-designated when they no longer meet the qualifying criteria or when they are derecognised from the statement of financial position consistent with the requirements of IFRS 9.

Documentation

18. The Board discussed and tentatively agreed that an entity should formally document:

- (a) The portfolio(s) of financial assets designated as part of the asset profile under the DRM accounting model.
 - (b) The methodology used by the entity to determine the amount of future transactions to be designated as part of the asset profile and how such designation is consistent with risk management policies and procedures.
 - (c) Evidence supporting the high probability of future transactions occurring.
19. The Board also tentatively agreed that the documentation provided should be supported by an entity's risk management procedures and objectives.

Target Profile

20. At the March 2018 Board meeting, the Board discussed the role of the target profile within the DRM model. In particular, the Board discussed what is a target profile, how it is determined, consistency of the asset profile and target profile, and the time horizon of the target profile. The paper also briefly discussed laddering strategies along with other matters that will be relevant regarding the target profile in future Board discussions.
21. The Board tentatively decided the staff should continue developing the model based on the following:
- (a) the target profile represents management's objective for a given asset profile;
 - (b) the entity's risk management strategy should define the target profile considering:
 - (i) the contractual terms of financial liabilities; and
 - (ii) the entity's approach to core deposits where present.
 - (c) the notionals of the asset profile and the target profile are required to be the same but not the tenors; and
 - (d) the time horizon of the target profile is the period of time over which the entity is managing interest rate risk.

Target Profile: Qualifying Criteria

22. At the April 2018 Board meeting, the Board discussed the application of qualifying criteria to financial liabilities used to determine the target profile, as well as designation of items within the asset profile and documentation requirements.

Qualifying criteria

23. Based on the staff analysis the Board identified the following qualifying criteria for financial liabilities to be eligible as part of the target profile:
- (a) Financial liabilities must be measured at amortised cost under IFRS 9;
 - (b) Future transactions such as refinancing of maturing financial liabilities or growth must be highly probable;
 - (c) Future transactions must result in financial liabilities that are classified as subsequently measured at amortised cost under IFRS 9;
 - (d) Financial liabilities and future transactions are not already designated in another hedge accounting relationship for interest rate risk; and
 - (e) Financial liabilities and future transactions must be managed on a portfolio basis for interest rate risk.
24. Additionally, it was tentatively decided that financial liability designated at fair value through profit or loss are not eligible when an entity determines its target profile. The staff plan to consider potential implications for transition during outreach.

Core Demand Deposits

25. Regarding core demand deposits, the Board tentatively decided the DRM model will allow for inclusion of core demand deposits based on an entity's risk management strategy in target profile, provided:
- (a) they have a demand feature; and
 - (b) they will not reprice with a change in market interest rates.
26. In addition, Board members directed the staff to add a criterion stating that the notional of demand deposits treated as core and the associated tenor must be based

on reasonable and supportable information. Board members also directed staff to clarify that, for a financial liability to be a demand deposit, the interest rate paid can change only at the discretion of the deposit taker and they are not contractually obligated to change the interest rate paid when market interest rates change. The staff will incorporate the feedback received prior to finalising the core model.

Designation on a portfolio basis

27. Consistent with the tentative decisions on the asset profile, the Board tentatively decided that financial liabilities and future transactions dynamically managed for interest rate risk and meeting the qualifying criteria should be designated on a portfolio basis. The Board also tentatively agreed that portfolios should be defined consistently with the entity's risk management policies and procedures and that portfolios should share similar risk characteristics and at a minimum, an entity should separate different currencies and core demand deposits when defining portfolios. In addition, the Board also tentatively agreed that changes to designated portfolios resulting in updates to the target profile should not represent a designation or a de-designation event but instead a continuation of the existing relationship.

Designation of a percentage of a portfolio

28. The Board tentatively agreed that the DRM accounting model should allow for designation of a percentage of a portfolio, provided that:
- (a) The designated percentage is consistently applied to all expected cash flows within the portfolio;
 - (b) The same percentage of a portfolio of financial liabilities is applied to a related portfolio of future refinancing; and
 - (c) Designation of a percentage of a portfolio is consistent with an entity's risk management strategy.
29. Regarding growth, the Board tentatively agreed an entity may choose to designate a proportion of growth in the target profile provided the designated percentage is consistent with the risk management strategy, and the designated amount is the same as the amount of growth designated as part of the asset profile.

De-Designation

30. The Board tentatively decided financial liabilities and future transactions should be de-designated when one of the following events take place:
- (a) Financial liabilities are derecognised in accordance with IFRS 9; or
 - (b) Any of the tentatively agreed qualifying criteria are no longer met.
31. In addition, the Board tentatively decided voluntary de-designation of portfolios within the target profile is not permitted when the risk management objective for a particular portfolio of financial liabilities remains the same and all other qualifying criteria are still met.

Documentation

32. The Board discussed and tentatively agreed that an entity should formally document:
- (a) The portfolio(s) of financial liabilities designated as part of the target profile under the DRM accounting model;
 - (b) A description of the methodology and key assumptions used by the entity to estimate the core and non-core portions of its demand deposit portfolio;
 - (c) The methodology used by the entity to determine the amount of future transactions to be designated as part of the target profile and how such designation is consistent with risk management policies and procedures;
and
 - (d) Evidence supporting the high probability of future transactions occurring.
33. The Board also tentatively agreed that the documentation provided should be supported by an entity's risk management procedures and objectives.