STAFF PAPER

June 2018

REG IASB Meeting

Project	**Dynamic Risk Management**		
Paper topic	Financial Performance		
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

Introduction

1. The purpose of this paper is to begin the discussions on performance within the Dynamic Risk Management (DRM) accounting model. More specifically, this paper discusses what performance means in the context of DRM and the information that should be provided in the statement of profit or loss regarding DRM activities. This paper also discusses how the proposed accounting achieves consistency with the agreed upon concepts. Finally, this paper uses scenarios discussed in previous Board meetings to demonstrate the application of the proposals.

2. This paper is structured as follows:

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

   (b) Plan for discussing performance (paragraphs 4 – 7);

   (c) What information should be provided in the statement of profit or loss in cases of perfect alignment (paragraphs 8 – 20);

   (d) What is perfect alignment and measurement of perfect alignment (paragraphs 21 – 35);

   (e) Reclassification (paragraphs 36 – 63);

   (f) Testing (paragraphs 64 – 77); and

(g) Discontinuation of the model under certain circumstances (paragraphs 78 – 81).

Summary of staff recommendations

3. In this paper the staff recommend that:

(a) The results reported in the statement of profit or loss should reflect the entity's target profile in the case of perfect alignment. This in conjunction with the designated liabilities will ensure the net of interest income and expense will reflect the risk management strategy. Deferral and reclassification are the mechanisms by which the DRM accounting model achieves the above;

(b) Perfect alignment is achieved when the asset profile, in conjunction with the designated derivatives, equal the target profile;

(c) Reclassification should occur over the time horizon of the target profile such that, in conjunction with the asset profile, the results reported in the statement of profit or loss reflect the entity's target profile;

(d) In order to apply the DRM accounting model, entities must demonstrate the existence of an economic relationship on an on-going basis; and

(e) If an entity chooses to discontinue the DRM accounting model and at the date of termination the cash flows from the designated assets and liabilities still exist and future transactions are still expected to occur, the amount deferred in Other Comprehensive should be reclassified over the life of the target profile such that the results reported reflect the target profile.

Introduction to performance

4. As discussed at the November 2017 Board meeting[1], 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

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

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.'[2] Thus, 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.

5. The asset profile, target profile and derivatives are the three areas through which the DRM accounting model captures an entity's interest rate risk management activities. In order to faithfully represent the impact of these risk management activities in financial reporting, the DRM accounting model must consider the information provided in the statement of financial position, the statement of profit or loss and through disclosure regarding these three areas.

6. Considering the tentative decisions previously reached by the Board, the information content to be provided in the statement of financial position has been determined. In particular, as only financial assets and financial liabilities measured at amortised cost under IFRS 9 are eligible for designation in the DRM accounting model, amortised cost information will be provided for these financial assets and liabilities. Fair value is the applicable measurement method for derivatives in the statement of financial position, including those that are designated derivatives in the DRM model. In addition, as tentatively agreed, a portion of changes in fair value of designated derivatives will be deferred in Other Comprehensive Income.

7. Having defined the information to be provided in the statement of financial position, the two other areas to be discussed with the Board are the information the DRM model should provide in the statement of profit or loss and through disclosure. Specifically the staff plan to structure the discussion in the following order:

   (a) *Information when an entity perfectly aligns the asset and target profiles:* This will cover the information to be provided in the statement

[2] Refer to paragraph 1.6 of the Conceptual Framework for Financial Reporting.

of profit or loss when an entity achieves and maintains perfect alignment. In particular, the staff will propose a principle regarding the information to be provided in the statement of profit or loss and consider the consequential requirements, specifically the deferral of a portion of changes in fair value of designated derivatives in Other Comprehensive Income and subsequent reclassification to the statement of profit or loss. The staff believe it would be inefficient and potentially ineffective to discuss any matters related to imperfect performance before tentatively agreeing on the information to be provided in an ideal scenario.

(b) *Information when an entity does not perfectly align the asset and target profiles:* The staff will consider what additional information should be provided when an entity does not achieve perfect alignment. This includes potential implications of the deferral in Other Comprehensive Income and reclassification, as well as the following topics applicable in the context of imperfect alignment:

  (i) *Target profile defined as a range:* In practice, DRM often accept some variance from the target profile. Thus, the staff will explore whether the target profile could be defined as a range instead of a specific expected outcome.

  (ii) *The 'lower of' test:* The staff will explore the applicability and associated implications of the 'lower of' test, which is currently required for cash flow hedge relationships under IFRS 9[3].

(c) *How the DRM model should reflect some certain events:* The staff believe that additional consideration will be required regarding how the DRM model should reflect the following events in financial reporting:

[3] IFRS 9, Paragraph BC6.372 and BC6.373, "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 flows hedges are highly probable forecast transactions. Hence, recognising gains and losses on those items in excess of the gains and losses on the hedging instrument is tantamount to recognising gains and losses on items that do not yet exist.'… 'The 'lower of test' ensured that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not recognised.'

(i) Changes in inputs, more specifically, updates to the asset profile, target profile and derivatives arising from the dynamic nature of portfolios;

(ii) Changes in assumptions such as the prepayment rate used to determine expected cash flows within the asset profile;

(iii) Breaches of qualifying criteria, for example, when future transactions are no longer highly probable; and

(iv) Changes in risk management strategy.

(d) *Presentation and disclosure:* The staff will consider what additional information should be provided through disclosure and also critically presentation within the statement of profit or loss.

What information should be provided in the statement of profit or loss in cases of perfect alignment?

8. As noted in paragraph 5, the DRM accounting model has three pillars, specifically the asset profile, the target profile and the derivatives used for alignment. In the context of risk management, the cash flows from the asset profile, the financial liabilities used to determine the target profile and the designated derivatives are linked because the derivatives are executed with the explicit purpose of aligning the cash flows from the asset profile and the financial liabilities used to determine the target profile to achieve the entity's risk management strategy.

9. However, as derivatives are measured at fair value through profit or loss but the asset profile and the financial liabilities used to determine the target profile are measured at amortised cost, this gives rise to a measurement difference because linked cash flows are recognised in the statement of profit or loss using two different measurement bases. In addition, when entities use derivatives to manage the interest rate risk associated with future transactions, these derivatives are recognised when they are transacted while the future transactions are recognised on the balance sheet when they occur. These measurement and recognition differences likely do not provide a faithful representation in the statement of profit or loss of the entity's performance for the reporting period. In this context, paragraph 6.58 of the Conceptual Framework states:

> [...] If financial statements contain measurement inconsistencies, those financial statements may not faithfully represent some aspects of the entity's financial position and financial performance. Consequently, in some circumstances, using the same measurement basis for related assets and liabilities may provide users of financial statements with information that is more useful than the information that would result from using different measurement bases. This may be particularly likely when the cash flows from one asset or liability are directly linked to the cash flows from another asset or liability.

10. Given these measurement and recognition differences, the DRM accounting model proposes to address the concerns highlighted in paragraph 9 through deferral and reclassification, as done by other hedge accounting models. More specifically, the DRM model based on cash flow hedge mechanics, proposes that the changes in fair value of the designated derivatives be deferred in Other Comprehensive Income and reclassified to profit or loss when certain conditions are met.

11. As discussed at the March 2018 Board meeting, the target profile represents the objective that management works towards achieving using DRM for a given asset profile. In addition, because an entity's asset profile must be funded, any target profile has to consider the entity's financial liabilities to ensure such a target profile is achievable. As a result, when determining the target profile an entity considers the following:

    (a) The re-pricing profile of financial liabilities within the scope of DRM; and

    (b) The risk management strategy regarding re-pricing of interest income and interest expense.[4]

12. For example, assume an entity that has an asset profile comprised of CU 1,000 3-year fixed rate financial assets and CU 1,000 of 3-year floating rate financial liabilities. Assuming the entity's risk management strategy is to stabilise the net of

[4] For further information, refer to paragraphs 6–8 of the March 2018 Agenda Paper 4B *Target profile*.

interest income and interest expense for the next 3 years, the entity's target profile must be a 3-year floating rate profile (ie a 3-year floating rate financial asset) to match the re-pricing of the financial liabilities. Consequently, the perfect derivative to achieve perfect alignment is a 3-year pay fixed, receive floating interest rate swap.

13. Assuming the entity executes such a perfect derivative, the combination of the asset profile cash flows and the derivative cash flows results in the entity achieving the cash flows of a 3-year floating rate financial asset, which is the entity's target profile. This in conjunction with the cash flows arising from the designated liabilities ensure the net interest income and expense are stable over the 3- year period (ie the period over which the entity is managing interest rate risk). Consequently, the risk management strategy to stabilise the net interest income and expense over the period of the target profile is achieved when an entity perfectly aligns its asset profile with its target profile (with or without the use of derivatives).

14. When an entity uses derivatives to achieve its risk management strategy, the derivative(s) that achieve perfect alignment, or the entity's risk management strategy perfectly, are termed 'perfect derivatives, for the purposes of this discussion.

15. The aim of the DRM model is to faithfully represent the impact of a financial institution's risk management activities in financial performance. Consequently, when an entity achieves its risk management strategy perfectly, the aim of the model is to reflect in the statement of profit or loss the entity's target profile. This is achieved through the recognition of interest income arising from the designated financial assets in scope of the model and the deferral and reclassification of the changes in fair values of the designated derivatives. This will enable the entity to faithfully reflect the risk management strategy in the statement of profit or loss after applying the effective interest rate to those financial liabilities designated when determining the target profile (ie a stable net interest income and expense over the period of its risk management).

16. Consequently, if the entity achieves perfect alignment, as in the above example, the results reported in the statement of profit or loss should reflect the target

profile. This is achieved through deferral and reclassification as outlined in paragraph 10.

17. This provides users with useful information for assessing the entity's prospects for future cash flows and for predicting how efficiently and effectively management will use the entity's economic resources in future periods. The staff believe that this information has predictive value, since the target profile can be used as an input to processes employed by users to predict future outcomes. This information also has confirmatory value, as the target profile information for the current year can be compared with predictions that were made in previous years, helping users to correct and improve the processes in place to make such predictions.[5]

18. The staff would also highlight that, if an entity dynamically manages interest rate risk and achieves perfect alignment *without* the use of derivatives (ie the entity's asset profile equals its target profile), this entity has achieved its objective of stabilising how the net of interest income and expense will change with interest rates over time without using derivatives. This entity's statement of profit or loss would naturally reflect the target profile and risk management strategy given no mitigating actions are required. Assuming a different entity has an identical target profile but uses derivatives to achieve perfect alignment, then both entities have identical expected future cash flows and will be impacted by changes in interest rates over time in a similar manner. Given the entities have identical future expected cash flows, the staff believe that similar, if not the same, information should be provided in the statement of profit or loss. Ensuring the results reported in profit or loss reflects the target profile when perfect alignment has been achieved would provide consistent and comparable information for entities with identical target profiles, irrespective of the manner in which perfect alignment is achieved. According to paragraph 2.24 of the Conceptual Framework, information about a reporting entity is more useful if it can be compared with similar information about other entities. For information to be comparable, paragraph 2.27 of the Conceptual Framework states that 'like things must look alike and

[5] The staff highlight that, according to paragraphs 2.6–2.7 of the Conceptual Framework, financial information is relevant when it has predictive value, confirmatory value or both. According to paragraphs 2.8–2.9 of the Conceptual Framework, financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes; while financial information has confirmatory value if it provides feedback about (confirms or changes) previous evaluations.

different things must look different'. Thus, the staff believe that the DRM model would provide comparable information between these entities as they have identical future cash flows and therefore their reported financial performance should be similar. Furthermore, for a complete comparison, information regarding both entities and how their risk management activities will affect their current and future economic resources, disclosures on the entities' target profile and risk management strategy would be critical. As noted in paragraph 7, the staff will discuss the information to be provided through disclosure at a future Board meeting.

19. Further consideration will be required regarding situations of imperfect alignment and specific events that could impact an entity's performance. As noted in paragraph 7, the staff plan to discuss at a future Board meeting the information that should be provided in the statement of profit or loss when an entity does not perfectly align the asset and target profiles. In addition, the staff will consider further how the DRM model should reflect some specific events, such as changes in inputs, changes in assumptions, breaches of qualifying criteria and changes in an entity's risk management strategy.

Preliminary Staff View

20. It is the preliminary view of the staff that in order to provide a faithful representation in the statement of profit or loss, the results reported should reflect the target profile when perfect alignment has been achieved. Deferral and reclassification are the mechanisms by which the DRM model provides a faithful representation of performance in the statement of profit or loss. This will result in representation of performance on a basis that is consistent with the outcome of an entity's DRM activities. In addition, this will provide users with useful information for assessing the entity's prospects for future cash flows and for predicting how efficiently and effectively management will use the entity's economic resources in future periods and facilitate a like for like comparison of entities with identical target profiles irrespective of the manner in which perfect alignment is achieved.

Question for the Board

Question for the Board
1) Does the Board agree with the preliminary staff view in paragraph 20?

What is perfect alignment and measurement of perfect alignment

21. As noted in paragraph 20, deferral and reclassification are the mechanisms by which the DRM model would faithfully represent an entity's financial performance in a situation of perfect alignment. In particular:

    (a) changes in fair value of the designated derivatives should be deferred in Other Comprehensive Income rather than recorded directly in the statement of profit or loss; and

    (b) a portion of the change in fair value should be reclassified over time such that the results reported in the statement of profit or loss reflects the target profile.

22. For example, consider Scenario A discussed during the April 2018 Board meeting where an entity has CU 1,000 3-year floating rate financial assets yielding LIBOR +1.00% and CU 1,000 of 3-year fixed rate financial liabilities that bear 6.00% interest and a strategy to stabilise the net of interest income. Considering the entity's financial liabilities and a strategy to stabilise, the target profile is defined as a 3-year fixed rate financial asset. The tenor of asset and target profiles before any derivatives are executed are as follows:

Chart 1[6]

Scenario A	**Float**	**20X1**	**20X2**	**20X3**	**Total**
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Difference	**1,000**			**(1,000)**	**0**

[6] All figures in this paper are hypothetical.

23. In this example, the derivative required for perfect alignment is a CU 1,000 3-year receive fix, pay float interest rate swap bearing a market rate of interest at the beginning of 20X1. This would be the 'perfect derivative' as it will remove any variability attributable to changes to the floating rate and also fixes interest income for a 3-year period. In that way, the derivative transforms the 3-year floating rate financial asset such that it is equivalent to a 3-year fixed rate financial asset. Given target profile is a 3-year fixed rate financial asset, perfect alignment has been achieved, and therefore the derivative is the perfect derivative.

24. In keeping with IFRS 9, the staff believe the DRM accounting model should not specify a specific method for measuring alignment[7]. Nonetheless, perhaps the most intuitive method to facilitate measurement would be to compare the executed derivative(s) designated within the DRM accounting model with the CU 1,000 3-year receive fix, pay float interest rate swap which is the perfect derivative required for alignment. This approach should enable the entity to establish the extent to which it has achieved alignment and provide a mechanism to quantify the extent to which the entity has not achieved alignment. This would allow the entity to determine the impact from imperfect alignment not only on the current period but also the expected impact on future periods, both of which would be useful information for users of financial reporting.

25. The staff would highlight that this approach is similar, but not identical, to the IFRS 9 requirements regarding cash flow hedge accounting.

26. If the entity executes and designates that specific derivative then it has achieved perfect alignment. This is because the executed derivative and the derivative required for alignment are the same (ie a CU 1,000 3-year receive fix, pay float interest rate swap). Thus, the entire change in fair value of the derivatives will be deferred such that the results reflected in the statement of profit or loss can reflect the target profile after reclassification.

[7] IFRS 9 Paragraph B6.4.13

Perfect alignment in a dynamic environment

27. As discussed in the April 2018 Board meeting, the changing nature of portfolios is a real economic phenomenon, not simply a term used within accounting literature. As such, given the asset and target profiles are subject to change over time, the portfolio of derivatives required for perfect alignment will also change over time. Re-visiting Scenario E also discussed at the April 2018 Board meeting concerning open portfolios demonstrates how new originations will impact the asset and target profiles as well as the derivatives required for alignment.

28. Consider an entity that has CU 1,000 of 3-year floating rate financial assets yielding LIBOR +1.00% and CU 1,000 of 3-year fixed rate financial liabilities with a yield of 6.00% as at 20X1. Having completed the necessary documentation requirements, the entity begins applying the DRM accounting model to the formally designated portfolios. The asset, target profile, and the derivatives required for perfect alignment are identical as described in paragraphs 23 and 24.

29. At the beginning of 20X2, the entity successfully issues another CU 1,000 of 3-year fixed rate financial liabilities. However, given a change in market interest rates, these liabilities bear 4.00% interest. In addition, the entity successfully originates another CU 1,000 of 3-year floating rate financial assets yielding LIBOR +1.00%. The asset and target profiles after the updates are as follows:

Chart 2

Scenario B	Float	20X2	20X3	20X4	Total
20X1 Assets	1,000				1,000
20X2 Assets	1,000				1,000
20X1 Target Profile			1,000		1,000
20X2 Target Profile				1,000	1,000
Difference	**2,000**		**(1,000)**	**(1,000)**	**0**

30. In this example, there are two CU 1,000 3-year receive fix, pay float interest rate swaps required for perfect alignment. However, one swap has a contractual start date at the beginning of 20X1 and bears a market rate interest determined at the beginning of 20X1, while the other has a contractual start date at the beginning of 20X2 and bears a market rate interest determined at the beginning of 20X2. While both are CU 1,000 3-year receive fix, pay float interest rate swaps, their contractual terms are different, specifically regarding their start date, contractual maturity and the fixed interest coupon. Therefore, because the two swaps are not identical and therefore the derivatives required for perfect alignment would reflect two derivatives. The perfect derivatives required for alignment is summarised below:

Chart 3

Derivative #	Notional	Start date	End date	Fixed rate	Float rate
1	1,000	01/01/X1	31/12/X3	6.00%	1M LIBOR
2	1,000	01/01/X2	31/12/X4	4.00%	1M LIBOR

31. Continuing the scenario where in both 20X3 and 20X4 the entity successfully issues an additional CU 1,000 of 3-year fixed rate financial liabilities bearing 3.00% interest. Also, the entity successfully originates another CU 1,000 of 3-year floating rate financial assets yielding LIBOR +1.00%. The updated tenors are as

follows after incorporating the updates to the asset profile, the target profile and the derivatives required for alignment:

Chart 4

Scenario B	Float	20X4	20X5	20X6	Total
20X1 Assets					
20X2 Assets	1,000				1,000
20X3 Assets	1,000				1,000
20X4 Assets	1,000				1,000
20X1 Target Profile					
20X2 Target Profile		1,000			1,000
20X3 Target Profile			1,000		1,000
20X4 Target Profile				1,000	1,000
Difference	**3,000**	**(1,000)**	**(1,000)**	**(1,000)**	**0**

32. The updates shown in chart 4 are very similar in nature to those illustrated in chart 2. However, the staff would highlight that the initially designated financial assets, liabilities and therefore the perfect derivatives required for alignment with a start date of 20X1 have matured. As such, they should be removed from group of perfect derivatives required for alignment at the end of 20X3, consistent with their maturity date. The perfect derivatives required for alignment at the end of 20X3 is as follows:

Chart 5

Derivative #	Notional	Start date	End date	Fixed rate	Float rate
2	1,000	01/01/X2	31/12/X4	4.00%	1M LIBOR
3	1,000	01/01/X3	31/12/X6	3.00%	1M LIBOR
4	1,000	01/01/X4	31/12/X7	3.00%	1M LIBOR

33. In this example, the derivatives described in chart 5 would be the ‘perfect derivative’ given the respective asset and target profiles. If the entity executes and

designates those specific derivatives then it has achieved perfect alignment. This is because the executed derivative and the derivative required for alignment are the same. Thus, the entire change in fair value of the derivatives will be deferred such that the results reflected in the statement of profit or loss can reflect the target profile after reclassification.

34. Scenario B illustrates that the perfect derivatives will become layered as the target profile becomes layered considering the dynamic nature of portfolios. The staff acknowledge layering as described above could be operationally complicated, however, while risk management is conducted on an aggregated basis, some specificity is required in order successfully manage interest rate risk. Nonetheless, the staff believe the Board should discuss potential options for simplification to ease the potential operational burden implied by Scenario B. This will be discussed at a subsequent Board meeting.

Preliminary Staff View

35. It is the preliminary view of the staff that perfect alignment is achieved when the asset profile, in conjunction with the designated derivatives, equal the target profile. Consequently, derivatives required for perfect alignment are those derivatives that achieve a perfect transformation of the asset profile to those of the target profile. When measuring alignment, while the DRM accounting model will not specify a method, entities could do so by comparing the designated derivatives to the perfect derivatives as described in paragraph 24.

Question for the Board

Question for the Board
2) Does the Board agree with the preliminary staff view in paragraph 35 that perfect alignment is achieved when the derivatives in conjunction with the asset profile equal the target profile? Does the board agree with the preliminary staff view that when measuring alignment, entities could do so by comparing the designated derivative(s) to the perfect derivative(s)?

Reclassification

36. The DRM model aims to provide a faithful representation of performance in the statement of profit or loss through deferral and reclassification of the changes in fair value of the designated derivative instruments. This section addresses the manner in which reclassification should be done under the model.

37. There are two elements required regarding reclassification:

    (a) The time period over which reclassification should occur; and

    (b) The amount to be reclassified each period.

Time period over which reclassification should occur

38. As outlined in Agenda Paper 4B *The Target Profile*, discussed during the March Board Meeting, while the time horizon of an entity's risk management can be the life of the entity, and thus perpetual assuming the entity is a going concern, the entity will define a period over which they actively manage how the net of interest income and expense will change with interest rates over time and this is the time horizon of the target profile. Irrespective of the time horizon of the asset profile, the period over which management stabilises the net of interest income and expense is the time horizon of the target profile (ie the time horizon of the target profile is the period of time over which the net of interest income and expense are managed). This applies to all target profiles irrespective of the contractual tenor of financial liabilities or the risk management strategy applied to core deposits.

39. Consequently, in the staffs preliminary view, the period of time or the time horizon over which an entity reclassifies the amount deferred in Other Comprehensive Income is the time horizon of the target profile, ie the fair value of designated derivatives deferred in Other Comprehensive Income should be reclassified to profit or loss over the time horizon of the entity's target profile. The key consequence of the above is that the amount deferred in Other Comprehensive Income should be zero when the time horizon of the target profile comes to an end. The time horizon of the target profile defines the period over which the net of interest income and expense is managed and consequently the staff cannot contemplate a reason for having changes in fair value of designated derivatives remaining in Other Comprehensive Income after such a period.

40. In most instances this requirement has little impact as derivative instruments pull to par at maturity and consequently the fair values deferred in Other Comprehensive Income pull to zero. However, the period of amortisation becomes critical in the event of a termination of the relationship prior to maturity. If the relationship is terminated prior to the derivatives pulling to par, the balance in Other Comprehensive Income will need to be reclassified to ensure there are no balances left at the end of the risk management period (this of course assumes that the balance does not need to be reclassified immediately – an issue that will be discussed when considering imperfect alignment) and this will have to be done over the remaining period of the target profile.

The amount to be reclassified each period

41. Assuming the Board agree with the staff preliminary view in paragraphs 20, the results reported should reflect the target profile when perfect alignment has been achieved. This is achieved through the recognition of interest income arising from the designated financial assets in scope of the model and the deferral and reclassification of the changes in fair values of the designated derivatives. This will enable the entity to faithfully reflect the risk management strategy in the statement of profit or loss after applying the effective interest rate to those financial liabilities designated when determining the target profile. In this section, the staff explore an updated version of Scenario C from the April 2018 Agenda Paper 4C to illustrate the concepts regarding the amount to be reclassified each period.[8]

E*xample*

Scenario C – Static Profile – reinvestment

42. Consider an entity that has CU 1,000 3-year fixed rate financial assets yielding 5.00% and CU 1,000 of 6-year fixed rate financial liabilities that bear 8.00% interest. Consistent with the entity's risk management policies and procedures, the entity defines the financial assets as a portfolio within the asset profile and

[8] For further information, refer to the April 2018 Agenda Paper 4C *The Dynamic Nature of Portfolios*. The corresponding fact patterns were summarised when information was not relevant to illustrate the mechanics of deferral and reclassification discussed in this paper.

designates the portfolio of financial liabilities used to determine the target profile. As the entity's risk management strategy is to stabilise the net of interest income and expense over a period of 6 years, the target profile is a 6-year fixed rate target profile which is the period over which the entity is managing interest rate risk. However, given the asset profile will mature after 3 years, the entity must reinvest in order to achieve alignment with the 6-year fixed rate target profile. Therefore, the entity must formally designate future transactions in the asset profile and document how it satisfies the applicable qualifying criteria for those future transaction(s).

43. Having completed the necessary documentation requirements, the entity begins applying the DRM accounting model to the formally designated portfolios. The tenor of asset profile and target profile before any executed derivatives are as follows:

Chart 6

Scenario C	**Float**	**20X1**	**20X3**	**20X6**	**Total**
Asset Profile			1,000	1,000 (Float)	1,000
Target Profile				1,000	1,000
Difference			**1,000**	**(1,000)**	**0**

44. The tenor of the asset profile is partially fixed and partially floating because the asset profile is comprised of:

(a) existing fixed rate financial assets until the end of 20X3; and

(b) highly probable future transactions from the end of 20X3 until 20X6. The reinvestment will reflect market rates at the end of 20X3 because the future financial assets have not yet been priced.

45. In order to achieve alignment, the entity requires a CU 1,000 3-year pay fix, receive float interest rate swap that will transform the 3-year fixed rate financial assets to 3-year floating rate financial assets. The market rate for the fixed leg of the 3-year interest rate swap is 4.00% and LIBOR for the floating leg. In addition,

to achieve its target profile, the entity also requires a CU 1,000 6-year receive fix, pay float interest rate swap. Assume the market rate for the fixed leg of the 6-year interest rate swap is 8.00% and LIBOR for the floating leg. As such, the perfect derivatives required for perfect alignment are as follows:

Chart 7

Derivative	Notional	Start date	End date	Fixed rate	Float rate
Swap 1	1,000	01/01/X1	31/12/X3	(4.00)%	LIBOR
Swap 2	1,000	01/01/X1	31/12/X6	8.00%	(LIBOR)

46. Assuming the entity executes and designates the perfect derivatives, the tenor of the asset profile and the target profile after the executed derivatives are as follows:

Chart 8

Scenario C	Float	X1	X3	X6	Total
Asset Profile			1,000	1,000 (Float)	1,000
Target Profile				1,000	1,000
Initial Difference			**1,000**	**(1,000)**	**0**
Swap 1: pay fix, receive float	1,000		(1,000)		0
Swap 2: receive fix, pay float	(1,000)			1,000	0
Final Difference	**0**		**0**	**0**	**0**

Chart 9

Scenario C	AP	- Swap 1 PFix	+ Swap 1 RFlt	+ Swap 2 RFix	- Swap 2 PFlt	∑ =	TP	Aligned ?
20X1	1,000 20X3	(1,000) 20X3	1,000 Float	1,000 20X6	(1,000) Float	1,000 20X6	1,000 20X6	Yes
20X2	1,000 20X3	(1,000) 20X3	1,000 Float	1,000 20X6	(1,000) Float	1,000 20X6	1,000 20X6	Yes
20X3	1,000 20X3	(1,000) 20X3	1,000 Float	1,000 20X6	(1,000) Float	1,000 20X6	1,000 20X6	Yes
20X4	1,000 Float			1,000 20X6	(1,000) Float	1,000 20X6	1,000 20X6	Yes
20X5	1,000 Float			1,000 20X6	(1,000) Float	1,000 20X6	1,000 20X6	Yes
20X6	1,000 Float			1,000 20X6	(1,000) Float	1,000 20X6	1,000 20X6	Yes
Total	**1,000**					**1,000**	**1,000**	**Yes**

47. In this scenario, as perfect alignment has been achieved, the results reported in the statement of profit or loss should reflect the entity's target profile over the 6-year period as demonstrated below:

Chart 10

Year	Libor[(a)]	Target Profile (9.00%)	Financial liability (8.00%)	Net of interest income and expense
20X1	5.50%	90	(80)	10
20X2	5.00%	90	(80)	10
20X3	4.50%	90	(80)	10
20X4	2.00%	90	(80)	10
20X5	2.50%	90	(80)	10
20X6	3.00%	90	(80)	10

[(a)] For illustrative purposes only.

48. Chart 10 shows the net of interest income and expense recognised in profit or loss over the 6-year time horizon. More specifically, each period the entity will recognise interest income of 9.00% from the transformed asset profile (5.00% - 4.00% + LIBOR – LIBOR + 8.00%). The entity will also recognise 8.00% interest expense from its financial liabilities. As such, the net of interest income and expense will be stable at 1.00% over the 6-year period, thereby faithfully reflecting the risk management strategy.

49. To illustrate this, we first demonstrate the recognition of interest income and interest expense for the financial assets designated within the asset profile and the financial liabilities designated when determining the target profile. Then we demonstrate how changes in fair value of the interest rate swap should be deferred in Other Comprehensive Income and reclassified to profit or loss. The staff would highlight that the mechanics proposed in paragraphs 51 - 57 are consistent with the existing mechanics regarding cash flows hedge accounting and would specifically highlight paragraph B6.6.16 of IFRS 9 that states, ‘The entity’s hedge objective is to transform the fixed-interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationships by accruing the net interest accrual on the interest rate swap in profit or loss’.

50. It is important to note that alignment is only achieved assuming the highly probable forecast transaction occurs in form of reinvestment and provides LIBOR based cash flows in 20X4, 20X5 and 20X6. For simplicity the staff have assumed

that the entity originates a 3-year floating rate financial asset earning LIBOR + 1.00% at the end of 20X3.

Chart 11

Year	**Libor**[(a)]	**Financial assets** (5.00%)	**Re Invested Assets** (LIBOR + 1.00%)	**Financial liability** (8.00%)	**Net of interest income and expense**
20X1	5.50%	50		(80)	(30)
20X2	5.00%	50		(80)	(30)
20X3	4.50%	50		(80)	(30)
20X4	2.00%		30	(80)	(50)
20X5	2.50%		35	(80)	(45)
20X6	3.00%		40	(80)	(40)

[(a)] For illustrative purposes only.

51. Chart 11 shows the net of interest income and expense recognised in profit or loss using the effective interest rate method over the 6-year period (note that the amounts recognised do not consider the executed derivative described in paragraph 45). As observable in years 20X4 and onwards, the results do not reflect stability as the net of interest income and expense fluctuates with changes in Libor. To reflect the entity's target profile in a situation of perfect alignment, interest income on the asset profile and changes in fair value of derivatives must be recognised in the statement of profit or loss in the same period. Thus, in the following charts we demonstrate how changes in fair value of the two interest rate swaps should be deferred in Other Comprehensive Income and reclassified to profit or loss.

Chart 12

Year	Interest rate swaps		Accrual (a) – (b)
	Changes in fair value (a)	**Changes in fair value excluding accrual** (b)	
20X1	47	7	40
20X2	0	(40)	40
20X3	200	160	40
20X4	(30)	(90)	60
20X5	655	10	55
20X6	13	(47)	50
Accumulated changes	**295**	**0**	**295**

52. Chart 12 shows changes in the swaps' change in fair values in addition to their interest accrual each period. Note the interest accrual is determined based on the contractual terms of the swaps in questions, specifically, their stated notional amounts and coupons. Considering the entity's target profile aims to stabilise the net of interest income and expense at 1.00% (ie CU 10 in monetary terms), the next chart shows the statement of profit or loss after considering recognition of the net of interest income and expense and reclassification over the 6-year period.

Chart 13

Year	Financial assets (5.00%) or (LIBOR + 1.00%)	Reclassification	Combined	Financial liability (8.00%)	Net of interest income and expense
20X1	50	40	90	(80)	10
20X2	50	40	90	(80)	10
20X3	50	40	90	(80)	10
20X4	30	60	90	(80)	10
20X5	35	55	90	(80)	10
20X6	40	50	90	(80)	10

53. As shown in Chart 13, the combination of the amount reclassified from Other Comprehensive Income and the net of interest income and expense resulted in the amount of CU 10 recognised in the statement of profit or loss over the 6-year period. Reflecting the entity's target profile in the statement of profit or loss has faithfully represented the impact of the entities DRM activities.

54. At the end of the 20X3, there will be two updates to the items designated within the DRM accounting model. First, the existing 3-year fixed rate financial asset and the 3-year pay fix, receive floating interest rate swap will mature and therefore will be de-designated from the DRM model. Then, the designated future transaction will occur as expected and the resulting financial asset will be designated in the DRM accounting model. The tenor of asset profile and target profile after the updates are as follows:

Chart 14

Scenario C	Float	20X4	20X5	20X6	Total
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Initial Difference	**1,000**			**(1,000)**	**0**
Swap 2: receive fix, pay float	(1,000)			1,000	0
Final Difference	**0**		**0**	**0**	**0**

55. Also, as the 20X3 interest rate swap matured, the only derivative required for alignment is the 20X6 interest rate swap as shown below:

Chart 15

Derivative #	Notional	Start date	End date	Fixed rate	Float rate
Swap 2	1,000	01/01/X1	31/12/X6	8.00%	(LIBOR)

56. In this scenario, as perfect alignment has been maintained, the results reported in the statement of profit or loss should continue to reflect the entity's target profile over the remaining 3-year period (ie CU 1,000 * 9.00% or CU 90 in 20X4, 20X5, 20X6, etc.). See chart below:

Chart 16

Year	Financial assets (LIBOR + 1.00%)	Reclassification	Combined	Financial liability (8.00%)	Net of interest income and expense
20X4	30	60	90	(80)	10
20X5	35	55	90	(80)	10
20X6	40	50	90	(80)	10

57. At the end of the 6-year period, financial assets, financial liabilities and the interest rate swap will mature. As indicated in chart 12, as the entire change in fair value of has been reclassified to the statement of profit or loss there remains nothing deferred in Other Comprehensive Income at the end of the 6-year period. As such, the proposed mechanics not only provided a faithful representation in the statement of profit or loss, but also result in no balances being deferred in Other Comprehensive Income at the end of the time horizon through a combination of the pull to par effect and reclassification.

Other Matters

58. The discussion in paragraphs 41 - 57 implies reclassification should be presented as part of interest income in the statement of profit or loss, however, the staff believe presentation within the statement of profit or loss should be discussed separately when the Board discusses the presentation and disclosure requirements of the DRM accounting model in a future Board meeting.

59. The staff would like to note that the principles outlined in paragraphs 36 – 57 governing the period of reclassification and the amount to be reclassified each period, achieves the objective of reflecting the risk management strategy in the statement of profit or loss under all scenarios. More specifically, the staff evaluated various scenarios fixed or floating asset profiles both with and without the designation of future transactions (including growth) compared with fixed or floating asset profiles both with and without the designation of future transactions (including growth). In all scenarios the staff concluded that the fair value of designated derivatives should be reclassified such that the results reported reflect the target profile.

60. Furthermore, the staff would like to note the DRM accounting aims to reflect and not govern risk management. Therefore, the staff have considered whether the proposed mechanics would faithfully reflect risk management strategies other than stabilisation. For example, an entity’s risk management strategy may be to have the net of interest income and interest expense change in perfect correlation with changes in 1-month LIBOR. The mechanics discussed above will provide a faithful representation of this risk management strategy.

61. However, as also previously discussed, the staff will propose qualifying criteria intended to preclude certain types of strategies from being designated as part of the DRM accounting model because the proposed performance principles may not provide a faithful representation for those strategies (ie leverage). For example, in all scenarios illustrated to date, the time horizon, not the tenor, of the asset profile and target profile have been the same. Said differently, the maturity date of the asset profile has been the maturity date of the target profile. This follows logically from the discussion during the March 2018 Board meeting that stated 'an entity's asset profile must be funded. Consequently, any desired asset profile, that is captured and defined through the entity's target profile, has to consider the entity's financial liabilities to ensure that such a target profile is achievable.[9]' 'If the notionals of the target and asset profile are not aligned then this implies either:

    (a) the target profile represents something other than specified re-pricing dates for items designated within the asset profile based on an entity's risk management strategy. For example, this could imply leverage within the target profile; or

    (b) financial assets within the asset profile are funded by financial liabilities that are outside the scope of the entity's DRM policies and procedures. This would imply the risk management objective is not to manage the net of interest income and expense but merely interest income.[10]'

62. The staff will discuss potential qualifying criteria intended to preclude certain trading strategies from being designated as part of the DRM accounting model in more detail after the discussions on performance are completed.

Preliminary Staff View

63. The staff is of the preliminary view that the period of time, or the time horizon, over which an entity reclassifies the amount deferred in Other Comprehensive Income is the time horizon of the target profile. Furthermore, the staff are of the preliminary view that the amount to be reclassified each period is the amount that ensures the statement or profit or loss, in conjunction with the application of the

[9] Paragraph 7, Agenda Paper 4B: The Target Profile

[10] Paragraph 28, Agenda Paper 4B: The Target Profile

effective interest method to the financial assets within the asset profile, reflect the target profile.

Question for the Board

Question for the Board

3) Does the Board agree with the preliminary staff view in paragraph 63? Does the Board have any questions or concerns regarding the mechanics proposed in paragraphs 41 – 57?

Testing

64. When an entity obtains and maintains perfect alignment between the asset and target profiles, then and only then, will the results recorded in the statement of profit or loss reflect the target profile. If not perfectly aligned, then the results recorded in the statement of profit should not reflect target profile because the target profile has not been achieved. Consequently, deviations from the target profile need to be considered. The staff will discuss deviations from the target profile in two sections:

    (a) *Assessment of alignment*: Should the DRM accounting model require a prospective test as a pre-condition for applying the model;

    (b) *Measurement of imperfection*: How should imperfect alignment be reported in the statement of profit or loss? How will the DRM accounting model consider the specific events mentioned in paragraph 7(c) (ie changes in inputs, changes in assumptions, breaches of qualifying criteria and changes in the entity's risk management strategy).

65. The remainder of this paper will focus on the prospective test. While the staff considered if the DRM accounting should require a retrospective test as a pre-condition for applying the model, the staff believe such a discussion would be inefficient and potentially ineffective without first discussing the requirements

regarding measurement of imperfection. As such, the staff will discuss measurement of imperfection and the potential requirement for a retrospective test jointly in a future Board meeting.

Testing Requirements

66. The treatment for designated derivatives proposed in paragraph 20 represents a deviation from the normal accounting for derivatives under IFRS Standards and as such, the staff have considered what requirements, if any, should exist to ensure an entity has indeed achieved and maintained alignment between the asset and target profiles. The staff recognise the objective of the model is not to govern or restrict risk management, but reflect the impact of risk management activities in financial reporting. While introducing requirements to demonstrate alignment has been achieved and maintained could create tension with that objective, the staff believe the requirement is necessary because:

    (a) The Conceptual Framework highlights that user's need information about how efficient and effectively the reporting entity's management has discharged its responsibilities to protect the entity's economic resources from unfavourable events. According to the Conceptual Framework, 'such information is also useful for predicting how efficiently and effectively management will use the entity's economic resources in future periods'.[11] Requiring entities to demonstrate the extent to which they have achieved alignment should provide users with this information in the context of DRM;

    (b) The Conceptual Framework highlights that under exceptional circumstances income or expense arising from a change in the current value of an asset or liability should be included in Other Comprehensive Income. As discussed in paragraph 20, deferral and reclassification are the mechanisms by which the DRM model would faithfully represent an entity's financial performance in a situation of perfect alignment. Requiring entities to demonstrate they have achieved

[11] Refer to paragraphs 1.22-1.23 of the Conceptual Framework.

and maintained alignment helps justify the use of the exception is appropriate; and

(c) As noted in paragraph 9, if financial statements contain measurement differences involving cash flows from assets and liabilities that are directly linked, those financial statements may not faithfully represent some aspects of the entity's financial position and financial performance. This is the case of the DRM model as the cash flows from the asset profile are linked to the cash flows from the financial liabilities used when determining the target profile through the designated derivatives. Requiring entities to demonstrate they have achieved and maintained alignment should provide evidence that the cash flows of items designated within the DRM accounting model are and continue to be linked.

67. A central requirement within the existing hedge accounting requirements of IFRS Standards is the hedging relationship must be effective if the entity wishes to qualify for hedge accounting. IFRS 9 paragraph BC6.266 states, "The method used to assess the effectiveness of the hedging relationship need to be suitable that the objective of the hedge effectiveness assessment has been achieved". In the case of the DRM accounting model, the objective of the designated relationship is for the designated derivatives to achieve and maintain alignment between the asset and target profiles. For an entity to demonstrate that it has aligned the asset and target profiles, it could compare the derivatives designated in the DRM accounting model with the perfect derivatives as described in paragraph 24.

68. In IFRS 9, the IASB decided to replace the hedge effectiveness assessment of IAS 39 with a more principles based approach and proposed replacing the bright line test in IAS 39 with a notion that aims to reflect the way entities look at the design and monitoring of hedge relationships from a risk management perspective. This linked the risk management perspective with the hedge accounting model's general notion of offset between gains and losses on hedged instruments and hedged items[12]. More specifically, IFRS 9 paragraph 6.4.1(c) states that there must be an economic relationship between the hedged item and hedging

[12] IFRS 9, Paragraph BC6.252

instrument and the effect of credit risk does not dominate the value changes that result from that economic relationship in order to qualify for hedge accounting.

69. In the context of the DRM accounting model, the staff believe it appropriate to require an entity to demonstrate that there is an economic relationship between the asset profile, designated derivatives, and the target profile in order to justify the deviation from normal accounting standards and also prove that the cash flows from the three pillars are indeed linked.

70. In the context of the existing hedge accounting requirements in IFRS 9, an economic relationship means 'that the hedging instrument and the hedged item have values that generally move in the opposite direction[13].' Given the DRM accounting model is focused on alignment rather than offset, an economic relationship would have a different meaning not focused on offsetting changes in values between the hedged item and the hedging instrument. Given the DRM accounting model is focused on an entity's ability to align the asset and target profiles using derivatives, the staff believe the term economic relationship should focus on the concept of alignment. More specifically, whether the designated derivatives are designed to and will be successful in transforming the designated asset profile such that it is better aligned with the target profile. Said differently, if the designated derivatives increase the misalignment between the asset and target profiles, then there is no economic relationship. Furthermore, consistent with paragraph B6.4.6 of IFRS 9, the staff believe the entity should demonstrate the existence of an economic relationship considering '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.'

71. As discussed in paragraph 24, maintaining consistency with the existing requirements in IFRS Standards, the staff are of the preliminary view the DRM accounting model should not specify a specific method to demonstrate the existence of an economic relationship. Consequently, since the aim of testing is to demonstrate the existence of an economic relationship, the test should provide evidence of an economic relationship as described in paragraph 70 for the

[13] IFRS 9, Paragraph B6.4.4

purposes of the DRM accounting model, one such method being the perfect derivative method described in paragraph 24.

72. If the demonstration indicates that there is no economic relationship between asset profile, designated derivatives, and the financial liabilities used when defining the target profile, then this implies there is no link between those cash flows. Furthermore, if there is no economic relationship, it would be difficult, if not impossible, for an entity to assert the designated derivatives are executed to achieve the entity's risk management strategy represented by the target profile. Therefore, if the assessment indicates there is no economic relationship, the staff believe the use of the model should be discontinued. If there is a balance deferred in Other Comprehensive Income because the entity had previously passed the prospective test, it should be reclassified to the statement of profit or loss as discussed in paragraphs 78 – 81 as this represents a discontinuation event for the DRM accounting model.

73. Furthermore, while the staff considered including a bright line assessment within the DRM accounting model because this would provide strong quantitative evidence that the cash flows from the three pillars designated within the model are indeed linked, the staff are of the preliminary view to not include a bright line test for the following reasons:

    (a) A bright line test could be inconsistent with the objectives of the DRM accounting model to improve information provided regarding risk management and how risk management activities affect the financial institution's current and future economic resources. As the IASB has previously received feedback that if hedge accounting was not achieved because the entity failed the bright line test within IAS 39, the information provided was difficult to understand, the staff are concerned re-introducing such a bright line test may not improve the information content in financial reporting[14].

    (b) A bright line test would define a minimum performance threshold for risk management. The staff are concerned defining the minimum

[14] IFRS 9 Paragraph BC6.232

performance threshold could be viewed governing rather than reflecting risk management. This is especially the case as any threshold chosen (ie 80 -125) will most likely be arbitrary. Furthermore, given the IASB has received feedback to this effect[15] and the requirements of IFRS 9 in this regard, the staff are of the preliminary view to not introduce a bright line test within the DRM accounting model.

Preliminary Staff View

74. For the reasons stated in paragraphs 66 through 73, the staff is of the preliminary view that entities should be required to demonstrate that there is an economic relationship between the asset profile, designated derivatives, and the target profile in order to justify the deviation from normal accounting standards and also prove that the cash flows from the three pillars are indeed linked. If this assessment indicates there is no economic relationship, entity should apply the discontinuation requirements as described in paragraphs 78 - 81. Also, for the reasons stated in paragraph 73, the staff are of the preliminary view not to define a minimum performance threshold, colloquially referred to as a 'bright line test'.

Question for the Board

Question for the Board
4) Does the Board agree with the staff preliminary view in paragraph 74?

Frequency of testing

75. Under IFRS 9, the hedge effectiveness requirements shall be assessed on an ongoing basis. This is because these requirements should be met throughout the

[15] IFRS 9 Paragraph BC6.232

term of the hedging relationship.[16] In particular, paragraph B6.4.12 of IFRS 9 states:

> An entity shall assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements.

76. Provided the Board tentatively agree with the staff preliminary view in paragraph 74, the staff believe that an entity should demonstrate the existence of an economic relationship, at a minimum, at each reporting date. This is because, similarly to IFRS 9 guidance noted in paragraph 75, this requirement should be met throughout the designation of the DRM accounting model. The staff highlight that, in practice, for an entity to demonstrate it has maintained alignment over time, it would need to do so at each update to the portfolios of financial assets, liabilities and derivatives designated within the DRM accounting model. Given the dynamic nature of portfolios, these updates are expected to occur frequently and therefore the test will be performed frequently.

Preliminary Staff View

77. For the reasons stated in paragraphs 75 and 76, the staff is of the preliminary view that entities shall assess the existence of an economic relationship on an ongoing basis.

[16] According to paragraph 6.263 of the Basis for Conclusions of IFRS 9, '[…] the IASB considered that an entity should assess, on an ongoing basis, whether the hedge effectiveness requirements are still met, including any adjustment (rebalancing) that might be required in order to continue to meet those requirements. This was because the proposed hedge effectiveness requirements should be met throughout the term of the hedging relationship.'

Question for the Board

Question for the Board
5) Does the Board agree with the staff preliminary view in paragraph 77 that entities should demonstrate the existence of an economic relationship on an ongoing basis?

Discontinuation of the model under certain circumstances

78. In the scenario discussed in paragraphs 42 – 57, and all scenarios discussed during the April 2018 Board meeting, the DRM model terminated when the time horizon of the asset and target profiles lapsed and nothing remained designated in the DRM accounting model. Given risk management is done on a continuous basis and it is very likely that entities will continue to manage interest rate risk, it is possible that an entity may never discontinue the DRM accounting model. However, the staff would highlight that it is possible that under certain conditions discontinuation of the DRM accounting will either be mandated (for example items within the asset profile or the target profile no longer meet the qualifying criteria) or arise because of management decisions and actions (for example when an entity changes its risk management strategy). The former represent events that are examples of imperfection and will therefore be discussed in subsequent Board meetings. In this section, the staff would like discuss to the implications when either an entity chooses to discontinue the DRM accounting model because of a change in risk management strategy or fails the prospective test. More specifically how to reclassify any remaining accumulated balance in Other Comprehensive Income to the statement of profit or loss the model is terminated before the time horizon of the asset and target profiles lapses.

79. For the purpose of this discussion, the staff believe there are two ways in which an entity could choose to discontinue the DRM accounting model. Firstly, the entity could change the risk management strategy such that the use of derivatives is no longer necessary. The other is where the entity fails the prospective test. The latter is considered a choice because the entity has chosen to not manage the target

profile as per their documented risk management strategy. Regardless of the manner in which the entity choses to discontinue the DRM accounting model, in both instances, the entity was previously successful in aligning the asset and target profiles and at the date of termination the cash flows from the designated assets and liabilities still exist and future transactions are still expected to occur. In the staff's preliminary view, the remaining balance in Other Comprehensive Income should be reclassified over the life of the target profile (ie the period over which the entity was managing risk) such that the results reported reflect the target profile consistent with the principles discussed in paragraphs 36 – 57. The staff would highlight this is consistent with the requirements of cash flow hedge accounting in IFRS 9 that state reclassification should occur in the same period of periods during which the hedged expected future cash flows affect profit loss[17], if those hedged cash flows are still expected to occur[18]. Also similar to IFRS 9, if at the date of termination, the cash flows from the designated assets and liabilities do not exist and future transactions are not expected to occur, the remaining balance in OCI should be immediately reclassified to the statement of profit or loss[19].

80. The staff would also highlight that as a result of the dynamic nature of portfolios, the target profile will be changing frequently. Therefore, for the purposes of determining the period of reclassification in the event of discontinuation of the model, the target profile to be considered should be the one defined immediately prior to the discontinuation of the model (ie the target profile used for the last successful prospective test), as opposed to the target profile determined after the model has been discontinued. To reclassify over the life of the amended target profile would imply a change in the pattern of reclassification and could result in Other Comprehensive Income being deferred beyond the period over which risk was managed in the first place. As this would contradict the principle as described in paragraphs 36 – 57, the staff believe this would not be appropriate.

[17] IFRS 9, paragraph 6.5.11(d)(ii)

[18] IFRS 9, paragraph 6.5.12(a)

[19] IFRS 9, paragraph 6.5.12(b)

Preliminary Staff View

81. For the reasons stated in paragraphs 78 through 80, the staff is of the preliminary view that if an entity chooses to discontinue the DRM accounting model and at the date of termination the cash flows from the designated assets and liabilities still exist and future transactions are still expected to occur, the amount deferred in Other Comprehensive should be reclassified over the life of the target profile such that the results reported reflect the target profile consistent with the principles discussed in paragraphs 37 – 56. To do otherwise could result in Other Comprehensive Income remaining deferred beyond the period over which risk was managed.

Question for the Board

Question for the Board

6) Does the Board agree with the staff preliminary view in paragraph 80 that when an entity chooses to discontinue the DRM accounting model and at the date of termination the cash flows from the designated assets and liabilities still exist and future transactions are still expected to occur, the amount deferred in Other Comprehensive should be reclassified over the life of the target profile such that the results reported reflect the target profile consistent with the principles discussed in paragraphs 37 – 56?