STAFF PAPER

March 2018

REG IASB Meeting

Project	**Dynamic Risk Management**		
Paper topic	Target profile		
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

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board). The views expressed in this paper do not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

Introduction

1. The objective of this paper is to discuss the role of the target profile within the Dynamic Risk Management (DRM) accounting model. The paper outlines 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 discusses laddering strategies along other with matters that will be relevant regarding the target profile in future Board discussions.

2. This paper is structured as follows:

   (a) Background (paragraphs 3 – 5);

   (b) The target profile: Its role within the DRM accounting model and how is it determined (paragraphs 6 – 25);

   (c) Consistency between the asset profile and the target profile (paragraphs 26 – 31);

   (d) The time horizon of the target profile (paragraphs 32 – 40);

   (e) Laddering strategies and other matters (paragraphs 41 – 51); and

   (f) Topics to be discussed at future meetings (paragraphs 52 – 53).

The International Accounting Standards Board is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of International Financial Reporting Standards. For more information visit www.ifrs.org

Background

3. As discussed during the November 2017 Board meeting[1], the core economic activity of certain financial institutions can be described as raising funds to provide longer-term loans to customers. Consequently, lending and funding activities are generally the main contributors to interest income and interest expense of these financial institutions. Due to the exposure to interest rate risk arising from such activities, an adverse change in market rates can negatively affect the net of interest income and expense of these financial institutions. In this context, DRM is the process that involves understanding and managing how interest income and interest expense will change with interest rates over time.

4. Matching re-pricing dates of financial assets and financial liabilities is a common approach used to mitigate the potential impact from changes in market interest rates.[2] Financial instruments can be either floating or fixed rate. Floating-rate financial instruments re-price when interest rates reset, that is, the moment when interest rate readjusts to reflect changes in market rates, such as LIBOR. Re-pricing also occurs when either fixed or floating-rate financial instruments are replaced as they mature. This is because pricing of new financial instruments is determined based on market conditions at that point in time.

5. Some financial liabilities, specifically demand deposits, can be insensitive to market interest rates. When maintained with financial institutions for an extended period of time, these deposits effectively represent perpetual fixed rate financial liabilities. As perpetual fixed rate financial assets do not exist in sufficient quantity to match the quantum of these deposits, aligning the re-pricing of financial assets and financial liabilities is not be possible. This implies interest income will change whereas interest expense remains constant over time. Although the impact of changing interest income over time cannot be eliminated, through DRM an entity can determine when these changes in interest income occur by using derivative instruments. Derivatives allow the entity to control the

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

[2] For further information on the mentioned approach, refer to education sessions held in May 2017, June 2017 and September 2017.

re-pricing of financial assets such that they re-price as specified by an entity's risk management strategy instead of dates specified by the financial asset's contractual terms.

The Target Profile: Its role within the DRM accounting model and how it is determined

6. The target profile specifies the re-pricing dates for the asset profile based on an entity's risk management strategy. It represents the objective that management works towards achieving using DRM for a given asset profile and allows for the assessment of whether the executed derivative instruments were and continue to be effective in transforming the asset profile by defining the desired end state after completing transformation.

7. 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. Furthermore, as DRM is the process that involves understanding and managing how interest income and interest expense will change with interest rates over time, in order to faithfully reflect DRM in financial reporting, the accounting model must consider interest expense. By considering financial liabilities when defining the target profile, it also captures the management of interest expense within the DRM accounting model.

8. 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.

9. While the target profile is determined taking into account the profile of the financial liabilities, this paper does not cover the criteria used to define which financial liabilities are within the scope of DRM and therefore eligible for the DRM accounting model. The qualifying criteria used for such purpose will be discussed at a future Board meeting.

a) Re-pricing profile of financial liabilities within the scope of DRM

10. As outlined in paragraph 8, the determination of the target profile will consider the profile of the financial liabilities within the scope of DRM. For example, assume a fact pattern where an entity funds an asset profile of CU1,000 with interest-bearing debt instruments of the same amount. Financial assets within the asset profile and the financial liabilities bear fixed interest rates and will mature in 5 years. The entity's risk management strategy is to stabilise the net of interest income and interest expense for the next 5 years. The following table summarises this scenario.

Table 1

Scenario A	**Year 5**
Asset profile: 100% fixed rate	1,000
Financial liabilities: 100% fixed rate	(1,000)
Risk management strategy: stabilise the net of interest income and expense for the next 5 years	

11. In this scenario, the target profile equals the asset profile (ie the target profile is a CU 1,000 5-year fixed rate financial asset). This is because the asset profile already achieves the entity's risk management strategy by matching the re-pricing of its financial liabilities until the end of the 5th year without the need for derivatives.

12. Conversely, when the asset profile is not aligned with the target profile, derivatives can be used to transform financial assets within the asset profile such that interest income reacts to changes in market factors as defined by the entity's target profile.[3] To illustrate, assume the same fact pattern as in the previous example, but instead of fixed, assume the financial liabilities bear a floating interest rate for the same maturity of 5-years. The following table summarises this new scenario.

[3] Asset transformation focuses on derivatives used to transform an entity's asset profile to a defined target profile. For further information, refer to the Board meetings held in May 2017, June 2017 and September 2017.

Table 2

Scenario B	**Year 5**
Asset profile: 100% fixed rate	1,000
Financial liabilities: 100% floating rate	(1,000)
Risk management strategy: stabilise the net of interest income and expense for the next 5 years	

13. In this fact pattern, management's objective is to stabilise the net of interest income and interest expense for the next 5 years. Therefore, to match the re-pricing of financial liabilities, the target profile would be a 5-year floating rate profile (ie a 5-year floating rate financial asset). This implies the need for derivatives to change the re-pricing of the fixed rate asset profile and achieve the entity's risk management strategy (for example a 5-year pay fixed receive float swap).

14. The target profile in both scenarios A and B above can be described as a single financial asset given the simplicity of the example. This will not always be the case. To illustrate, assume the same fact pattern as in the previous example, but assume there are two financial liabilities, a CU 500 5-year fixed rate financial liability and a CU 500 5-five year floating rate financial liability. The following table summarises this new scenario.

Table 3

Scenario C	**Year 5**
Asset profile: 100% fixed rate	1,000
Financial liabilities: 50% floating rate	(500)
Financial liabilities: 50% fixed rate	(500)
Risk management strategy: stabilise the net of interest income and expense for the next 5 years	

15. In this fact pattern, management's objective is to stabilise the net of interest income and interest expense for the next 5 years. Therefore, to reflect the re-pricing of financial liabilities, the target profile would be the aggregation of a CU 500 5-year floating rate profile (ie a 5-year floating rate financial asset) and a CU 500 5-year fixed rate profile (ie a 5-year fixed rate financial asset). The objective of DRM is to align the asset profile with the target profile through the use of derivatives. In the above example, alignment has already been partly achieved without the use of derivatives as the target profile indicates CU 500 of 5-year fixed rate financial assets are required but the asset profile is comprised of CU 500 of 5-year fixed rates financial assets. The entity's mitigating actions will focus on the misalignment between the asset and target profile. More specifically, where the target profile requires a CU 500 of 5-year floating rate profile but the asset profile is a CU 500 of 5-year fixed rate profile. Consequently, although entities will manage the entirety of the target profile, this does not automatically imply that the entire target profile necessitates mitigating actions.

Core Deposits

16. In the above examples, the target profile was determined considering the entity's risk management strategy which in turn considered the profile of the entity's financial liabilities (ie contractual maturity dates and whether the financial liabilities bear a fixed or a floating rate). However, while it is relatively straightforward to stabilise the net of interest income and expense through matching re-pricing dates of financial assets and financial liabilities when the profile of the financial liabilities is defined by their contractual terms, core demand deposits raise other complications as they represent perpetual funding.

17. Consider an entity that has an asset profile comprised of CU1,000 5-year floating rate financial assets funded by 5-year floating rate financial liabilities and core deposits of equal amounts (ie CU 500 each). The entity's risk management strategy is to stabilise the net of interest income and expense within the scope of DRM for the next 5 years. This scenario is summarised in the following table.

Table 4

Scenario D	**Year 5**
Asset profile: 100% floating rate	1,000
Financial liabilities: 50% fixed rate	(500)
Financial liabilities: 50% fixed rate (core deposits)	(500)
Risk management strategy: stabilise the net of interest income and expense for the next 5 years	

18. As shown in the table above, although core deposits are considered perpetual in nature, they are allocated into time buckets. For any form of fixed rate perpetual funding, for risk management to be able to stabilise the net of interest income and expense it has to originate fixed rate perpetual life assets, which is not possible in reality. Consequently, the only other alternative is to break the perpetual life fixed rate funding into manageable time periods and stabilise the net of interest income and expense over that period. The time period chosen by an entity for this purpose is based on the entity's risk management strategy which in turn is often informed by the availability and liquidity of derivatives. In this manner management chooses the time horizon over which the net of interest income and expense will be managed (ie 5 years in this example). In particular, this period will inform which derivatives, if any, are required to achieve the entity's risk management strategy.

19. Similar to scenario C, the target profile in scenario D will be composed of two parts. The first part is a CU 500 5-year fixed rate profile. The second part of the target profile is also a CU 500 5-year fixed rate profile. This is because the entity has CU 500 of core deposits and the entity's risk management strategy defines a period of 5 years over which the net of interest income and expense should be stabilised. In other words, for the purpose of DRM, management treats the core deposits as a 5-year fixed rate financial liability in order to execute its risk management strategy. Comparing scenario D (where the target profile partially reflects core deposits and therefore management's strategy) to scenario A (where the target profile reflects 5-year fixed rate financial liabilities), in both scenarios,

the target profile is a 5-year fixed profile because this is the time period defined by the entity's risk management strategy. The fact that the risk management strategy reflects the contractual terms of the originated liabilities in scenario A whereas the strategy is more nuanced in scenario D does not change the fact that the target profile in both scenarios is a 5-year fixed rate profile beginning at T^0.

20. This scenario also illustrates how the target profile will incorporate core deposits. This will allow the model to alleviate the capacity issue discussed during the November 2017 Board meeting.

21. The staff also recognise that certain entities will consider equity in a similar manner as core deposits when establishing the target profile. Equity as a source of funding will be discussed during the second phase of the project as agreed during the December 2017 Board meeting.[4]

b) Risk management strategy regarding re-pricing of interest income and interest expense

22. An entity's risk management strategy also establishes how interest income and interest expense should change with interest rates over time. The entity's key management personnel normally define this strategy. These strategies are often subject to internal governance processes and reviewed by prudential regulators. The staff have summarised the two most common risk management strategies as follows:

    (a) *Stabilise cash value of margin*: Certain entities want a high degree of predictability on the net of interest income and expense. Such entities will define the target profile consistent with the re-pricing profile of financial liabilities. The net of interest income and interest expense should represent a relatively stable stream of fixed cash flows over time; and

    (b) *Stabilise present value of future margin*: Other entities want to stabilise the net of interest income and expense on a present value rather than a cash basis. These entities would also define the target profile based on the re-pricing profile of financial liabilities. However, the stream of

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

future cash flows related to the net of interest income and expense is discounted and managed on a present value basis.

23. Regardless of an entity's decisions when defining its risk management strategy, the target profile would be compared with the asset profile for the purpose of determining which derivatives, if any, are required for alignment.

Preliminary Staff View

24. In the context of the DRM accounting model the preliminary view of the staff is that the target profile specifies the re-pricing dates for the asset profile based on an entity's risk management strategy. It represents the objective that the management works towards achieving using DRM for a given asset profile that the target profile. The determination of the target profile should take into account the entity's risk management strategy which in turn is influenced by:

(a) The contractual tenor of financial liabilities where present; and

(b) The risk management strategy when core deposits are present.

25. The staff also believe that this will enable the determination of whether the executed derivative instruments, if any, were and continue to be effective in aligning the asset profile with the target profile for the purpose of performance assessment. The staff plan to discuss at a future Board meeting the qualifying criteria used to define which financial liabilities are within the scope of DRM as well as criteria intended to preclude trading strategies from being designated as part of the DRM accounting model.

Question for the Board

Question for the Board
1) Does the Board agree with the preliminary staff view in paragraphs 24 and 25 that the target profile represent the objective that management is working towards for a given asset profile?

Consistency between the Asset Profile and the Target Profile

26. Assuming the Board agrees the target profile represents the objective that management is working towards for a given asset profile, there are certain considerations the staff would like to highlight regarding the consistency between the asset profile and the target profile. Consistency will be discussed in two dimensions:

    (a) Notional; and

    (b) Tenor (ie the length of the profile).

Notional

27. The asset profile is the combination of designated financial assets and future transactions. The target profile specifies the re-pricing dates for the asset profile based on an entity's risk management strategy. Therefore, the notional of the asset profile has to be consistent with the notional of the target profile by definition. However, this will have certain implications for growth, as growth of financial assets (ie origination in excess of maturities) must be funded by growth in financial liabilities. Because the designation of growth as part of the asset profile requires the future transaction to be highly probable, this implies the entity will have the necessary financial liabilities to support growth. This combined with the fact the entity should take into account financial liabilities when determining the target profile means the notionals of the target and the asset profile should be aligned, even when growth is designated within the asset profile.

28. 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.

29. For the reasons stated above, the staff are of the view that the notionals of the asset profile and the target profile should be aligned.

Tenor

30. Tenor refers to the length of the profile. More specifically, it is the amount of time until re-pricing occurs for the items within the profile. As the target profile specifies the re-pricing dates for the asset profile based on an entity's risk management strategy, by definition the tenor of the asset profile and the target profile need not be aligned. For example, if the asset profile is comprised of CU 1,000 7-year fixed rate financial assets, but the target profile is defined entirely as CU 1,000 of 5-year fixed rate financial assets then the tenors are misaligned. However, this misalignment can be addressed through the use of derivatives, which will be subject to performance assessment.

Preliminary Staff View

31. For the reasons stated in paragraph 26 through 30, the preliminary view of the staff is that that the notionals of the asset profile and the target profile should be aligned. However, the tenors of the asset profile and target profile do not require alignment.

Question for the Board

Question for the Board
2) Does the Board agree with the preliminary staff view that the notionals of the asset profile and the target profile should be aligned but not the tenors?

Time Horizon of the Target Profile

32. 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. As discussed in paragraphs 27 through 29, while the target profile should consider future transactions, if neither the future financial asset nor the future financial liability have been priced, then there is no need to consider them within the DRM accounting model. This is because a change in interest rates will have the same impact on interest income attributable to future financial assets as it will on interest expense attributable to future financial liabilities. If a change in interest rates will have no impact on the net of interest income and expense, there is no need for the use of derivatives or management. Irrespective of the tenor of the asset profile, the period over which management stabilises the net of interest income and expense is the tenor of the target profile.

33. The above is demonstrated by examining when the target profile reflects:

    (a) interest bearing financial liabilities; and

    (b) core deposits.

Interest bearing financial liabilities

34. Consider an entity that has raised 10-year fixed rate financial liabilities and wants to stabilise the net of interest income and expense over the next 10 years. In this example, the entity would need 10-year fixed rate financial assets to accomplish the goal and, therefore, this entity's target profile is a 10-year fixed rate profile. This could also be accomplished by using derivatives to transform financial assets such that the resulting combination is equal to a 10-year fixed rate profile. Regardless of the manner in which the entity achieves the target profile, the entity would recognise stable interest income and interest expense for a period of 10 years. At the end of 10 years, the target profile would mature and terminate. This would be accompanied by the maturity of designated financial assets and any designated derivatives.

35. Assuming the entity is a going concern, at the end of 10 years, the entity will re-invest the proceeds from the maturing financial assets. Given the requirement to repay the maturing financial liabilities, the entity will need new funding. Assuming the entity expected to re-finance the financial liabilities by issuing new 10-year fixed rate financial liabilities, the question arises if the tenor of the target profile is 10 or 20 years. At T^0, the entity knows interest expense between T^{11} and T^{20} will reflect the 10-year market interest rate at T^{11} because that is when it will re-finance the existing financial liabilities. The entity also knows that interest income for the same period will reflect market interest rates at T^{11} because that is when the asset profile matures. Therefore, at T^0 , it is known that both interest expense and interest income between T^{11} and T^{20} will reflect market interest rates as at T^{11}. As such, the entity's only required action to achieve the risk management strategy for periods T^{11} through T^{20} (ie stabilise the net of interest income and expense) is to wait until T^{11}. After 10 years have passed, the price will be established for both the newly issued financial liability and the newly originated financial assets, and any necessary derivatives for asset transformation will be executed at that time. The pricing of these three items will determine interest income and interest expense for the next 10 years.

36. On the other hand, assume the entity defined the tenor of the target profile as 20 years at T^0. To stabilise the net of interest income and interest expense between periods T^{11} and T^{20}, given the financial assets and liabilities in existence within the DRM accounting model at that time, it would execute a 10-year forward 10-year receive fix swap, fixing interest income. It would also execute a 10-year forward 10-year pay fix swap fixing interest expense. These two derivatives are perfectly inverse of each other and as such there is no difference in the cash flow pattern whether they are executed or not. As a result, while the entity could define the tenor of the target profile as 20 years, there is no economic or practical benefit in defining the tenor of the target profile longer than the period over which the entity manages (ie the tenor of the liability profile).

37. However, if the tenor of the asset profile is shorter or longer than the tenor of the target profile, the tenor of the target profile remains the period over which the net of interest income and expense is managed. Altering the above scenario, assume the entity's asset profile is entirely comprised of 20-year floating rate financial assets. The entity defines the target profile as a 10-year fixed rate profile reflecting both its financial liabilities and a risk management strategy to stabilise the net of interest income and expense. In this case, the entity executes the necessary 10-year receive fix swap to align the asset profile with the target profile. Interest income and interest expense are stabilised until T^{10} and the entity has achieved alignment.

38. After 10 years have passed, the entity must re-finance the financial liabilities given the asset profile is a contractual 20-year profile. Therefore, at T^0 , it is known that interest expense for periods T^{11} through T^{20} will reflect market rates. Furthermore, it is also known that interest income will reflect market rates for the same period as the asset profile is a 20-year floating rate profile and all derivatives mature at the end of T^{10}. As such, changes in interest income and interest expense between T^{11} and T^{20} will offset as both will reflect market prices. Given a change in interest rates will have no impact on the net of interest income and expense, the entity has already achieved alignment and no active management is required. Therefore, the existence of the 20-year asset profile does not alter the conclusion that the period of time over which the net of interest income and expense are managed is the tenor of the target profile.

Core Deposits

39. When the target profile is composed of core deposits, although they are perpetual in nature and different from other forms of financial liabilities, the tenor of the target profile is established by risk management as discussed in paragraphs 18 and 19. Consequently, while the tenor of core deposits is defined by the entity, the tenor remains the period over which the net of interest income and expense are managed. Therefore, the concepts discussed in paragraphs 34 through 38 are equally applicable.

Preliminary Staff View

40. For the reasons discussed in paragraph 32 through 39, the preliminary view of the staff is 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 if they consider the contractual tenor of financial liabilities or they the risk management strategy applied to core deposits. The time horizon of the target profile will be important when the staff discuss performance, as it defines the period of time over which the entity's ability to manage will be assessed.

Question for the Board

Question for the Board
3) Does the Board agree with the preliminary staff view that the time horizon of the target profile is the period of time over which the entity is managing the net of interest income and expense?

Laddering strategies and other matters

41. As noted in paragraphs 4 and 5, while matching re-pricing dates of financial assets and financial liabilities is a common approach used to stabilise the net of interest income and expense, core demand deposits raise other complexities as they represent perpetual funding. In this context, laddering strategies are commonly applied to manage the effect of changes in interest rates over time when financial assets are funded by core deposits.

42. As argued previously in this paper, if both financial assets and financial liabilities re-price simultaneously, then there is no risk to manage (see scenario D). However, with core deposits even though they are bucketed into specified time periods based on the entity's risk management, they never re-price as they represent perpetual fixed rate financial liabilities. So, in scenario D, there will be no change in interest expense after 5 years have passed. The fact that 100% of the transformed financial assets will re-price after 5 years means the net of interest

income and interest expense could experience a significant change depending on the interest rate environment at the end of year 5. The potential for significant change is colloquially referred to as a ‘cliff effect’.

43. In order to avoid the cliff effect, an entity can define the target profile as a ladder. A ladder is a portfolio of financial assets where each financial asset has a different maturity date. Ideally, the maturity dates of the financial assets are evenly spaced over time (months or years) so that the maturing financial assets are re-invested at regular intervals. A ladder distributes the percentage of financial assets maturing over multiple periods, thereby reducing the impact changes in interest rates can have on the portfolio in any single period. This reduces the potential for cliff effects. While the DRM accounting model will not mandate the use of ladders in the target profile, laddering strategies are common.

44. For example, assume an entity’s financial liabilities are entirely comprised of core deposits and their risk management strategy is to stabilise by having a 5-year evenly distributed ladder. Therefore, the target profile is defined as a 5-year evenly distributed ladder of fixed rate financial assets. For illustrative purposes, assume the asset profile is comprised of five CU 200 fixed-rate financial assets, and the entity was able to originate these financial assets such that the asset profile perfectly aligns with the target profile. Specifically, the entity has a CU 200 1-year fixed rate financial asset representing the first step of the ladder, a CU 200 2-year fixed rate financial asset representing the second step of the ladder, and so on until the fifth step. Each financial asset was originated at T^0 thus the 1-year financial asset reflects the one year fixed rate at T^0 whereas the 2-year financial asset reflects the two year fixed rate at T^0, and so on. This fact pattern is summarised in the table below.

Table 5

Asset profile	Year 1	Year 2	Year 3	Year 4	Year 5
CU 200 1-year loan	5.00				
CU 200 2-year loan	5.50	5.50			
CU 200 3-year loan	6.00	6.00	6.00		
CU 200 4-year loan	6.50	6.50	6.50	6.50	
CU 200 5-year loan	7.00	7.00	7.00	7.00	7.00
new CU 200 5-year loan		2.50	2.50	2.50	2.50
new CU 200 5-year loan			4.75	4.75	4.75
new CU 200 5-year loan				7.00	7.00
new CU 200 5-year loan					4.00
Asset profile interest rate(*)	**6.00**	**5.50**	**5.35**	**5.55**	**5.05**
changes		*-0.50*	*-0.15*	*0.20*	*0.50*
1-year market rate	**5.00**	**0.50**	**2.75**	**5.00**	**2.00**
changes		*-4.50*	*2.25*	*2.25*	*-3.00*

(*) Calculated as the average interest rate of the financial assets within the asset profile since these financial assets have the same notional amount.

45. The interest rates in the above table are used for illustrative purposes only. As time passes and the first financial asset matures, the available proceeds are re-invested and a new 5-year financial asset is originated at the then current market rate. This is added to the ladder as step 6, while step 1 is removed. Specifically, at the end of year 1, as the CU 200 1-year financial asset matures which bore a 5.00% fixed rate of interest, a new CU 200 5-year fixed rate financial asset is originated bearing a fixed 5-year market interest rate of 2.50%. This same re-investment process is repeated as time passes so that the impact of changes in interest rates is distributed over time rather than having the entire portfolio face the potential for a cliff effect in one period. To illustrate the benefits of such an approach, the table highlights the changes in the average interest rate over time for the asset profile. It also highlights what would have occurred if the entity had executed a different strategy (ie defining the target profile entirely as a 1-year profile). The difference in how interest income changes each period is significant.

46. For simplicity, the above example assumed the asset profile reflects an ideal composition of fixed-rate financial assets (ie all fixed rate and equally distributed into specified time buckets that are perfectly aligned with the target profile). However, in practice, as management cannot force customers to originate financial assets that themselves perfectly reflect an evenly distributed ladder, derivatives are used to transform portfolios of financial assets.

47. To demonstrate how a target profile is determined when a ladder is created and maintained through the use of derivatives, assume an asset profile comprised of CU 1,000 5-year floating rate financial assets and the asset profile is entirely funded by core demand deposits. In this scenario, the entity's risk management strategy is a 5-year ladder. This fact patter is summarised in the following table.

Table 6

Scenario E	**Time buckets**				
	Y 1	Y 2	Y 3	Y 4	Y 5
Asset profile: 100% floating rate					1,000
Financial liabilities: 100% fixed rate (core deposits)	(200)	(200)	(200)	(200)	(200)
Risk management strategy: Stabilise the net of interest income and expense using a 5-year ladder					

48. In this fact pattern, management's re-pricing objective is to achieve a 5-year ladder. Therefore, the target profile is 20% 1-year fixed rate profile, 20% 2-year fixed rate profile and so on until the fifth year. This also implies the need for derivatives to change the re-pricing of the CU 1,000 5-year floating rate financial assets.

Tolerance for variations in the target profile

49. It is also important to note that when entities align the asset profile and the target profile using derivatives, entities often tolerate some variation between the combination of their asset profile and derivatives versus the target profile. Defined tolerances for variation are a common practice and exist for various reasons, for

example cost considerations, availability of small notional derivatives to mention but a few. To elaborate, assume the same fact pattern from paragraphs 46 and 47 where the risk management strategy is to achieve a 5-year evenly distributed ladder and derivatives are required to transform the re-pricing profile of financial assets within the asset profile. In this scenario, considering derivative contracts have standard sizes and maturity dates, the entity might tolerate some deviation in relation to the transformation of financial assets required by the target profile. More specifically, if the comparison of the target profile and the asset profile indicated a CU 200.10 derivative is required, the entity might execute a CU 200 derivative given standard market conventions. This would imply the entity has not perfectly aligned with the target profile but management is content the strategy has been achieved to the best extent possible. This means the entity has achieved a profile where 19.9% is allocated to a specific time bucket rather than 20%. This would also mean that the entity has another time bucket where 20.1% has been allocated rather than 20%. The staff intend to discuss how tolerance thresholds, such as described above, will be reflected in the DRM accounting model during the discussions on performance. More specifically when the staff discuss what should be the information content from perfect and imperfect alignment.

Other matters

50. The staff acknowledge that in some circumstances an entity can have more than one target profile. While dynamic risk management is conducted on an aggregated basis, there are instances where the risk management policies and procedures of an entity dictates separation (for example, due to a lack of homogeneity between certain products or the availability of suitable derivatives). Also, an entity operating in multiple jurisdictions could elect or be required to segregate profiles due to differing currencies, different loan features, or different regulatory regimes.[5] As such, an entity could have multiple target profiles within the DRM accounting model. However, the number of target profiles must be consistent with the entity's risk management policies and procedures and there should be an equal number of asset profiles as there are target profiles. At a future Board meeting, the

[5] It is somewhat common for regulators to mandate isolated risk positions.

staff will consider whether performance assessment should be conducted at the profile level.

51. While the target profile will change as a result of the dynamic nature of portfolios, changes in the target profile resulting from a change strategy should be rare. The staff acknowledge these changes can occur from time to time in response to a change in the regulatory environment or a structural change in the interest rate environment. However, the staff are of the view that a target profile should not change to achieve a specific accounting outcome that is inconsistent with the purpose of the DRM accounting model. Assuming the target profile changes for reasons inconsistent with the purpose of the DRM accounting model, consideration should be given to discontinuing the use of the model. Target profiles that are inconsistent with the purpose of the DRM accounting model will be discussed at a future Board meeting.

Topics to be discussed at future meetings

52. The staff expect to bring at the next Board meeting some specific topics concerning the target profile. In particular, the staff expect to discuss the qualifying criteria applicable to the target profile. Also, the staff expect to discuss how asset profile and target profile will interact specifically focussing on the dynamic nature of portfolios. Subsequently, the staff expect to discuss derivative instruments.

53. Once the staff have completed the discussion on these three core areas (asset profile, target profile and derivatives) this staff intend to begin discussions on performance.