STAFF PAPER

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Project	**Dynamic Risk Management**		
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Introduction

1. The purpose of this paper is to discuss how an entity applying the DRM accounting model should treat a change in its risk management strategy. More specifically, this paper discusses how a change in risk management strategy will impact the statement of profit or loss and the amount recorded in Other Comprehensive Income. This paper focuses on changes in risk management strategy that require a change in the entity's target profile.

2. This paper is structured as follows:

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

   (b) Background (paragraph 4–6); and

   (c) Change in risk management strategy (paragraph 7–28).

Summary of staff recommendations

3. In this paper the staff recommend that, when a change in risk management strategy requires a change in the entity's target profile, the accumulated amount in Other Comprehensive Income should be reclassified to profit or loss over the life of the target profile as defined prior to the change in risk management strategy.

Background

4. During the June 2018 Board meeting, the Board tentatively decided that to provide a faithful representation in the statement of profit or loss of an entity's DRM activities, the results reported should reflect the target profile when perfect alignment has been achieved. 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 model provides a faithful representation of performance in the statement of profit or loss.

5. Also during the June 2018 Board meeting, the staff indicated it would further consider how the DRM accounting model should reflect specific events that will arise over time, such as changes in the risk management strategy. While an entity can change its risk management strategy for various valid reasons, the staff expect such changes to occur infrequently. If these changes occur frequently, this lessens the usefulness of information provided by the DRM accounting model and, therefore, consideration should be given as to whether management should discontinue the use of the DRM model.

6. In the following paragraphs, the staff consider the impact of a change in the risk management strategy that require a change in the entity's target profile. More specifically, the staff consider three possible approaches for reflecting such an event in financial reporting in the context of the DRM accounting model.

Change in risk management strategy

7. For the purpose of the DRM accounting model, a change in risk management strategy is when management makes a decision that requires a change in the entity's target profile. An example of a change in strategy that requires a change in the entity's target profile would be a modification in the time horizon of risk management (ie moving from stabilising over a 3-year to a 5 year period) or say altering the strategy from managing the net of interest income and expense on an undiscounted basis to a present value basis. It is important to note that entities change their risk management strategy for valid reasons. For example, a change in

risk management strategy could occur in response to changes in the economic environment, such as a structural change in the interest rate environment.

8. The staff would highlight that a change in inputs is not a change in risk management strategy. For the purpose of the DRM model, changes in inputs are updates to the asset profile and target profile arising from originations or maturities of financial assets and liabilities as well as any updates to the designated derivatives for the purposes of maintaining alignment. In addition, when an entity decides to alter the scope of the DRM accounting model (for example, an entity that decides to de-designate items from the asset profile, in totality or partially), this should be treated as a termination (or a partial termination) of the DRM model and thus the termination requirements as tentatively agreed by the Board in June 2018 would apply.[1] Furthermore a change in assumption, such as a change in prepayment speeds, is not a change in strategy. A change in prepayment speeds impacts the asset profile but does not impact the target profile.

9. After a change in the risk management strategy, the question that arises is how the DRM accounting model should reflect the new strategy. More specifically, the key question is whether a change in risk management strategy should be treated as a termination event or a continuation of the DRM accounting model. This decision will have impact on the statement of profit or loss, since this will affect the reclassification pattern of the accumulated amount recorded in Other Comprehensive Income related to the previous risk management strategy.

10. To illustrate, consider an entity that 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 3.00% 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 designates the portfolio of financial liabilities used to determine the target profile. As the entity's risk management strategy is to

[1] As noted in paragraphs 78–81 of the June 2018 Agenda Paper 4C *Financial Performance*, 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 recorded in Other Comprehensive should be reclassified over the life of the target profile such that the results reported reflect the target profile.

stabilise the net of interest income and expense over a period of 3 years on an undiscounted basis, the target profile is a 3-year fixed rate target profile which is the period over which the entity is managing interest rate risk. The entity executes the necessary derivative to achieve perfect alignment which is a CU 1,000 3-year receive fix 3.00%, pay float interest rate swap and successfully transforming the 3-year floating rate financial assets into 3-year fixed rate financial assets.

11. However, at the end of 20X1, due to a significant decrease in market interest rates, the entity decides, after following a previously documented approval process, to change the risk management strategy to stabilise the net of interest income and expense until the end of 20X2 rather than the end of 20X3 and accept whatever volatility may arise in 20X3 from a change in market interest rates. This means that, as at the end of 20X1, the target profile is no longer a 2-year fixed rate target profile, Instead, the target profile is a 1-year fixed rate target profile followed by a 1-year floating rate target profile as illustrated in the chart below:

Chart 1

Year	**Old target profile**	**New target profile**
20X1	1,000 20X3 fixed	
20X2	1,000 20X3 fixed	1,000 20X2 fixed
20X3	1,000 20X3 fixed	1,000 20X3 float
Total	**1,000**	**1,000**

12. As the benchmark derivative is the derivative(s) required to achieve perfect alignment, the benchmark derivative will have to change in response to the new risk management strategy. As at the end of 20X1, ie the time when the risk management strategy changed, assuming that the entity wants to continue the DRM model, the benchmark derivative becomes a 1-year receive fix pay floating interest rate swap instead of the existing 2-year receive fix pay floating interest rate swap (note that the remaining life of the existing swap is 2 years because 1 year has already passed).

13. In order to maintain perfect alignment, the entity will need to complete the following mitigating actions: i) cancel the 3-year receive fix, pay floating interest

rate swap designated at the beginning of 20X1; and ii) execute a new 1-year receive fix 1.50%, pay floating interest rate swap to achieve alignment. For simplicity, this example assumes the entity enters into an offsetting 2-year pay fix 2.00%, receive floating interest rate swap that effectively cancels the first designated derivative that has 2 years of contractual life remaining.[2] For illustrative purposes, it is assumed that, at the end of 20X1 (the date of the change in risk management strategy) the accumulated changes in fair value recorded in Other Comprehensive Income was CU 19.

14. The question that follows is how the accumulated amount in Other Comprehensive Income should be reclassified to the statement of profit or loss after the change in risk management strategy. The staff considered three possible approaches to address this matter:

(a) Alternative 1: Reclassify accumulated Other Comprehensive Income immediately;

(b) Alternative 2: Amend the reclassification pattern to align with the revised target profile; and

(c) Alternative 3: Maintain the previous reclassification pattern.

Alternative 1 – Reclassify accumulated Other Comprehensive Income immediately

15. A method to treat changes in risk management strategy would be to stop reflecting the old strategy in financial reporting as soon as the decision to change the strategy is made. This would require immediate reclassification of the entire amount recorded in Other Comprehensive Income to the statement of profit or loss when the change in risk management strategy occurs. In addition, the derivatives no longer required for aligning the asset profile with the new target profile should be de-designated from the DRM accounting model as they are no longer used for the purposes of risk management. In applying this approach to the example illustrated in paragraphs 10–13, the entity would reclassify the CU 19 recorded in Other Comprehensive Income at the beginning of 20X2.

[2] Interest rates for a 1-year swap and a 2-year swap are likely to differ because they have different contractual maturity dates. The market rates used in this paper are for illustrative purposes only.

16. The staff would not recommend this approach because the entity has been successful in aligning the asset profile with the target profile prior to changing its risk management strategy. In addition, at the termination date, the cash flows from the designated assets and liabilities still exist and future transactions are still expected to occur. At its June 2018 Board meeting, the Board tentatively decided that, at termination, if the cash flows arising from the designated assets and liabilities still exist and future transactions are still expected to occur, the amount recorded in Other Comprehensive should be reclassified over the life of the target profile such that the results reported reflect the target profile. Consequently, immediately reclassifying the accumulated amount in Other Comprehensive Income would be inconsistent with the principles discussed during the June 2018 Board meeting.

17. Furthermore, the staff would highlight that, requiring the entity to reclassify the amount deferred in Other Comprehensive Income immediately could lead to entities changing their risk management strategy at their discretion to achieve a specific accounting outcome that is inconsistent with the purpose of the DRM accounting model.

18. Finally, the staff would highlight that the proposed treatment is inconsistent with the cash flow hedge accounting requirements in paragraphs 6.5.11(d)(ii) and 6.5.12(a) of IFRS 9 that state reclassification should occur in the same period or periods during which the hedged expected future cash flows affect profit loss, if those hedged cash flows are still expected to occur.

19. For these reasons, the staff do not support this approach.

Alternative 2 – Amend the reclassification pattern to align with the revised target profile

20. Another method to treat changes in risk management strategy would be to amend the reclassification pattern of the amount accumulated in Other Comprehensive Income arising from the old derivatives that were successful in aligning the asset and target profiles such that reclassification occurs over the life of the new target profile and apply the performance requirements of the DRM accounting model to the newly designated derivatives. In applying this approach to the example illustrated in paragraphs 10–13, the entity would reclassify the CU 19 recorded in

Other Comprehensive Income until the end of 20X3 as that is the remaining time horizon of the new target profile.

21. This would avoid the concerns note in paragraph 17 of immediately reflecting any amounts accumulated in Other Comprehensive Income to the statement of profit or loss and thus the potential for abuse of the DRM accounting model to achieve a specific accounting outcome. In addition, as the asset profile remains unchanged and is still designated within the DRM accounting model (ie future cash flows arising from the asset profile are still expected to occur), this would maintain consistency with paragraphs 6.5.11(d)(ii) and 6.5.12(a) of IFRS 9 that state reclassification should occur in the same period of periods during which the hedged expected future cash flows affect profit loss, if those hedged cash flows are still expected to occur.

22. However, the staff would highlight that this approach appears reasonable because the time horizon of the target profile has not changed in the example provided. The time horizon of the target profile is 3 years both prior and after the change in the entity's risk management strategy. If the target profile changed from a 3-year profile to a 5-year profile, then reclassifying 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. For example, rather than reclassifying CU 19 over the period of 3 years, the entity would reclassify the same amount over a period of 5 years. This would be inconsistent with the principle tentatively agreed during the June 2018 Board meeting as described in paragraph 16.

23. Furthermore, because a change in risk management strategy could result in a modification in the reclassification pattern, the staff believe there would be a potential for entities changing their risk management strategy to achieve a specific accounting outcome that is inconsistent with the purpose of the DRM accounting model. For example, the DRM model would not preclude entities from changing its risk management strategy with the sole purpose of modifying the period over which the accumulated amount in Other Comprehensive Income is reclassified to the statement of profit or loss.

24. For these reasons, the staff do not support this approach.

Alternative 3 – Maintain the previous reclassification pattern

25. Alternative 3 considers reclassification of the amount accumulated in Other Comprehensive Income over the life of the previous target profile, and not the new target profile. More specifically, using the example discussed in paragraphs 10–13, rather than reclassifying the amount of CU 19 attributable to Swap 1 (see Chart 2 above) over the life of the amended target profile, reclassification would occur over the life of the target profile as defined prior to the change in risk management strategy (ie the end of 20X3).

26. Under this approach, a change in risk management strategy would effectively be treated as a termination event. This is because Alternative 3 maintains the previous reclassification pattern for the amounts recorded in Other Comprehensive Income before a change in risk management strategy takes place, which is consistent with the termination requirements as tentatively agreed by the Board at its June 2018 meeting[3] (ie reclassification of the amount recorded in Other Comprehensive Income over the life of the target profile as defined prior to the termination event).

27. Finally, the staff believe that Alternative 3 would address the concerns raised in paragraph 17 regarding the potential for entities changing their risk management strategy to achieve a specific accounting outcome that is inconsistent with the purpose of the DRM accounting model. This is because a change in risk management strategy would not modify the reclassification pattern defined by the previous target profile.

Preliminary Staff View

28. For the reasons stated in paragraphs 25–27, the staff is of the preliminary view that when a change in risk management strategy requires a change in the entity's target profile, the information provided in the statement of profit or loss should be as described in Alternative 3 (ie the accumulated amount in Other Comprehensive Income should be reclassified to profit or loss over the life of the target profile as defined prior to the change in risk management strategy). This approach precludes entities from changing its risk management strategy to achieve a specific

[3] For further information, refer to the June 2018 Agenda Paper 4C *Financial Performance*.

accounting outcome that is inconsistent with the purpose of the DRM accounting model and is consistent with the performance principles and termination guidance tentatively agreed during the June 2018 Board meeting.

Question for the Board

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1) Does the Board agree with the staff preliminary view in paragraph 28 that changes in the risk management strategy that requires a change in the entity's target profile should be accounted for as described in Alternative 3 (ie the accumulated amount in Other Comprehensive Income should be reclassified to profit or loss over the life of the target profile as defined prior to the change in risk management strategy)?