IFRS® Foundation

Dynamic Risk Management

October 2019 ASAF meeting

Agenda paper 2

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Objective

The objective of this meeting is to provide an update on the *Dynamic Risk Management* (DRM) project and request input from the ASAF members on potential ways forward with regards to outreach on the core version of the DRM model.

This presentation is structured as follows:

a) Background

b) Objective and outline of the model

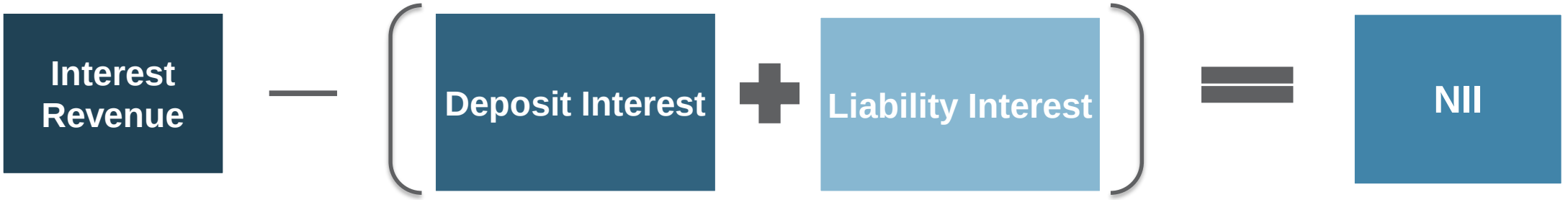
c) Model overview

d) Next steps and input request to the ASAF

Background

Business Activity of Financial Institutions

The difference between **interest revenue** and **interest expense** represent **net interest income (NII)**.



Dynamic Risk Management is the process that involves understanding and managing how and when a change in interest rates can impact NII. As NII is the net of interest revenue and interest expense, a change in interest rates that has an equal impact on both would not impact NII.

Consequently, one of the best ways to prevent NII from changing due to a change in interest rates is to "match" assets and liabilities, a common approach used by financial institutions.

Transformation

- IAS 39 and IFRS 9 require hedges to either be a fair value hedge or a cash flow hedge

Fair Value Hedge

A hedge of the exposure to changes in fair value.

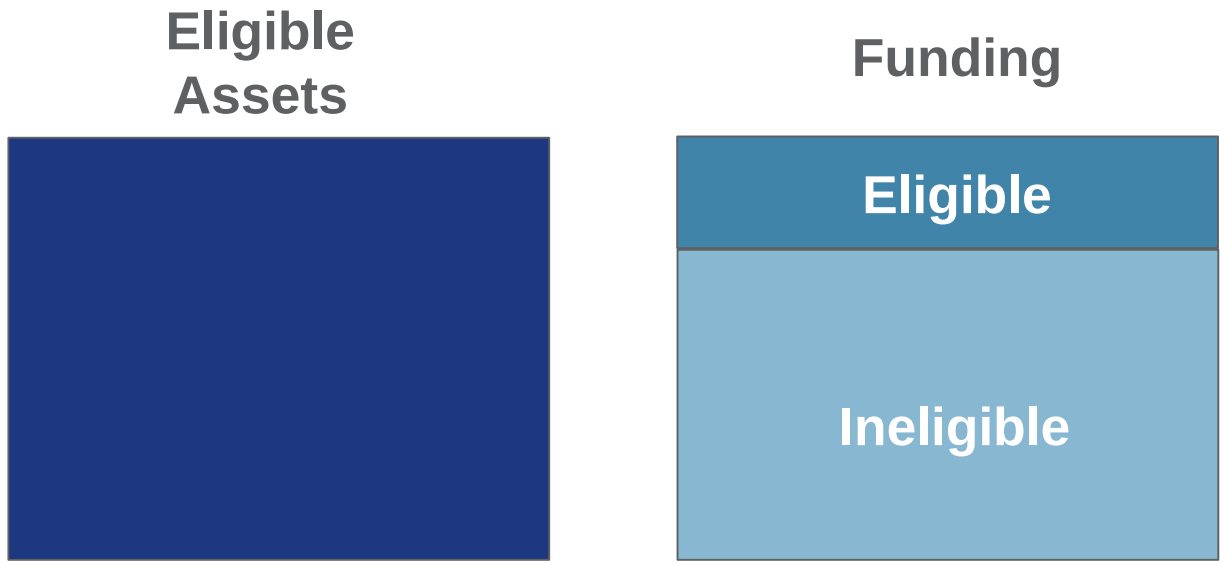
Cash Flow Hedge

A hedge of the exposure to variability in cash flows.

- While the DRM accounting model uses Other Comprehensive Income and reclassification, it is neither a cash flow hedge nor is it a fair value hedge model
- The proposed model creates a new type of relationship focused on “transformation” whereby derivatives are used to alter a financial asset such that it meets the entity’s interest rate risk management objective

Transformation and capacity

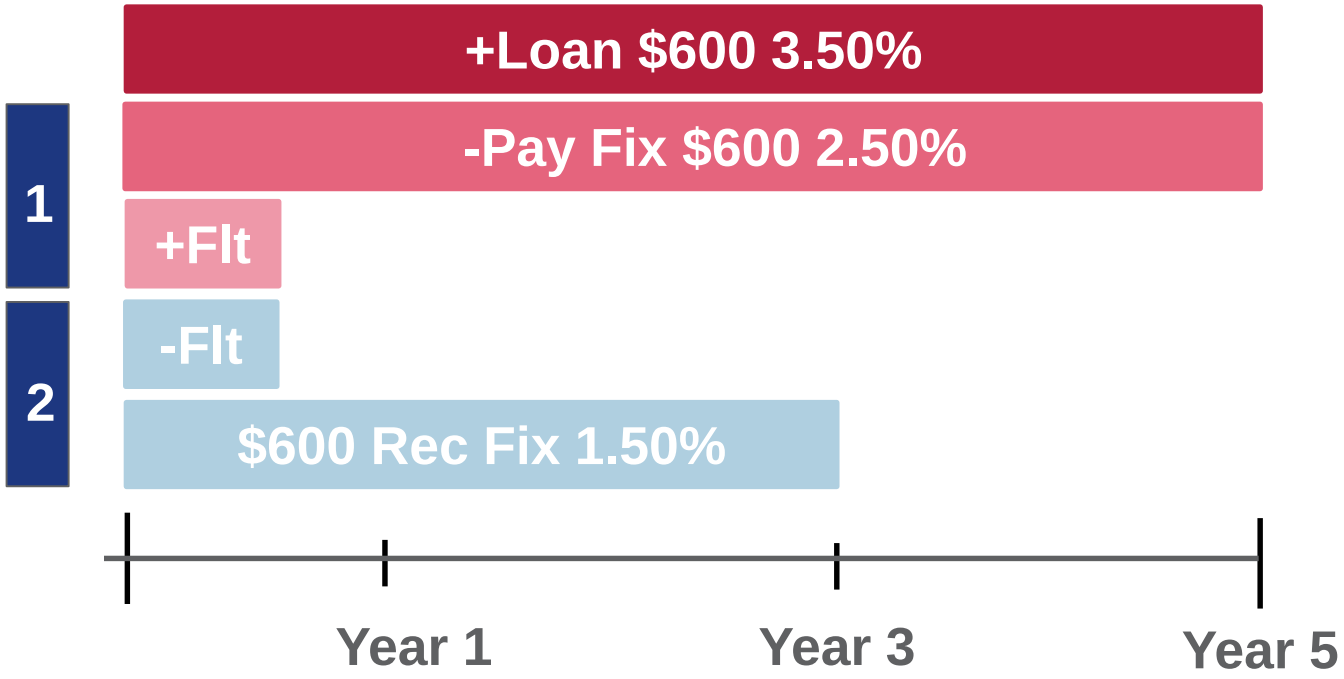
The intersection of risk management and the existing hedge accounting requirements creates the "**capacity issue**" where certain items are ineligible for hedge accounting even though they are considered from a risk management perspective. The best example is **core demand deposits**.



Transformation activities allow entities to alter financial assets such that they meet the risk management objective (ie, the altered assets match the liabilities).

Transformation—Example

An entity wants to transform a 5-year fixed rate financial asset such that it will re-price at the end of year 3, rather than the end of year 5. It can do so by using two interest rate swaps:



1 The five year pay fix, receive float interest rate swap "transforms" the loan from a fixed rate loan to a floating rate loan;

2 The three year receive fix, pay float interest rate swap transforms the combination to a 3-year fixed rate loan.

Transformation is important because matching assets and liabilities does not necessarily align with the fair value or cash flow hedge models.

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Why is the project important?

Under the current hedge accounting requirements it is often difficult to accommodate open portfolios, because the **current requirements usually require a one-to-one designation** between the hedged item and the hedging instrument. In effect, open portfolio scenarios are forced into closed portfolio scenarios for hedge accounting purposes.

In addition, there are restrictions imposed by the current hedge accounting requirements regarding what are eligible hedged items, the most important example being **core demand deposits**.

These constraints increase complexity and make it difficult to faithfully reflect dynamic risk management in the financial statements. Entities frequently revert to alternative reporting methods to communicate with users of their financial statements.

Objective and outline of the model

Objective of the model

To **improve** the usefulness of **information** provided about interest rate risk management and how it affects a financial institution's **current and future economic resources**.

Outline of the model

When derivatives (A) are successful in aligning the asset profile (B) with the target profile (C), changes in fair value of such derivatives are deferred in OCI and reclassified to the statement of profit or loss.

Assuming perfect alignment, the results reported in the statement of profit or loss should reflect the entity's target profile.

Asset Profile

Before transformation can begin, someone (ie, the entity) must know what it wants to transform.

The model calls the **financial assets subject to transformation** the "**Asset Profile**"

What is the asset profile?	The asset profile allocates designated financial assets into time buckets based on their re-pricing date
Board Tentative Decisions	Formal designation and documentation required Financial assets must be measured at amortised cost Future transactions must be highly probable

Target Profile

Similar to the asset profile, before transformation can begin, the entity must know what it wants to accomplish through transformation.

The model calls the **transformation objective** the "**Target Profile**"

How is the target profile determined?

The target profile must be based on the entity's risk management strategy which in turn is influenced by:

i. The contractual tenor of financial liabilities; and

ii. The entity's core deposits.

Target Profile—Example

Risk Management Strategy	Financial Liabilities	Deposit Approach
• Match assets and liabilities to stabilise net interest income	• CU 500 3-year fixed financial liabilities • CU 500 core demand deposits	• Treat the core demand deposit as 3-year fixed rate financial liabilities

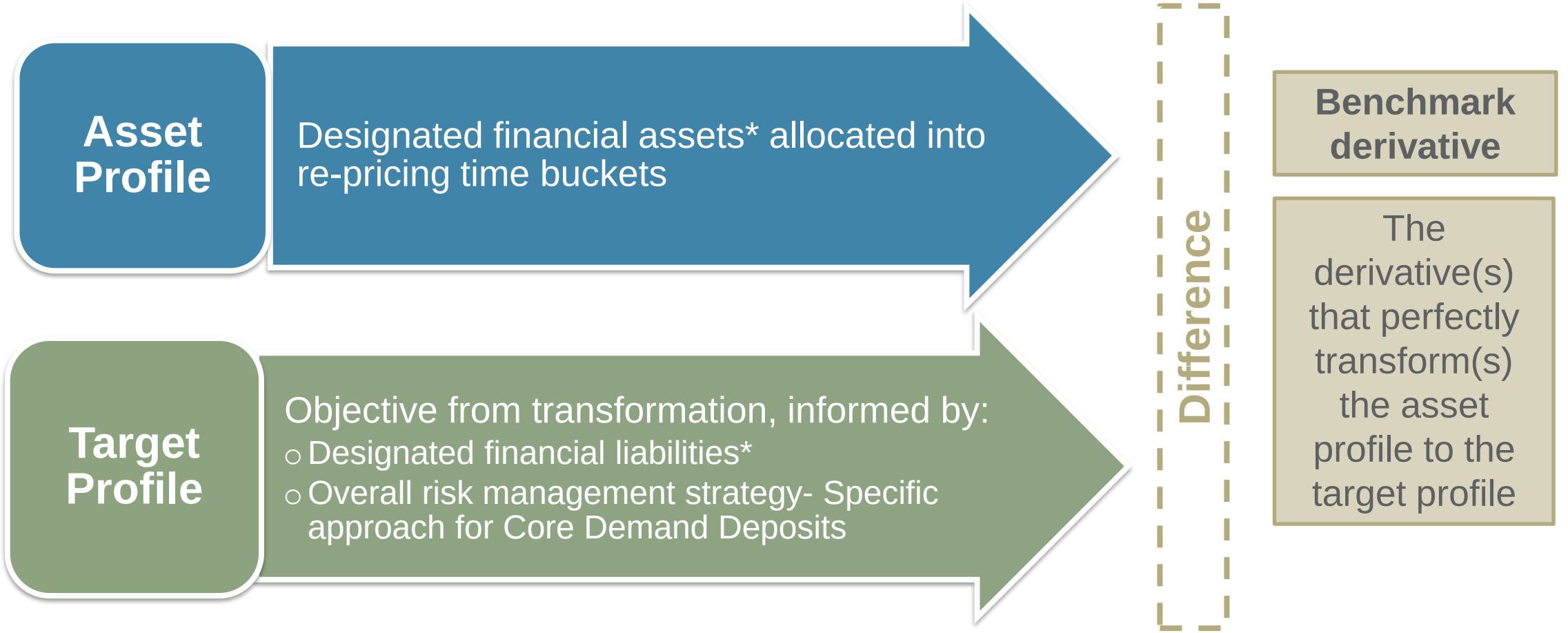
In this example, the target profile is a 3 year fixed rate profile because:

- The entity's strategy is to match assets and liabilities to stabilise net interest income over a 3-year period; and
- The entity's financial liabilities are 3-year fixed rate considering the entity's approach to core deposits.

The combination of assets and derivatives required to accomplish the entity's objective creates a 3-year fixed rate financial asset.

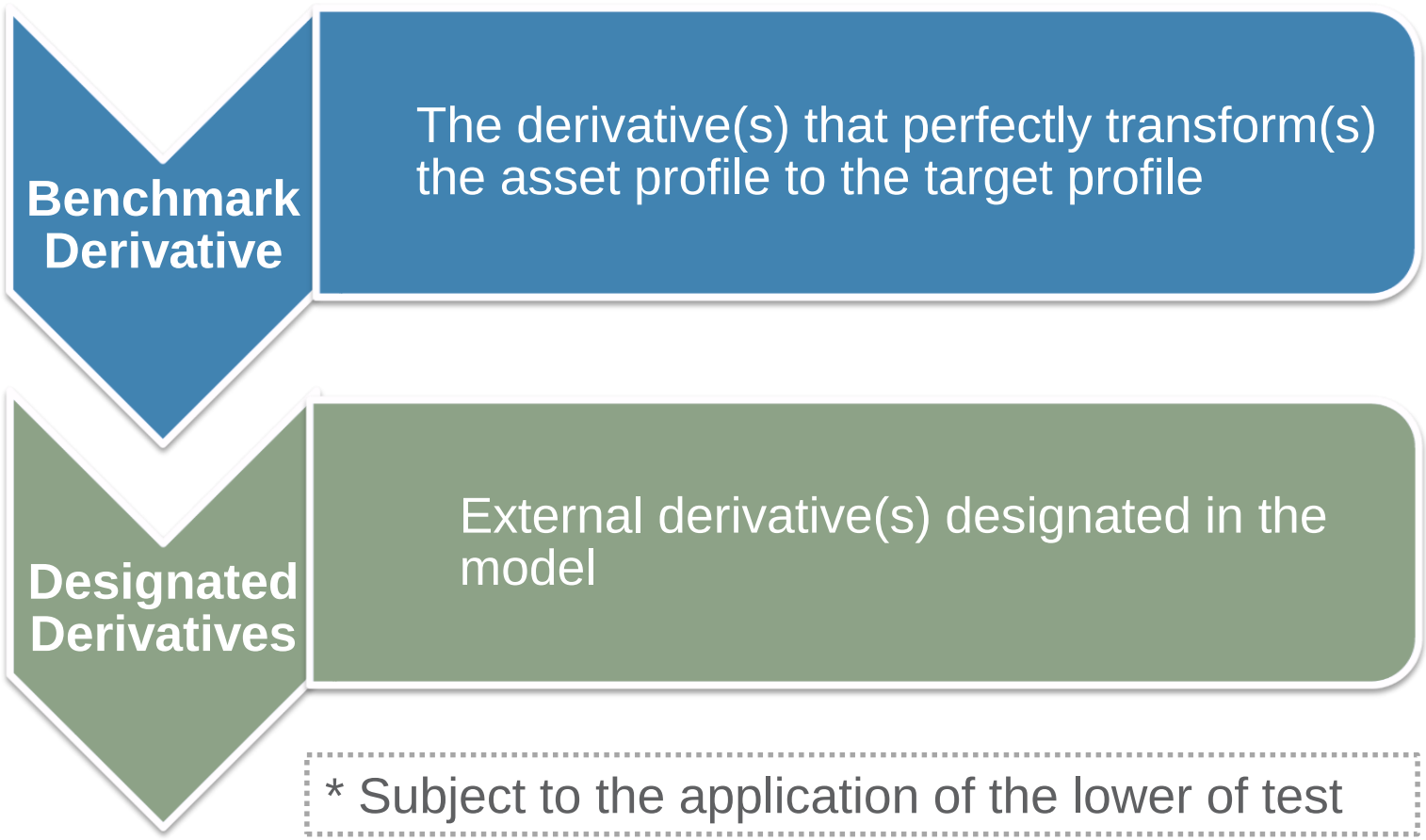
Model overview

DRM Model—Overview



* Subject to qualifying criteria

DRM Model—Overview (cont)



Comparison

Financial Performance

Aligned portion of designated derivative(s) presented in OCI and then re-classified to the P&L over the life of the target profile.

Mis-alignment presented in P&L*

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DRM Model—Example

Asset Profile

CU 1000 5YR Fixed Rate Financial Assets

Target Profile

CU 1000 3YR Fixed Rate – because:

- Entity has 3YR fixed rate funding
- Risk Management Strategy is to match assets and liabilities

Subject to qualifying criteria and the existence of an economic relationship

Difference

Benchmark derivatives

CU1000 5YR Pay Fix, Receive Floating Interest Rate Swap

&

CU1000 3YR Rec Fix, pay floating interest rate swap

Next steps and input request to the ASAF

DRM Model—Next Steps

Next Steps

- Q4 2019 – Commence outreach on core model

Outreach

- At this stage, the Board has tentatively decided not to issue a formal due process document
- The Board will consider the nature and format of outreach in the coming months
- Based on feedback received, the Board will determine next steps

Input request to the ASAF

- Do ASAF members have any views or recommendations on the nature and format of the outreach that could assist the Board in developing its outreach plan?