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Project	**Dynamic Risk Management (DRM)**	
Paper topic	Executive summary of feedback from outreach	
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1. Introduction

1. We received a large volume of feedback from participants in the outreach. To facilitate our analysis and reporting, we grouped the feedback based on the element of the DRM model to which it relates. However, because the elements of the DRM model are interrelated and interdependent, some feedback might be reported in more than one paper.

2. This paper provides an executive summary of the feedback. Other agenda papers for this meeting (4C–4E) include more detailed feedback on individual elements of the DRM model which were identified as key areas that might need further consideration to meet the Board's objective of better reflecting an entity's risk management strategy.

3. We are not asking the Board to make decisions at this meeting. However, we welcome any views or questions Board members may have on the feedback, as this will help us to formulate a plan for the next steps in the project.

2. Key messages in this paper

4. In principle, almost all participants supported the objective of the DRM model to better reflect interest rate risk management strategy and activities (risk management view or dynamic risk management) in the financial statements. However, many

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commented that an equally important objective for the DRM model must be resolving the accounting mismatch arising from the execution of risk management strategy. See paragraphs 12–19 for further feedback on this topic.

5. In addition, participants expressed the following views on the DRM model:

   (a) almost all participants said that their risk management strategy defines the target profile on a risk limits basis. This is different from the DRM model which requires the target profile to be defined on a single outcome basis. These participants said that the incorporation of risk limits into the DRM model is key to achieve the objective for better reflection of the risk management view (see paragraph 30).

   (b) most participants also highlighted their concerns about elements of the DRM model that either do not fully resolve the accounting mismatch or that are inconsistent with existing accounting practices (see paragraphs 31–32).

   (c) some participants suggested the Board consider alternatives to the DRM model which would not necessarily achieve better alignment to risk management view (see paragraph 19).

   (d) notwithstanding the above-mentioned feedback, almost all participants welcomed some elements of the DRM model such as the ability to designate a net open risk position and additional hedged items that are eligible for designation, such as core demand deposits (see paragraphs 21–28).

3. Structure of this paper

6. This paper is structured as follows:

   (a) Background (Section 4);

   (b) Feedback received (Section 5); and

   (c) Question for the Board (Section 6).

7. In section 5, the staff analyse separately feedback received for the following topics:

   (a) Objective of the DRM model (paragraphs 12–19);

(b) Key advantages of the DRM model (paragraphs 20–28); and

(c) Key areas for improvement in the DRM model (paragraphs 29–32).

4. Background

4.1 Outreach with participating banks

8. Consistent with the Board's objectives for the outreach discussed at the October 2019 meeting, this round of outreach focussed exclusively on banks that manage interest rate risk using dynamic risk management strategies. We have carried out the outreach through individual meetings with participants which enabled us to obtain detailed feedback from each participant about their strategy and activities to manage interest rate risk.

9. The staff acknowledge that feedback from participants naturally provides the views and concerns only from a banking preparer perspective and does not necessarily reflect the perspectives of other stakeholders such as regulators and users of financial statements. Consequently, the staff think that it is important that the feedback from this outreach presented at this meeting, is read in that context.

4.2 Objective of the DRM model

10. Previous consultations and feedback from stakeholders, in particular, users of financial statements, suggested that better alignment between financial reporting and risk management could ultimately provide more useful information. This feedback was based on the view that existing accounting requirements (ie IAS 39 or IFRS 9 hedge accounting) do not always adequately represent risk management when it is dynamic rather than static. This is because in effect, open portfolios are forced into closed portfolios for hedge accounting purposes. Consequently, the application of hedge accounting in a 'patchwork' manner or through proxy designations to account for dynamic risk management has resulted in a lack of transparency of financial information. As dynamic risk management is an important function for financial institutions, a better representation of dynamic risk

management activities would provide more useful information to the users of the financial statements. [1]

11. In light of this feedback, the Board decided that the objective of the DRM model must be to enable entities to more faithfully represent their dynamic interest rate risk management activities in the financial statements, thereby achieving better alignment between financial reporting and interest rate risk management.

5. Summary of feedback received

5.1 Objective of the DRM model

12. In principle, almost all participants supported the objective of the DRM model to better reflect their risk management view in the financial statements. However, many participants were of the view that an equally important objective for the DRM model must be to *eliminate accounting mismatch*—that is, to address the accounting mismatches which arise between assets and liabilities accounted for at amortised cost and derivatives accounted for at fair value through profit or loss. In their view, the DRM model does not fully achieve such objective due to its mechanism for recognising changes in fair value of designated derivatives in other comprehensive income (OCI) (see paragraph 32).

13. Overall, while almost all participants acknowledged the necessity for improvement of current hedge accounting requirements for dynamic risk management activities, mixed feedback was received on what is the right accounting approach.

Achieving better representation of risk management

14. Some participants said that an accounting model designed to better represent risk management is needed. This is because, due to the disconnect with risk management view, the resulting hedge accounting information in financial statements is currently complex to understand and makes it difficult to communicate to users of financial statements the underlying business context of hedge accounting designations.

[1] Refer to paragraphs 6–8 of the agenda paper 4C discussed at the Board's February 2015 meeting.

15. These participants noted that because current hedge accounting requirements have limitations when applied to dynamically managed interest rate risk exposures, banks have developed accounting approaches to accommodate their dynamic risk management activities with so-called 'proxy hedge accounting' which has led to a disconnect with the risk management view. The following reasons were mentioned to illustrate the use of proxy hedge accounting:

    (a) where direct reflection of risk management view through the application of hedge accounting in the financial statements is not possible. For example, using a gross designation for hedge accounting purposes when risks are managed on a net open risk position basis or using designations of variable rate assets as proxy when risk management is based on the deemed interest rate risk exposures (ie equity, future transactions).

    (b) to achieve outcomes that avoid volatility in the statement of profit and loss. For example, selectively finding eligible hedged items to be designated based on the derivatives designated for risk management purposes solely to avoid profit and loss volatility.

16. These participants agreed that the DRM model would address the main issues described in paragraph 15. As a result, hedge accounting information generated by the DRM model would better reflect the risk management view.

17. However, participants were of the view that while better alignment between interest rate risk management activities and the financial statement has conceptual and operational merits, achieving this objective might be very challenging, especially when considering the diversity of risk management activities and techniques amongst banks. All participants recommended that the DRM model incorporate risk limits as opposed to a single target outcome in order to achieve better alignment to dynamic risk management (see paragraph 30). However, participants could not provide specific suggestions about how to effectively achieve this.

Other views

18. Although many other participants said that a dynamic hedge accounting model would be required if they are no longer able to apply the macro hedge accounting models in IAS 39, they also commented on the following:

(a) *implementation costs and change of current practices*—by virtue of its objective for better alignment to dynamic interest rate risk management, the DRM model would inevitably require changes to the current macro hedge accounting practices applied by banks. Long-standing use of current hedge accounting practices has resulted in implementation of significant processes and systems (eg to frequently re-designate hedge relationships).[2] While they acknowledge that the application of a DRM model designed to better reflect risk management may be beneficial in the long-term, some participants were concerned that significant investment in new information systems and accompanying resources may be necessary to implement the DRM model;

(b) *users' need for information about dynamic interest risk management*—some participants questioned the prevalence of financial statement users' need for more useful information about dynamic risk management. This is because they typically do not receive requests from analysts or investors for additional information on dynamic risk management. A few banks also commented that this may be because, albeit to a limited extent, users of financial statements could obtain such information indirectly from the regulatory reporting submission (eg information required by Interest Rate Risk in the Banking Book (IRRBB) framework[3]); and

(c) *disclosure of sensitive information*—a few participants also commented that alignment between risk management and financial reporting may lead to disclosure of information that could be considered as commercially sensitive. They asked the Board to consider this factor in the development of DRM model and related disclosure requirements.

19. Some of the participants who hold the views described in paragraph 18 suggested the Board could consider alternatives to the DRM model which may not necessarily

[2] This is despite recognising that proxy hedge accounting generally introduces a significant level of operational complexity, for example, treating open portfolios as a series of closed portfolios.

[3] These participants referred to information required by the Interest Rate Risk in the Banking Book (IRRBB) framework which is part of the Basel Committee on Banking Supervision capital framework's Pillar 2 (Supervisory Review Process).

achieve better alignment to risk management view but would help address the accounting mismatch and their concerns with the current hedge accounting models. They suggested the Board retain the hedge accounting requirements in IAS 39 but amend it by:

(a) adding eligible hedged items (eg core demand deposits, equity, future transactions) so that it addresses what is commonly referred as capacity issue—that is, the inability to designate significant components of the exposures that are managed for risk purposes as eligible hedged items, and therefore achieve hedge accounting; and

(b) adopting the so-called ‘bottom layer approach’ for designation of prepayable assets so that alignment with the EU carve-out version of IAS 39 is achieved (see paragraph 31).

5.2 Key advantages of the DRM model

20. In this section, we summarise feedback on areas that participants identified as the key advantages of the DRM model.

Better reflection of risk management view

21. In addition to what is described in paragraph 16, many risk managers and treasurers who participated in the outreach said that if risk limits were to be incorporated into the DRM model, the model has the potential of more faithfully reflecting the risk management view. This is because the DRM model integrates the entity’s risk management strategy, extends the eligible items and contemplates an aggregated view of the interest rate exposure which then forms the basis of the target profile.

Designating net open interest rate risk position

22. Participants welcomed that the DRM model would enable entities to designate the net open interest rate risk position (ie the net open interest rate risk position when combining the assets with the liabilities). In their view, this is not only consistent with some entities’ risk management strategies, but also considered necessary to faithfully represent the risk management view. This is because, as noted in paragraph 15(a), currently, these entities do an artificial representation by

identifying eligible assets or liabilities and designating them as hedged items on a gross basis to obtain hedge accounting.

23. Also, participants said that designating the net open risk position would enable them to reflect the effect of natural hedges, which in effect, would reduce the need for ‘gross designations’.

Eligible items

24. All participants overwhelmingly supported the Board’s tentative decision to incorporate core demand deposits and future transactions as eligible items for the DRM model. They said that adding these items, in particular core demand deposits, would address one of the key problems that leads to capacity issues. Ultimately, participants said this tentative decision would allow them to better reflect their risk management view.

25. They also added that additional eligible items in the DRM model would limit the use of proxy hedge accounting. As noted in paragraph 15(a), due to the capacity issue (eg core demand deposits and future transactions), hedge accounting is currently applied selectively, or proxy hedge accounting techniques are used, rather than applying accounting that fully reflects dynamic risk management.

26. Nonetheless, some participants encouraged the Board to also address the deemed interest rate risk exposure of equity as part of the *core* elements of the DRM model. See agenda paper 4B for this meeting for details on this topic.

Transparency

27. Many participants said that the performance reporting elements of the DRM model such as alignment and misalignment of the target profile would provide information in the financial statements about the extent to which the entity was successful in achieving its risk management strategy for interest rate risk management. They explained that, for purposes of internal reporting on risk management, they primarily focus on monitoring compliance with the risk limits, whereas for regulatory reporting, they prospectively monitor sensitivity (eg the effect in profit or loss from specific shifts in the yield curve) and the impact on net interest income. However, these participants observed that currently information about the extent to

which the entity has achieved its risk management strategy is not necessarily included in the financial statements.

28. A few of these participants added that, at a minimum, reducing the extent of proxy hedge accounting, coupled with the objective of better reflecting a bank's risk management view would improve financial reporting and its communication to investors about the business context of hedges entered for risk management purposes (see paragraph 14).

5.3 Key areas for improvement in the DRM model

29. In this section, we summarise the feedback on the key areas that participants identified for improvement in the DRM model. Detailed feedback on these areas is included in separate papers.

Interaction of risk limits and target profile

30. Universally, all participants said that, unlike to what is required in the DRM model, their risk management strategy does not define a target profile on a single outcome basis. Instead, their target profile is defined on a risk limits basis. Consequently, if the DRM model were to require the target profile to be a single outcome, that would be an arbitrary outcome and a fundamental departure from their risk management view. All participants, therefore, identified the inclusion of risk limits in the DRM model as a pre-requisite to achieve better alignment to their risk management view. Agenda paper 4C for this meeting contains detailed feedback on this topic.

Designation of a proportion of prepayable assets in the DRM model

31. The Board tentatively decided that the DRM model would allow designation of a percentage of a portfolio (proportion), provided that is consistent with an entity's risk management strategy and is consistently applied to all expected cash flows within the portfolio. However, most participants recommended that instead, the Board allows the designation of a layer of nominal amounts of prepayable assets (eg bottom layer) in the DRM model. Agenda paper 4D for this meeting contains detailed feedback on this topic.

Recognising changes in fair value of derivatives in OCI

32. The Board tentatively decided that when derivative instruments are successful in aligning the asset profile with the target profile, the changes in fair value of such derivatives are recognised in OCI. All participants said that they are concerned about the potential impact this may have on their regulatory capital ie common equity tier 1 (CET1) and the resulting volatility of capital. In addition, some participants were also concerned with the resulting volatility of IFRS equity ie equity reported in the IFRS financial statements. Agenda paper 4E for this meeting contains detailed feedback on these topics.

6. Question for the Board

33. The staff would like to ask the Board the following question.

Question for the Board
Does the Board have any views, comments or questions on the feedback that would help the staff formulate the plan for the next steps in the project?