STAFF PAPER

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Project	Dynamic Risk Management (DRM)	
Paper topic	Feedback summary: Target Profile	
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1. Introduction

1. This paper provides a summary of feedback received from the outreach on the target profile element of the DRM model.

2. The Board tentatively decided that the entity's interest rate risk management strategy would be considered when determining the target profile. Agenda paper 4B for this meeting contains information received during outreach about risk management strategies adopted by participants and as such provides relevant background information for the feedback summarised in this paper.

3. We are not asking the Board to make decisions during this meeting. However, we welcome Board members' comments on any feedback that was unclear, that provides new information, or that needs further research.

2. Key messages in this paper

4. The key messages in this paper are summarised as follows:

   (a) All participants said that their interest rate risk management strategy does not define a target profile (ie a desired net open risk position) as a *single* outcome as contemplated in the DRM model. Instead, their strategies define risk limits, which would be expressed as a range of possible outcomes. Consequently, if the DRM model were to require entities to define their target net open risk position as a single outcome, that would be an artificial exercise and a fundamental departure from their interest rate risk management strategy and activities. Therefore, it would be inconsistent with the objective of the DRM model to better reflect entities' risk management strategies in the financial statements. Further feedback on this topic is set out in Section 4; and

(b) Many participants said that the 'target profile' as defined in the DRM model is not a component of their interest rate risk management strategy and activities per se and requested the Board to provide further explanation and guidance to help them better understand what the target profile represents and how to apply the related requirements. Further feedback on this topic is set out in Section 5.

3. Structure of this paper

5. The structure of this paper is as follows:

   (a) Risk limits and the single outcome target profile (paragraphs 7–15);

   (b) Meaning of the target profile (paragraphs 16–19);

   (c) Changes in the target profile (paragraphs 20–24);

   (d) Strategies with combined metrics (paragraphs 25–28); and

   (e) Question for the Board (paragraph 29).

6. For each topic discussed we provide:

   (a) a summary of the Board's discussions and tentative decisions;

   (b) a summary of the feedback received; and

   (c) staff observations, providing further context and observations related to the feedback.

4. Risk limits and the single outcome target profile

4.1 Summary of the Board's discussions and tentative decisions

7. During the development of the DRM model the Board considered in September 2018 whether the target profile should be defined as a range of possible outcomes

or as a single outcome. In addition, the Board noted that the concept of risk limits (ie a defined tolerance) was considered in the Discussion Paper *Accounting for Dynamic Risk Management: A portfolio revaluation approach to macro hedging* issued in 2014 (2014 DP). The feedback received at the time supported the Board's preliminary view not to consider risk limits due to its conceptual challenges and complexity in incorporating such limits into the DRM model. Therefore, the Board tentatively decided that the target profile within the DRM model should be defined as a single outcome.

4.2 Summary of feedback received

8. Universally, all participants said that their interest rate risk management strategies do not define a target net open risk position as a single outcome as it is contemplated in the DRM model. In contrast, all participants said their interest rate risk management strategies define risk limits, which would be expressed as a range of possible outcomes.

9. Participants said that risk managers decide not only how to manage the net open risk positions but also the extent to which they want to manage the risk through hedging. In the case of the latter, as described in agenda paper 4B for this meeting, the activities of risk managers are usually controlled by delegated mandates for risk limits. Risk limits are thresholds set for risk levels that banks are willing to bear, ie risk levels that they can accept. Consequently, participants noted that their risk limits are entity-specific thresholds that trigger to what extent the entity undertakes risk management through hedging activities.

10. Participants further said that as long as a net open risk position remains within a bank's risk limit, this would mean that the bank considers its dynamic interest rate risk management activities as being 'successful'. Conversely, when a bank's net open risk position is approaching its risk limits, the bank may carry out hedging activities to adjust its net open risk position in order to avoid a situation in which it is exposed to a higher risk than it is willing to tolerate ie that would breach its established risk limits.

11. Participants said that if the DRM model were to require banks to define their target profile (that is the desired net open risk position) as a single outcome, that would be artificial and a fundamental departure from their interest rate risk management

strategy and activities. They also noted that the concept of risk limits is consistent with the regulatory framework for interest rate risk in the banking book. The following challenges regarding the single outcome were also highlighted by participants:

(a) *arbitrary 'target' leads to misleading information*—requiring a single outcome means entities would have to arbitrarily determine a target profile to be used for measurement of performance for dynamic hedge accounting purposes. From those banks' perspective such performance measurement would be misleading.

(b) *prospective vs retrospective view*—risk managers highlighted that, unlike for financial reporting, they are not focussed on a backward-looking assessment of past performance but instead their primary objective is to manage interest rate risk on a forward-looking basis. Consequently, detailed retrospective analysis to assess whether past risk management actions were successful may mean banks need to capture additional information which could be operationally complex. However, these participants acknowledged that this issue would not be fully addressed even if risk limits were incorporated in the DRM model.

12. Overall, participants noted that a single outcome target profile would not achieve the objective of the DRM model to better reflect entity's interest rate risk management strategy in the financial statements. In their view, this outcome would also significantly limit the usefulness or relevance of the information presented in the financial statements. Almost all participants described risk limits as the most significant challenge towards viability and operability of the DRM model and therefore, suggested the Board reconsider its tentative decision for the target profile to be defined as a single outcome.

13. A few participants mentioned that the Board could for example allow a range of 'acceptable outcomes' but acknowledged that addressing this issue introduces conceptual and operational challenges. For example how to measure performance in accounting terms (ie perfect *versus* imperfect alignment) when the target profile is defined as a range of possible outcomes. Most participants did not provide

particular suggestions about how to incorporate such risk limits into the DRM model.

4.3 Staff observations

14. The staff acknowledge the feedback that a single outcome target profile would not achieve a closer alignment of the DRM model with an entity's risk management views but instead be a significant departure, and therefore, not achieve the objective of the DRM model to achieve better alignment with risk management.

15. The staff note that the 2014 DP discussed the potential incorporation of risk limits. Developing the core DRM model, the issue of risk limits was further discussed at the September 2018 meeting where the Board tentatively agreed that the target profile should be based on a single outcome. This decision was partly based on the assumption that an entity usually develops a limit range around a pre-defined desired net open risk position and therefore should be able to articulate that as single outcome target. At the time, the Board noted that the consideration of risk limits would reflect an aspect of dynamic risk management, however, its incorporation would represent significant conceptual challenges. For example, during the outreach some participants had the view that being within the risk limit may mean no imperfect alignment should be recognised in profit and loss (ie in such a situation all fair value changes of the designated hedging instruments would be recognised in OCI). However, this would lead to a situation where, the wider the risk limits, the less imperfect alignment might need to be recognised in profit and loss unless accounting restrictions are introduced to limit this effect.

5. Additional feedback on the target profile

5.1 Meaning of the target profile

Summary of Board's discussions and tentative decisions

16. The Board developed target profile within the DRM model on the following basis:

    (a) the target profile represents management's objective for a given asset profile;

(b) the bank's risk management strategy defines the target profile considering:

(i) the contractual terms of financial liabilities; and

(ii) the bank's approach to core demand deposits where present.

(c) the notionals of the asset profile and the target profile are required to be the same but not the tenors;

(d) the DRM model would not permit negative balances to be designated within the target profile; and

(e) the time horizon of the target profile is the period of time over which the bank is managing interest rate risk.

Summary of feedback received

17. Many participants asked the Board to clarify the meaning of the target profile. Their comments included:

(a) the concept of target profile, including the terminology used, is new and neither a component in their risk management view per se nor referred to in the regulatory framework for Interest Rate Risk in the Banking Book.[1]

(b) the Board's description of target profile (see paragraphs 16(a)–16(b)) is interpreted such that the entity's risk management strategy would define target profile considering only entity's financial liabilities and its approach regarding core demand deposits but not consider entity's financial assets. Participants said that in practice, their interest rate risk management strategies always consider the entity's net open risk position from (expected) assets and liabilities (see also paragraph 22(a) to additional related question on the target profile). Hedging activities are then executed to manage the existing net open risk position in line with the entity's risk management strategy.

18. Acknowledging that the restrictions described in paragraphs 16(c)–16(d) intend to prevent entities from introducing leverage (ie introducing risk) through the

[1] These participants referred to 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).

application of the DRM model or by applying it to 'trading-like' activities, many participants highlighted the following concerns:

(a) *additional application guidance*— additional clarity and application guidance would be required for preparers to apply these requirements. In particular, how to meet the requirement of aligning portfolio notionals in situations where some items are not eligible for designation in the DRM model. For example, in situations where liabilities may already be hedged under the general hedge accounting model in IFRS 9 and the entity may only consider hedging the remaining assets.

(b) *increased cost of hedging*—some banks said that not permitting negative balances would artificially increase the cost of hedging. This is because banks may no longer be able to transact derivatives on the liquid part of the yield curve (ie in adjacent buckets to where the assets are held) without recognising imperfect alignment in profit and loss.

Staff observations

19. The staff acknowledge that the target profile is a new concept to participants and is a terminology that has not been used in IFRS Standards before. During the discussions with participants, the staff observed that describing the target profile as the 'desired net open interest rate risk position' after taking into account behaviouralisation for assets and liabilities for expected cash flows, often helped participants to better understand the meaning of target profile. Appendix A includes a chart that illustrates a potential alternative approach to describe the target profile (using the same components of the DRM model as per the Board's tentative decisions), contemplated during outreach with participants.

5.2 Changes in the target profile

Summary of Board's discussions and tentative decisions

20. The Board acknowledged that to reflect the dynamic nature of an open portfolio changes to the inputs of the target profile (as defined in Agenda Paper 4B from March 2018) occur frequently. The Board concluded that for the purpose of the DRM model:

(a) 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. Therefore, changes in inputs would not cause imperfect alignment as this would only require a prospective alignment of designated hedging derivatives;

(b) changes in assumptions, such as changes in prepayment assumptions (ie a change in prepayment amounts and timing), would trigger a requirement to measure imperfect alignment. This is because when a change in prepayment assumption occurs, it indicates that management's estimation about when a loan (or portfolio of loan) will mature was inaccurate. Therefore, some degree of imperfect alignment should be captured by measurement; and

(c) changes in inputs and changes in assumptions are not changes in the risk management strategy.

21. However, the Board concluded that changes in risk management strategy directly impacting the target profile are accounted for as a prospective discontinuation of the current DRM model.

Summary of feedback received

22. Most participants asked the Board to provide sufficient application guidance that would clarify the following concepts within DRM model:

(a) *changes in strategy that lead to changes in target profile*—participants asked the Board to provide additional application guidance that would help them determine what changes in entity's risk management strategy would lead to changes in target profile ie the accounting for a discontinuation. In particular, how to distinguish between changes in inputs, changes in assumptions and changes in risk management strategy.

(b) *frequent changes in the desired net open risk position ie the single outcome*—many participants said that their target position referred to here as the 'desired net open risk position' changes frequently within their risk limits. They asked the Board to provide sufficient guidance to help them determine what accounting effect such a change in single outcome would have within the DRM model.

Staff observations

23. The staff acknowledge being a new accounting model, stakeholders would require sufficient clarity in definitions and application guidance to illustrate the elements of the DRM model.

24. The staff observe that this feedback is also correlated with participants' comments that the meaning of target profile may need to be articulated more clearly (see paragraph 17).

5.3 Strategies with combined metrics and the target profile

Summary of Board's discussions and tentative decisions

25. The Board did not prescribe the risk management strategies that would be eligible for application of the DRM model. When developing the core DRM model, the Board considered a range of risk management strategies including strategies that are based on stabilising the cash value of margin and/or stabilising the present value of future margin. However, for the purposes of illustrating the application of the DRM model, the examples have mainly been focused on a risk management strategy of stabilising net interest income (NII) for simplicity purposes.

Summary of feedback received

26. Almost all participants said that their risk management strategy is not primarily and entirely focusing on a notional transformation view ie on stabilising NII. Banks observed that for risk management purposes they would apply a combination of measures. For example, measures based on economic value of equity (EVE), NII targets and interest rate gap sensitivities, sometimes by time bucket. Banks were unclear if the suggested model could accommodate such different and/or multifaceted risk management strategies, and if so, how it could be applied within the DRM model.

27. Participants therefore asked the Board to illustrate the application of the DRM model through examples based on different risk management strategies.

Staff observations

28. The staff acknowledge that DRM model is currently illustrated through examples which focus on a risk management strategy of stabilising NII. The staff observe that this was primarily done for simplicity purposes and does not preclude risk management strategies with combined metrics to be eligible for application of DRM model.

6. Question for the Board

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

Question for the Board
Does the Board have comments on any feedback that was unclear, that provides new information, or that needs further research?

Appendix A—Meaning of Target Profile

A1. As discussed in paragraph 19 , the following chart illustrates potential refinements to the description of target profile, discussed during outreach with participants.