

## STAFF PAPER

April 2021

## IASB® meeting

<b>Project</b>	<b>Dynamic Risk Management (DRM)</b>	
<b>Paper topic</b>	Feedback summary: Recognition of fair value changes in OCI	
CONTACT(S)	Iliriana Feka	<a href="mailto:ifeka@ifrs.org">ifeka@ifrs.org</a>
	Zhiqi Ni	<a href="mailto:zni@ifrs.org">zni@ifrs.org</a>
	Matthias Schueler	<a href="mailto:mschueler@ifrs.org">mschueler@ifrs.org</a>
	Emilio Maffi	<a href="mailto:emaffi@ifrs.org">emaffi@ifrs.org</a>
	Riana Wiesner	<a href="mailto:rwiesner@ifrs.org">rwiesner@ifrs.org</a>

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does 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 the IASB® *Update*.

## 1. Introduction

1. For the DRM model, the Board tentatively decided that when derivatives align the asset profile with the target profile, the changes in fair value of such derivatives are recognised in other comprehensive income (OCI). This paper provides a summary of feedback received in the outreach in response to this tentative decision.
2. We are not asking the Board to make decisions at this meeting. However, we welcome Board members' comments on any feedback that was unclear, that provides new information, or that needs further research.

## Key messages in this paper

3. The key messages included in this paper are as follows:
  - (a) All participants said that recognising the aligned portion of changes in the fair value of designated derivatives in OCI would only be worth exploring if the prudential regulators provided a filter which allowed them to eliminate any volatility in regulatory capital that might arise from the application of the DRM model. Further feedback for this topic is set out in paragraphs 11–14.

- (b) Some participants were also concerned about the potential volatility of IFRS equity. In their view, this approach would create an artificial volatility in OCI—which could have a material effect on an entity’s IFRS equity—and would be misleading to the users of their financial statements. Further feedback for this topic is set out in paragraphs 15–18.

## 2. Structure of this paper

- 4. This paper is structured as following:
  - (a) summary of the Board’s discussions and tentative decisions (paragraphs 5–7);
  - (b) summary of the feedback received (paragraphs 8–18);
  - (c) staff observations to provide further context and information related to the feedback (paragraphs 19–21); and
  - (d) Question for the Board (paragraph 22).

## 3. Summary of the Board’s discussions and tentative decisions

- 5. The Board noted that the DRM model has three key areas through which it captures an entity’s interest rate risk management activities; the asset profile, the target profile and the derivatives used for alignment. However, as derivatives are measured at fair value through profit or loss, but the asset profile and the financial liabilities used to determine the target profile are measured at amortised cost, this gives rise to a measurement difference in the statement of profit or loss. In addition, when entities use derivatives to manage the interest rate risk associated with future transactions, these derivatives are recognised when they are transacted while the future transactions are only recognised when they occur. These measurement and recognition differences likely do not provide a faithful representation in the statement of profit or loss of the entity’s performance for the reporting period.
- 6. Previous consultations and feedback from some stakeholders in response to the Discussion Paper *Accounting for Dynamic Risk Management: A portfolio revaluation approach to macro hedging* issued in 2014 (2014 DP) suggested that

the Board should consider a model which uses cash flow hedge mechanism (ie recognising fair value changes of designated derivatives in OCI).<sup>1</sup>

7. To address the concerns highlighted in paragraph 5 and based on the feedback on the 2014 DP noted in paragraph 6, the Board developed the DRM model using a mechanism of deferral and reclassification similar to cash flow hedge accounting. The Board, therefore, tentatively decided that to the extent that derivatives are successful in aligning the asset profile with the target profile, changes in the fair value of such derivatives are recognised in OCI and recycled to profit or loss as the asset profile affects the statement of profit or loss. Accordingly, in a situation of perfect alignment, interest income would reflect the entity's target profile.

#### 4. Summary of the feedback received

8. Almost all participants acknowledged that using the cash flow hedge mechanism of deferral and reclassification within the DRM model means that the results reported in the statement of profit or loss would reflect the entity's target profile and ensure that the net of interest revenue and expense better reflects the entity's risk management strategy.
9. Similarly, they acknowledged that this mechanism is designed to address the issue of measurement asymmetry between the underlying hedged positions and the hedging instruments (often referred as 'accounting mismatch'). However, they noted that this mechanism addresses the accounting mismatch only partially. That is, while it eliminates the mismatch in the statement of profit or loss, it causes volatility in OCI.
10. Consequently, almost all participants expressed concerns about the potential implications of this mechanism on regulatory capital—that is, volatility of regulatory capital. Furthermore, some participants were also concerned about the volatility of IFRS equity, ie equity reported in financial statements prepared in accordance with IFRS Standards.

---

<sup>1</sup> See paragraphs 10(a) and 27 of agenda paper [4A Feedback summary: general overview](#) presented at the February 2015 Board meeting.

#### **4.1 Volatility of regulatory capital**

11. Almost all participants said their primary concern regarding the use of cash flow hedge mechanism is that it could lead to significant volatility in the OCI reserve which would ultimately lead to overall significant volatility in their regulatory capital—that is, the Common Equity Tier 1 (CET1) capital—and that such volatility would be artificial.
12. They noted that CET1 capital is the highest quality of regulatory capital as it absorbs losses as they occur. There are regulatory adjustments (ie filters and deductions) made to total shareholders' equity as per the IFRS balance sheet in order to get to CET1 capital. For this reason, participants were concerned that the cash flow hedge mechanism in the DRM model could result in debit (negative) balances being recognised in OCI which would be deducted from and therefore, ultimately reduce their regulatory capital.
13. Participants said that this issue could be addressed if the prudential regulators would apply a prudential filter to the DRM reserve in OCI, similar to the prudential filter currently in place for the cash flow hedge reserve.
14. Accordingly, participants acknowledged that this is a regulatory matter but nonetheless encouraged the Board to maintain dialogue with prudential regulators so that they can make an informed decision about whether the prudential filter should also extend to the DRM reserve in OCI.

#### **4.2 Volatility of IFRS equity**

15. Some participants expressed an additional concern with respect to potential volatility of IFRS equity caused by recognising changes in fair value of derivatives in OCI. In their view, this mechanism would create an artificial volatility in OCI—which could have a material effect on an entity's equity—and would be misleading to the users of their financial statements. These banks also highlighted the likely effect of such volatility on their key performance indicators such as return on equity.
16. These participants are a subset of banks who raised the issue in paragraph 11 and consist of banks who operate in particular jurisdictions, have lower levels of equity relative to other market participants, and for whom the use of cash flow hedge

mechanism represents a change from their current practice. Specifically, they were concerned with volatility of IFRS equity mainly because of:

- (a) *potential significant volatility due to the extent of derivatives used.* Some participants operate in specific jurisdictions where the market is dominated by long-dated financial assets such as mortgages and short or medium-term funding such as customer deposits. Consequently, the lack of natural offset due to their balance sheet structure means that greater transformation through derivatives would be required, leading to a higher volume of derivatives required for hedging. Coupled with the fact that hedging in these circumstances is done through long-dated derivatives, it ultimately could lead to significant volatility in the OCI reserve. For example, when a bank issues fixed interest rate mortgages with 20-year maturity but receives short or medium-term funding, there is a greater repricing gap between these assets and liabilities. Accordingly, in this example, the perfectly successful derivatives would be of longer maturity and possibly of higher volume, and therefore would give rise to higher level of OCI volatility compared to a bank that has a natural offset between its assets and liabilities (eg a bank that issues long-term assets and receives long-term funding thereby does not require extensive use of derivatives for alignment, which ultimately lead to less volatility in OCI).
- (b) *the bank's equity level.* For banks with lower level of IFRS equity, potential volatility in the DRM reserve in OCI may represent a significant movement, which in extreme circumstances may lead to a negative equity balance.
- (c) *the effect of change compared to current practice.* Currently, these banks mainly apply fair value hedge accounting. As a result, they do not experience OCI volatility related to their hedging activities. These banks were concerned whether users of their financial statements would be misled by the potential volatility of IFRS equity and misinterpret what such OCI volatility would represent.

17. Finally, as an alternative to cash flow hedge mechanism (ie recognising fair value changes of designated derivatives in OCI), a few of these participants suggested

that the Board consider changing the DRM model to use the fair value hedge mechanism—that is, adjusting the carrying amount of the hedged item (ie the portfolios in scope of DRM) for its fair value changes.

18. It is worth noting that the feedback described in paragraphs 15–17 was not shared by all participants. In contrast, many participants said that if the prudential filter would be in place for regulatory capital purposes, they would **not** be concerned with volatility of IFRS equity. This group of participants consisted of:
- (a) banks that currently apply cash flow hedge accounting and therefore already recognise a portion of changes in fair value of derivatives in OCI and therefore, already experience the volatility of IFRS equity arising from the use of cash flow hedge mechanism; and
  - (b) other banks which currently apply fair value hedge accounting, but that do not expect a significant impact on their IFRS equity arising from OCI volatility because of the structure of their assets and liabilities, ie they have assets and liabilities that naturally offset, or have high levels of IFRS equity.

## 5. Staff thoughts

19. The changes in the fair value of derivatives that are recognised in OCI would reflect the extent of transformation performed through derivatives—that is, the extent that derivatives were used to achieve entity’s risk management strategy. Therefore, such information would not be artificial, as it would also be reflecting the underlying business models and risk management practices applied by banks.
20. The staff note that the feedback in paragraph 17 is inconsistent with some feedback received in response to the 2014 DP. At the time, the Board discussed Portfolio Revaluation Approach (PRA) which used fair value hedge mechanism. Most respondents to the 2014 DP rejected this approach saying that ‘revaluing’ exposures as proposed in the PRA does not necessarily reflect dynamic risk management in all circumstances. They said, for instance, a cash flow hedge accounting model reflects DRM activities better when interest rate risk is managed in terms of cash flow variability. For this reason, as noted in paragraph 6, some of these respondents had

suggested that it would be appropriate for the Board to consider a model which uses cash flow hedge mechanism as an alternative to the PRA.

21. The staff also note that in addition to feedback described in paragraph 20, respondents to the 2014 DP highlighted concerns about significant operational complexity. Some of those concerns, such as onerous tracking and amortisation requirements, would equally arise if the Board were to consider changing the DRM model to apply a fair value hedge mechanism instead. This is because, unlike cash flow hedge mechanism which uses derivatives to determine the hedge adjustment, fair value hedge mechanism uses hedged items to determine the hedge adjustment. In a dynamic risk management, the hedged item consists of open portfolios which change frequently (ie due to originations or repayments of underlying items). Therefore, it would require onerous tracking of items originally designated in the DRM portfolios in order to determine accurate amortisation.

## 6. Question for the Board

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

### Question for the Board

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