STAFF PAPER

May 2021

IASB® meeting

Project	**Dynamic Risk Management (DRM)**
Paper topic	Proposed next steps and indicative timeline

CONTACT(S)	Zhiqi Ni	zni@ifrs.org
	Matthias Schueler	mschueler@ifrs.org
	Iliriana Feka	ifeka@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

1. Introduction

1. At the April 2021 Board meeting, the Board discussed feedback received from the outreach on the dynamic risk management (DRM) model. The feedback was based on the core DRM model as discussed at the July 2019 Board meeting, with the objective of assessing the viability and operability of the DRM model and whether it will enable banks to better reflect their risk management in the financial statements, compared to the current macro hedge accounting models.

2. As noted at the April 2021 Board meeting, in principle, almost all participants supported the objective of the DRM model to better reflect interest rate risk management strategy and activities in the financial statements. Participants acknowledged the significant benefits the DRM model would bring, such as extending the scope of eligible items and improved transparency in the financial statements.

3. However, participants in the outreach also identified challenges that are key to the viability and operability of the DRM model, namely:

    (a) interaction between risk limits and target profile;

    (b) designation of a proportion of prepayable assets in the DRM model; and

(c) recognising changes in the fair value of derivatives in other comprehensive income (OCI).

4. This paper sets out the proposed next steps and our indicative timelines to address the key challenges identified from the outreach set out in paragraph 3 of this paper.

5. At this meeting, the staff are not asking the Board to make any decisions based on this paper. Nevertheless, the staff welcome any questions or comments that Board members may have on the proposed next steps or the indicative project timeline.

2. Structure of this paper

6. This paper provides an overview of:

(a) Proposed next steps (paragraphs 7–9); and

(b) Key areas for further development in the core DRM model (paragraphs 11–19);

(c) Indicative timeline (paragraph 20); and

(d) Question for the Board (paragraph 21).

3. Proposed next steps

7. Consistent with the phased approach of the DRM project, the staff are of the view that it is essential to first focus on the questions and issues participants have identified as key to the viability and operability of the core DRM model as described in paragraphs 11–19. Other feedback relating to the refinement of the DRM model will be considered later in the project.

8. Accordingly, the staff plan to perform further research and analysis of the key elements of the core DRM model to explore whether acceptable solutions could be developed as the next step of the project. During this time, the staff will also reach out to other stakeholders, such as prudential regulators and users of financial statements on the key elements of the DRM model. This will help the Board to determine whether these issues can be resolved before deciding on the project direction.

9. The staff acknowledge that there may be entities in other industries (such as insurance companies) that have shown an interest in the DRM project, however, the staff do not plan on conducting wider outreach on the DRM model until the Board has decided on the project direction.

4. Key areas for further development in the core DRM model

10. The staff have presented the key issues listed in paragraph 3 of this paper, based on their significance to the viability of operability of the DRM model as well as the interaction among the topics, and thus the staff are of the view that it is best to consider the issues in the order listed below.

4.1 Interaction between risk limits and target profile

11. The target profile is one of the most important elements of the DRM model and has fundamental implications to the performance assessment of the DRM model. As discussed in the agenda paper 4C for the April 2021 Board meeting, participants universally said that their target profile is defined on a risk limits basis instead of a single outcome. Consequently, participants were of the view that if the DRM model were to require the target profile to be a single outcome, it would be an artificial exercise and a fundamental departure from their interest rate risk management strategy and activities.

12. Based on the feedback received, the staff are of the view that unless risk limits are incorporated into the target profile, the DRM model may not achieve the objective of better reflecting the entity's interest risk management strategy in the financial statements. We therefore consider the interaction between risk limits and the target profile the most significant issue that needs to be considered first.

13. In addition, the staff also think it would be helpful to revisit the definition of the target profile to closer align it with the concepts used in a risk management context, as suggested in the Appendix A of the agenda paper 4C for the April 2021 Board meeting.

4.2 Designation of a proportion of prepayable assets

14. As discussed in the agenda paper 4D for the April 2021 Board meeting, the 'bottom layer approach' was widely raised during the recent outreach and most outreach

participants recommended the Board to permit the designation of a layer (eg bottom layer) of prepayable assets in the DRM model. This is partly because the 'bottom layer' approach is applied as part of the EU carve-out of IAS 39, and some participants mentioned that the requirements issued by the Financial Accounting Standards Board (FASB) also include a similar approach—the 'last-of-layer' method.

15. The staff are of the view that a layer approach as a reflection of the interest rate risk management strategy is closely linked with the concept of risk limits. Risk managers would only be able to leave the interest rate risk from the upper layer unhedged when it falls within the acceptable risk limits, as otherwise they would not be able to achieve their interest rate risk management strategy. If a solution could be developed to incorporate risk limits into the target profile, changes in prepayment expectations might not result in the immediate recognition of a gain or loss (ie imperfect alignment), and therefore might achieve the main benefit of the layer approach as perceived by many participants (ie stability in profit and loss). As such, the staff propose to consider this issue next after the risk limits in Q4 2021.

4.3 Recognising changes in fair value of derivatives in OCI

16. Many banks provided feedback about recognising changes in fair value of derivatives in OCI similar to the mechanism of cash flow hedge accounting. Although most banks expressed concerns about the potential implications of this mechanism on regulatory capital, they acknowledged this is a regulatory matter and suggested the Board to keep dialogue with the regulators.

17. Accordingly, the staff think it is important to engage with prudential regulators as early as possible to ensure a common understanding of the nature of the DRM reserve in OCI.

18. Some banks are also concerned about the potential volatility in IFRS equity caused by the DRM model. They are concerned that volatility in IFRS equity could impact key performance indicators such as return on equity and would be misleading to the users of the financial statements. In some extreme scenarios, it may even lead to a negative equity balance, meaning the bank would be technically insolvent. They have suggested the Board to consider the use of fair value hedge mechanism to

adjust the carrying amount of the hedged item (ie the portfolios in scope of DRM) for changes in its fair value attributable to interest rate risk.

19. The staff are of the view that although a detailed analysis of the implications of both fair value and cash flow hedge mechanisms is important, it is not as significant to the further development of the DRM model as the issues identified in paragraphs 11–15. This is because those issues would remain relevant regardless of which mechanism is used, and thus the analysis could wait until potential solutions are considered for the other two issues.

5. Indicative timeline

20. The following table illustrates the order and indicative timeline within which the staff expect to bring the analyses of issues to the Board for deliberations:

Indicative timeline	Topics and issues
Q3 2021	• Interaction between risk limits and target profile
Q4 2021	• Designation of a proportion of prepayable assets
Q1 2022	• Recognising changes in fair value of derivatives in OCI
H1 2022	• Decide on project direction

6. Question for the Board

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

Question for the Board

Does the Board have any questions or comments on the proposed next steps or indicative timelines for the key areas that the staff have identified for further research and analysis as set out in paragraphs 11 to 19?