IFRS® Accounting

Staff paper

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Project	**Dynamic Risk Management (DRM)**
Topic	**Items eligible for designation in the current net open risk position**

Contacts **Matthias Schueler** (mschueler@ifrs.org)
Zhiqi Ni (zni@ifrs.org)
Riana Wiesner (rwiesner@ifrs.org)

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Introduction

1. The IASB introduced the concept of current net open risk position (CNOP) in November 2021 as the net open interest rate risk exposure (by time bucket) derived from the combination of an entity's assets and liabilities (including core demand deposits) and eligible future transactions over the period the entity is managing such risk. In other words, this is the 'organic' interest rate risk exposure from the entity's underlying positions before considering any derivatives.

2. In the July 2022 project plan, we included the consideration of items that would be eligible for inclusion in the CNOP as one of the areas requiring further analysis in the DRM model. More specifically, we listed:

   (a) own equity (such as, equity reserves and equity instruments with characteristics of debt);

   (b) financial assets classified as fair value through other comprehensive income (FVOCI items); and

   (c) other financial assets that are classified as fair value through profit or loss (FVPL) as a result of not having contractual cash flows that are solely payments of principal and interest.

3. In its November 2022 meeting, the IASB discussed the inclusion of own equity in the CNOP and concluded it is not necessary to achieve the objectives of the DRM model, and therefore, equity is not eligible for designation in the CNOP.

4. At this meeting, we are analysing whether financial assets measured at FVOCI or FVPL are eligible for inclusion in the CNOP.

5. This paper is structured as follows:

(a) summary of staff recommendations;

(b) reminder of the qualifying criteria for inclusion in the CNOP;

(c) staff analysis; and

(d) question for the IASB.

Summary of staff recommendations

6. For the reasons explained in paragraphs 31–45, the staff recommend that financial assets measured at FVOCI are eligible for designation in the CNOP. However, for the reasons explained in paragraphs 22–30, we recommend that financial assets measured at FVPL are not eligible for designation in CNOP.

Reminder of qualifying criteria for inclusion in the CNOP

7. The IASB discussed the qualifying criteria for inclusion of financial assets and financial liabilities in the CNOP during February 2018 and April 2018 when deliberating the asset and target profile for the DRM core model.

8. The staff continues to believe that the DRM accounting model should provide additional guidance in the form of qualifying criteria. This is because these criteria will allow for clear identification of which risk exposures are included in the CNOP. Based on the CNOP the entity's risk mitigation intention (RMI) for the period is determined. In other words, it defines the risk exposures which are dynamically managed for interest rate risk and therefore are subject to performance assessment without an explicit link to the underlying assets and liabilities.

Summary of qualifying criteria

9. As a result of the deliberation on the DRM core model and the refinements made to date, the IASB has tentatively decided that the qualifying criteria for financial assets and liabilities to be eligible for designation in the DRM model are as follows:

   (a) financial assets or financial liabilities must be measured at amortised cost under IFRS 9;

   (b) the effect of credit risk does not dominate the changes in expected future cash flows;

   (c) future transactions must be highly probable;

(d) future transactions must result in financial assets or financial liabilities that are classified as subsequently measured at amortised cost under IFRS 9;

(e) items already designated in a hedge accounting relationship are not eligible under the DRM accounting model; and

(f) items must be managed on a portfolio basis for interest rate risk management purposes.

Eligible financial assets and financial liabilities

10. DRM is a process that involves understanding and managing how and when a change in market factors will impact interest income and interest expense. As interest income is calculated by applying the effective interest method to financial assets and financial liabilities classified at amortised cost, the IASB previously tentatively decided that the assets and liabilities designated in the DRM model should comprise only these financial assets and financial liabilities.

11. However, as discussed at previous Board meetings, the DRM model proposes a new type of risk mitigation relationship (see Agenda Paper 4A of the February 2022 IASB meeting), in which derivatives are used to mitigate the interest rate risk inherent in a portfolio of financial assets and financial (funding) liabilities such that they align with the entity's target profile (ie risk limits). This type of relationship is neither a fair value hedge of fixed-rate financial assets or liabilities nor is it a cash flow hedge of the exposure to variability in cash flows associated with floating-rate financial assets or liabilities.

12. The risk mitigation activities focus on derivatives used to reduce interest rate risk inherent in the CNOP to a defined target profile (ie by setting risk limits), regardless of whether the financial assets are fixed or floating rate. Consequently, the IASB decided that the CNOP should allow for designation of both fixed and floating-rate financial assets, financial liabilities and eligible future transactions.

13. Because dynamic risk management is generally performed on a portfolio instead of an individual basis, the IASB also tentatively decided that allowing financial assets or financial liabilities managed on an individual basis to be part of the CNOP would be inconsistent with the DRM accounting model's objective to faithfully represent, in the financial statements, the impact of DRM activities undertaken by an entity. Therefore, only financial assets and financial liabilities where risk is managed holistically on a portfolio basis should be eligible for inclusion within the DRM model.

14. In other situations, the effect of credit risk can be of such a magnitude that it dominates the changes in a financial asset's expected cash flows. Consequently, qualifying criteria would aim to preclude the designation of financial assets under such circumstances.

Staff analysis

15. We have approached our analysis of whether to include financial assets measured at FVPL or FVOCI by considering the economic phenomenon of dynamic risk management to evaluate if the inclusion of such financial assets in the CNOP would faithfully represent this phenomenon.

Economic phenomenon of dynamic risk management

16. As discussed in Agenda Paper 4A of the February 2022 meeting and several previous IASB meetings, for those entities applying dynamic risk management of repricing risk due to changes in interest rates, risk management activities typically look at the funding liabilities together with the interest generating assets, as the combination of the two is the source of any repricing risk. The refinements to the DRM model such as the CNOP and the RMI are also based on this aggregated risk (amount) view.

17. Entities typically use derivatives to manage this entity-wide risk position in line with their risk management strategy. To the extent that derivatives are successful in mitigating repricing risk, an entity achieves a 'protection/benefit' in the form of reduced variability from both earnings and economic value perspectives:

    (a) *earnings perspective*—by 'stabilising' the net interest income (ie reducing variability in the difference between interest income and expense when the benchmark interest rate changes), an entity has essentially reduced exposure to variability in its earnings for a chosen period of time;

    (b) *economic value perspective*—by 'protecting' the fair value of its assets, liabilities and future transactions, an entity has essentially reduced exposure to changes in the economic value of its assets, liabilities, and future transactions when the benchmark interest rate changes.

18. This combination is described as the *economic phenomenon* of entering into risk mitigation activities, where the value of the underlying items and designated derivatives systematically change in response to movements in the benchmark interest rate and generally move in the opposite direction.

19. In cases where the CNOP is exclusively based on amortised cost items, the DRM model and resulting recognition of the DRM adjustment in the statement of financial position (as discussed in as Agenda Paper 4A for the May 2022 IASB meeting) provides:

    (a) *faithful representation of the economic phenomenon*—that is, it faithfully represents the economic effects of dynamic risk management; and

    (b) *relevant information about the effectiveness of dynamic risk management*—that is, it enables users of financial statements to understand an entity's risk management strategy and how that affects the nature, timing and uncertainty of future cash flows.

20. In the following paragraphs the staff will assess whether the inclusion of items, that are not measured at amortised cost, in the CNOP, would still achieve the dual aspect of the 'protection/benefit' of dynamic risk management in form of reduced variability in both fair value and net interest income in profit and loss.

21. We will use simplified examples focusing on individual items assuming an entity's RMI is to fully mitigate interest rate risk. However, it is important not to forget that applying the DRM model as a dynamic risk management model there is no direct link between the underlying item(s) and the RMI. The only reason why we have selected individual items as examples is to simplify the underlying conceptual argument.

Financial assets measured at FVPL

22. As per paragraphs 4.1.2 and 4.1.2A of IFRS 9, one of the conditions for a financial asset to either be measured at amortised cost or fair value through other comprehensive income is that the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (SPPI).

23. The other condition is that those financial assets are held in a business model whose objective is to hold financial assets in order to collect contractual cash flows or both collecting contractual cash flows and selling financial assets. These financial assets have an economic value and earnings exposure to changes in interest rates.

24. However, financial assets could have SPPI cash flows but still be measured at FVPL if the business model is not one of those mentioned in paragraph 23. Paragraph B4.1.5 of IFRS 9 mentions for example financial assets held in a business model exclusively for sale. Because these financial assets are not held to collect the contractual cash flows, they would not be relevant to the DRM model because the entity makes decisions based on the assets fair values and manages the assets to realise that fair value. Therefore, from an earnings

perspective, net interest income (NII) is not relevant. For this reason, this section only focusses on the financial assets that do not have SPPI cash flows but are held in a business model as described in paragraph 23 of this paper.

Economic value perspective

25. Financial assets that do not have contractual cash flows that are SPPI, may still have exposure to interest rate risk. For example, an inverse floating-rate asset (see Instrument G of paragraph B4.1.14 of IFRS 9) still creates economic value variability through its inverse relationship with the benchmark interest rate. Applying IFRS 9, the item is measured at FVPL and changes in fair value are recognised in profit and loss.

26. An entity can still undertake risk mitigating activities on the portion of the fair value that relates to changes in the benchmark interest rate through the use of an interest rate derivative. This would mean that from an economic value perspective the entity has mitigated the interest rate risk inherent in the underlying item.

27. From an accounting perspective, the fair value movements on the item and on the derivative offset each other in the statement of profit and loss for the fair value changes related to changes in the benchmark interest rate. This is because the changes in fair value of the underlying items and the related derivatives are recognised in the same period in profit and loss. In other words, no accounting mismatch exists and therefore there is no ‘protection/benefit’ in the form of reduced variability from an economic value perspective to be gained from the DRM adjustment.

Earnings perspective

28. As explained in paragraph 17 of this paper, the earnings perspective of the DRM model focusses on NII. Although the use of the interest rate derivative will reduce the entity’s cash flow variability, that variability is not recognised in net interest income. This is because neither the gains or losses of the underlying item nor the designated derivative are recognised in interest income or expense (calculated using the effective interest method) and the entity is therefore not exposed to earnings variability.

29. This also means that from an accounting perspective there is no ‘protection/benefit’ in the form of reduced variability from an earnings perspective to be gained from the DRM adjustment.

Does application of the DRM model provide a faithful representation of the economic phenomenon for FVPL items?

30. In conclusion, in the staff's view, financial assets measured at FVPL should not be eligible to be designated in the CNOP because the general accounting requirements already achieve faithful representation of both the economic value and earnings perspective. This is because the protection/benefit provided by the derivative is recognised in the same period as the change in value of the underlying item in profit and loss.

Financial assets measured at FVOCI

31. Financial assets which are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets are measured at FVOCI if the instruments also have contractual cash flows that are SPPI.

32. For these financial assets, interest is recognised in profit or loss using the effective interest method (see paragraph 5.7.10 of IFRS 9). When the financial asset is derecognised, the cumulative gain or loss in OCI is reclassified to profit or loss. This means the amounts that are recognised in profit or loss are the same as if the financial asset had been measured at amortised cost (see paragraph 5.7.11 of IFRS 9).

33. Feedback from outreach on the core model suggested that risk managers might, as part of the entity's risk management strategy, consider items measured at FVOCI together with amortised cost assets or liabilities when determining their CNOP. This is because for risk management purposes, these two types of financial assets have the same profit and loss profile and interest rate exposure. Outreach participants further said that in some cases, financial assets measured at FVOCI (for example fixed rate bonds) can represent an important portion of the assets managed as part of their dynamic risk management.

Economic value perspective

34. Assuming an entity measures a fixed rate bond at FVOCI such an item would be exposed to variability in economic value caused by changes in the relevant benchmark interest rate. Applying IFRS 9, movements in the bond's fair value are recognised in other comprehensive income. Similar to the risk management activity described in paragraph 26 of this paper, an entity could still mitigate interest rate risk arising for changes in the benchmark interest rate by using interest rate derivatives.

35. Although an FVOCI financial asset is measured at fair value in the statement of financial position, changes in fair value are recognised in OCI and do not affect the amounts recognised in profit or loss using the effective interest method (see paragraph 32 of this paper).

36. Therefore, the financial assets measured at FVOCI and the derivatives used to mitigate the interest rate risk are both measured at fair value in the statement of financial position. However, in profit and loss, the entity will still have an accounting mismatch as the fair value of the financial assets are recognised in OCI (apart from the interest amount recognised in profit and loss) while the gains or losses on the derivative are recognised in profit and loss.

37. From an economic value perspective, applying the DRM model could therefore help the entity to achieve the 'protection/benefit' in the form of reduced variability to be gained from the DRM adjustment in the future. This is because to the extent the designated derivative has been 'successful' in achieving the RMI, the fair value changes of the derivative is would be recognised in future periods when the changes in economic value inherent in the underlying items are realised (as described paragraph 30 of Agenda paper 4B for the February 2022 meeting).

Earnings perspective

38. As noted in paragraph 32 of this paper, for financial assets measured at FVOCI interest is calculated using the effective interest method and recognised in profit and loss, in the same way as for financial assets measured at amortised cost. Therefore, an entity would be exposed to earnings variability.

39. However, as noted for the economic value perspective (see paragraph 36 of this paper), an accounting mismatch exists in profit or loss between interest recognised (calculated using the effective interest method) on the financial asset and the gain or loss on the derivative used to mitigate interest rate risk. As a result, the entity might need to mitigate the variability of its NII.

40. When applying the DRM model, the reduction in variability in net interest income is achieved through the unwinding of the DRM adjustment over time which will be recognised in NII, therefore providing 'protection/benefit' in future periods when the net interest income generated by the underlying items are recognised in profit or loss.

Does application of the DRM model provide a faithful representation of the economic phenomenon?

41. Applying the DRM model, the protection/benefit of dynamic risk management is realised in the form of a reduced variability in both fair value and net interest income. This benefit results from the economic relationship between the risk mitigation intention and the designated derivatives. The economic relationship is established by documenting the entity's risk management strategy and objective for managing repricing risk related to changes in interest rates.

42. As discussed in Agenda paper 4B for the February 2022 meeting, the DRM adjustment resulting from applying this approach represents the extent to which the derivatives mitigated the variability in both the fair value and the net interest income from the risk mitigation intention in profit and loss over the time horizon that the risk is mitigated.

43. The DRM adjustment would therefore achieve a reduction in variability in fair value movements and future net interest income in profit and loss as explained in paragraphs 34–40 of this paper.

44. However, it should be noted that the application of the DRM model to financial assets measured at FVOCI would not achieve a reduction in total fair value variability in the statement of financial position (ie in OCI), because the DRM model is not a fair value hedge and does not affect the measurement of the underlying items. For this reason, the DRM model (through the DRM adjustment) would also not be double counting for any fair value changes of the underlying items.

45. The staff believe that although including FVOCI financial assets in the CNOP would not achieve an offsetting position in the statement of financial position, the DRM adjustment would nevertheless achieve the dual objectives of the DRM model, ie provide an offset when the net interest income and/or economic value inherent in the underlying items is realised (when it affects profit or loss). Therefore, the staff think that the DRM adjustment does faithfully represent the underlying economic phenomenon and as a result FVOCI items should be eligible for designation in the CNOP.

Question for the IASB

Question for the IASB
Does the IASB agree with the staff recommendations set out in paragraph 6 of this paper?