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Introduction

1. The objective of this paper is to demonstrate how the dynamic nature of portfolios will affect both the asset and target profiles within the Dynamic Risk Management (DRM) accounting model based on tentative decisions to date. This paper also shows how the dynamic nature of portfolios will affect the interaction between the asset and target profile. This paper does not ask for any additional tentative decisions from the Board.
2. This paper is structured as follows:
 - (a) Background (paragraphs 3 – 6); and
 - (b) Interaction between Target and Asset Profile (paragraphs 7 – 65).

Background

3. Dynamic risk management is a process that involves understanding and managing how the net of interest income and interest expense will change with interest rates over time. DRM first aggregates individual financial assets and liabilities into portfolios and then manages the net of interest income and interest expense on a combined basis. However, portfolios are constantly changing, as new financial assets and liabilities are added and existing ones mature over time. The ever

changing nature of portfolios create significant operational difficulties when applying the existing hedge accounting requirements within IFRS Standards.

4. The staff would highlight that the changing nature of portfolios is a real economic phenomenon, not simply a term used within accounting literature. As such, when creating their risk management policies and procedures, entities will acknowledge that managed portfolios are subject to change over time and consider the impact of such changes on their ability to accomplish the risk management strategy. There are numerous events that can change the composition of a portfolio and while this paper does not provide an exhaustive list of events that could cause a portfolio to change, the majority of these events relate to:
 - (a) the maturity and origination of financial assets and / or liabilities; and
 - (b) the consequential adjustments required to derivatives used for alignment between asset and target profiles.
5. This paper does not discuss performance or recycling in any depth. As tentatively decided during the December 2017 Board meeting ([Agenda Paper 4](#)), these areas will be discussed after the scope of the DRM accounting model is agreed with the Board. Consequently, this paper does not cover changes to the asset or target profile resulting from:
 - (a) changes in assumptions (such as prepayments); or
 - (b) de-designation due to financial assets or liabilities no longer meeting the qualifying criteria.

Interaction between Target and Asset Profile

6. In the following paragraphs, the staff will demonstrate how the dynamic nature of portfolios will affect both the asset and target profiles. In particular, the staff use a series of hypothetical examples to demonstrate how the dynamic nature of portfolios will impact the interaction between the asset profile, the target profile and the derivatives required for alignment.
7. For illustrative purposes, these scenarios are separated into the following groups:

- (a) Static Profiles: where all future events are specifically identified, documented and designated at the inception of the DRM accounting model. This includes the following scenarios:
 - (i) termination of the DRM model at maturity;
 - (ii) continuation of the DRM model at maturity;
 - (iii) reinvestment designated within the asset profile; and
 - (iv) growth designated within the asset and the target profile.
- (b) Open Profiles: In addition to future events documented and designated at the inception of the DRM accounting model, open profiles consider future events not specifically identified at inception but nonetheless within the scope of the entities DRM function. This includes:
 - (i) changes in the notional of the asset and the target profile over time where growth is not designated.

Scenario A – Static Profile – termination at maturity

8. This scenario illustrates how an entity would initially designate both the asset and target profiles within the DRM accounting model. It also demonstrates what happens when all financial assets and liabilities mature and the DRM model terminates.
9. Consider an entity that has CU 1,000 3-year floating rate financial assets yielding LIBOR +1.00% and CU 1,000 of 3-year fixed rate financial liabilities that bear 6.00% interest. Consistent with the entity's risk management policies and procedures, the entity defines the financial assets as a portfolio within the asset profile and defines the portfolio of financial liabilities used to determine the target profile. The entity completes the necessary documentation requirements indicating:
 - (a) how the financial assets and financial liabilities within the scope of the DRM accounting model satisfy the applicable qualifying criteria;
 - (b) the entity intends to manage 100% of interest rate risk within the defined portfolios and sets the designated percentage as 100%; and
 - (c) the entity's risk management strategy which in this case is to stabilise the net of interest income and expense over a 3-year period. The time

horizon in this scenario is 3 years given the contractual terms of the entity’s financial liabilities as discussed in the March 2018 Board meeting.

10. Having completed the necessary documentation requirements, the entity begins applying the DRM accounting model to the formally designated portfolios. This is consistent with the Board’s tentative decision that the application of the DRM model should take effect from the date an entity has completed the necessary documentation to designate a specific portfolio. This requirement applies to both the asset and target profiles.
11. The tenor of asset profile and target profile before any derivatives are executed are as follows:

Chart 1¹

Scenario A	Float	20X1	20X2	20X3	Total
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Difference	1,000			(1,000)	0

12. As shown in chart 1, the entity has not achieved alignment and therefore uses derivatives to transform the asset profile and eliminates the difference between the asset and target profile. In this example, the entity executes a CU 1,000 3-year receive fix, pay float interest rate swap. The fixed leg of the interest rate swap has a stated coupon of 6.00% and the floating leg has a stated coupon of LIBOR.

¹ As previously indicated, all figures in this paper are hypothetical.

Chart 2

Scenario A	Float	20X1	20X2	20X3	Total
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Initial Difference	1,000			(1,000)	0
Receive Fix, Pay Float	(1,000)			1,000	0
Final Difference	0	0	0	0	0

13. Having achieved alignment, no further actions are required. Each period the entity will recognise interest income of 7.00% from the transformed asset (LIBOR + 1.00% + 6.00% - LIBOR²). The entity will also recognise 6.00% interest expense from its financial liabilities. As such, the net of interest income and expense will be stable at 1.00% over the 3-year period. More specifically, the entity will recognise 1.00% in 20X1, 20X2, and 20X3 respectively.
14. At the end of the 3-year period, the financial assets, the financial liabilities and the derivatives will mature. All will be derecognised and thus de-designated from the DRM accounting model. At this time, there should be no remaining balances in Other Comprehensive Income as all financial assets, financial liabilities, and derivatives within the DRM accounting model have matured. As there are no more items designated within the DRM accounting model, the entity would discontinue the use of the model at that time.

Scenario A – Conclusion

15. When applied to Scenario A, the DRM accounting model is similar to the existing hedge accounting requirements within IFRS Standards.

² The staff acknowledge that no tentative decision has been made regarding presentation in the statement of profit or loss.

Question for the Board**Question for the Board**

- 1) Does the Board have any questions regarding Scenario A?

Scenario B – Static Profile – continuation at maturity

16. The objective of Scenario B is to illustrate what happens when an entity's risk management strategy assumes financial liabilities are refinanced and financial assets reinvested on a continuous basis after maturity. In particular, instead of terminating the DRM model at the end of the 3-year period (as discussed in Scenario A), this scenario demonstrates how the DRM model will accommodate the continuous nature of risk management. In contrast to Scenario A where the risk management strategy was defined as a 3-year period, in this scenario the entity's risk management strategy is a rolling strategy. As part of the necessary documentation requirements, the entity clearly documents the rolling nature of its risk management policies and procedures. This is applicable both when defining and designating portfolios of financial assets and financial liabilities in the DRM accounting model. The entity also documents the time horizon of the target profile (ie the time period over which is the entity manages the net of interest income and expense). Given the requirement to consider the contractual terms of financial liabilities where present, the time horizon is defined as a rolling period of 3-years.
17. For the first 3 years, there is no difference between Scenario A and Scenario B. However, at the end of 20X3, assume the entity refinances the maturing financial liabilities by issuing another portfolio of 3-year fixed rate financial liabilities. Given a change in market interest rates since 20X1, the new financial liabilities bear 3.00% interest. The entity also originates a new portfolio of 3-year floating rate financial assets yielding LIBOR + 1.10%, which is 0.10% higher than the assets originated in 20X1.
18. As discussed at the February 2018 Board meeting ([Agenda Paper 4B](#)), once portfolios are identified and designated as part of the asset profile, new financial assets become part of the asset profile as they are recognised in the statement of

financial position in accordance with IFRS 9 if designation is consistent with the entities risk management policies and procedures. Such updates to the portfolio would not represent a designation or de-designation event but instead a continuation of the existing relationship. The same requirements are equally applicable to designated portfolios of financial liabilities considered when determining the target profile.³ As such, the DRM accounting model automatically applies to the new financial assets and liabilities recognised in the statement of financial position provided the qualifying criteria are met. This is because:

- (a) the newly originated financial assets and financial liabilities meet the definition of an already defined and designated portfolio; and
- (b) designation is consistent with the entity’s documented risk management policies and procedures.

19. In this scenario, at 20X1, the tenor of the asset and target profiles are the same as in Scenario A and therefore chart 1 has not been re-produced. Once the new financial assets and liabilities are originated at 20X4, the tenor of asset profile and target profile before any derivatives are executed are as follows:

Chart 3

Scenario B	Float	20X4	20X5	20X6	Total
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Difference	1,000			(1,000)	0

20. Similar to chart 1, the entity has not achieved alignment and therefore must execute new derivatives in 20X4 to accomplish its risk management strategy. The fixed leg of the interest rate swap executed at 20X4 has a stated coupon of 3.00% given a change in market interest since 20X1. The tenors of the asset, target profile and necessary derivatives are as follows at the beginning of 20X4:

³ For further information, refer to the April 2018 Agenda Paper 4B *Target Profile: Designation and Qualifying Criteria*.

Chart 4

Scenario B	Float	20X4	20X5	20X6	Total
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Initial Difference	1,000			(1,000)	0
Receive Fix, Pay Float	(1,000)			1,000	0
Final Difference	0	0	0	0	0

21. Similar to paragraph 13, the entity has achieved alignment and no further actions are required. However, given market interest rates have changed between 20X1 and 20X4, the amount of interest income and interest expense to be recognised will also change. Rather than 7.00% from the transformed asset, the entity will recognise 4.10% (LIBOR + 1.10% + 3.00% - LIBOR). However, the cost of the financial liabilities has also decreased from 6.00% to 3.00% and therefore, the net of interest income and expense will be 1.10% over the rolled 3-year period. More specifically, the entity will recognise 1.10% in 20X4, 20X5, and 20X6. Recognition in these periods is specifically attributable to the financial assets, liabilities, and derivatives originated at 20X4 rather than those originated at 20X1.
22. As discussed in paragraph 14, in Scenario B there should be no remaining balances in Other Comprehensive Income at the end of 20X3 and at the end of 20X6 as the derivatives required for alignment have matured.

Scenario B – Conclusion

23. This scenario demonstrates that there should be limited impact from re-balancing when new financial assets and liabilities are originated if risk management is conducted on a rolling basis and designation is consistent with the entity’s risk management policies and procedures. It also highlights the important role the time horizon of the target profile plays regarding performance. Contrasting Scenarios A and B, while both target profiles had a time horizon of 3 years, in Scenario A the entity discontinues the use of the DRM model after the period of 3 years, while

the DRM model accommodates the continuous nature of risk management in Scenario B.

Question for the Board

Question for the Board

2) Does the Board have any questions regarding Scenario B?

Scenario C – Static Profile – reinvestment

24. In Scenario B, the entity documented the risk management strategy would be continuous. However, in Scenario B the time horizon was a 3-year period as that is the period of time over which the entity was managing the net of interest income and expense. This was the time horizon because future financial assets and liabilities beyond the time horizon were not yet priced. Therefore, as the pricing of future assets and liabilities was already aligned, no further management was required. This is consistent with the discussion and tentative decisions reached during the March 2018 Board meeting ([Agenda Paper 4B](#)).
25. Scenario C demonstrates the application of the DRM accounting model when an entity needs to consider future transactions by extending the time horizon of the target profile past the contractual maturity of the asset profile. This would be the case if the entity issued 6-year fixed rate financial liabilities as opposed to 3-year fixed rate financial liabilities, keeping all other factors constant.
26. Consider an entity that has CU 1,000 3-year floating rate financial assets yielding LIBOR +1.00% and CU 1,000 of 6-year fixed rate financial liabilities that bear 8.00% interest. Consistent with the entity's risk management policies and procedures, the entity defines the financial assets as a portfolio within the asset profile and defines the portfolio of financial liabilities used to determine the target profile. The entity completes the necessary documentation requirements that are different when compared with Scenarios A and B for two reasons:

- (a) firstly, as tentatively agreed during the March 2018 Board meeting ([Agenda Paper 4B](#)), the time horizon of the target profile is the period over which the entity is managing interest rate risk. Therefore, given the entity’s risk management strategy is to stabilise the net of interest income and expense and the requirement to consider the contractual terms of the entity’s financial liabilities when determining the tenor of the target profile, also tentatively agreed during the March 2018 Board meeting ([Agenda Paper 4B](#)), Scenario C’s target profile is a 6-year fixed rate target profile. By contrast, Scenarios A and B have 3-year fixed rate profiles.
- (b) secondly, given the asset profile will mature after 3 years, the entity must reinvest in order to achieve alignment with the 6-year fixed rate target profile. Therefore, the entity must formally designate future transactions in the asset profile and document how it satisfies the applicable qualifying criteria for those future transaction(s).

27. Having completed the necessary documentation requirements, the entity begins applying the DRM accounting model to the formally designated portfolios. The tenor of asset profile and target profile before any executed derivatives are as follows:

Chart 5

Scenario C	Float	20X1	20X2	...	20X6	Total
Asset Profile	1,000			...		1,000
Asset Profile - FT						
Target Profile				...	1,000	1,000
Difference	1,000			...	(1,000)	0

28. The tenor of the asset profile is entirely float because the asset profile is comprised of:

- (a) existing floating rate financial assets until the end of 20X3; and

(b) highly probable future transactions from 20X3 until 20X6. It is known that the reinvestment will reflect market rates at 20X3 because the future financial assets have not yet been priced.

29. Similar to Chart 1, the entity has not achieved alignment and therefore must execute derivatives to accomplish the risk management strategy. The fixed leg of the interest rate swap executed at 20X1 has a stated coupon of 8.00%. The tenors of the asset, target profile and necessary derivatives are as follows at the end of 20X3:

Chart 6

Scenario C	Float	20X1	20X2	...	20X6	Total
Asset Profile - FA	1,000			...		1,000
Asset Profile - FT						
Target Profile				...	1,000	1,000
Initial Difference	1,000				(1,000)	0
Receive Fix, Pay Float	(1,000)				1,000	0
Final Difference	0	0	0	...	0	0

30. The entity has achieved alignment and no further actions are required. Each period the entity will recognise interest income of 9.00% from the transformed asset (LIBOR + 1.00% + 8.00% - LIBOR). The entity will also recognise 8.00% interest expense from its financial liabilities. The net of interest income and expense will be stable at 1.00% over the 6-year period. More specifically, the entity will recognise 1.00% in 20X1, 20X2, and 20X3.

31. At the end of 20X3, the existing financial assets will mature and the designated future transactions will occur, replacing the originally designated financial assets. As discussed in the February 2018 Board meeting ([Agenda Paper 4B](#)), when a designated future transaction occurs, the resulting financial asset must be allocated to a designated portfolio as long as it meets the qualifying criteria and designation is consistent with an entity’s risk management policies and procedures. Such

updating would not represent a designation or de-designation event but instead a continuation of the existing relationship.

32. Assuming for simplicity the new financial asset is also a 3-year floating rate financial asset, the resulting tenor of the asset profile, target profile, and the derivatives is as follows at 20X4:

Chart 7

Scenario C	Float	20X4	20X5	20X6	Total
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Initial Difference	1,000			(1,000)	0
Receive Fix, Pay Float	(1,000)			1,000	0
Final Difference	0	0	0	0	0

33. The entity is still aligned and no further actions are required. Each period the entity will recognise interest income of 9.00% from the transformed asset (LIBOR + 1.00% + 8.00% - LIBOR). The entity will also recognise 8.00% interest expense from its financial liabilities. As such, the net of interest income and expense will be stable at 1.00% over the remaining 3-year period. More specifically, the entity will recognise 1.00% in 20X4, 20X5, and 20X6.
34. As discussed in paragraph 14 and 22, there should be no remaining balances in Other Comprehensive Income at the end of 20X6 as the derivatives required for alignment have matured.

Scenario C – Conclusion

35. This scenario highlights there should be limited impact from re-balancing when an existing financial asset matures and is replaced by an already designated future transaction consistent with the entity’s expectations and documentation. While both Scenario B and C demonstrate the DRM accounting model over a 6-year time period, Scenario B achieved stability over a 3-year time horizon and demonstrated how the model will accommodate the rolling nature of risk management. In contrast, Scenario C had a 6-year time horizon and designation of

future reinvestments within the DRM model was required to achieve stability over the 6-year period..

Question for the Board

Question for the Board

3) Does the Board have any questions regarding Scenario C?

Scenario D – Static Profile – growth

36. In addition to designating reinvestment as a future transaction, as tentatively agreed during the February 2018 Board meeting ([Agenda Paper 4B](#)), entities may designate growth in the portfolio as a future transaction, subject to meeting the qualifying criteria. When entities designate growth, they should consider two additional factors:
- (a) to grow the asset profile, the entity would require additional funding, and therefore, the entity must designate growth in the target profile as well. This requires the entity to demonstrate that growth is highly probable for both the asset and target profile; and
 - (b) if an entity wishes to stabilise the net of interest income and expense, if neither growth in the financial assets nor the financial liabilities have been priced, no mitigating actions are required for the reasons discussed in paragraph 24. As such, as discussed in the February 2018 Board meeting, the staff expect growth to be designated most often when funded by expected growth in core demand deposits where future pricing is known and therefore, a mismatch in pricing exists.
37. Scenario D demonstrates the application of the DRM accounting model when an entity designates growth as a future transaction. The scenario assumes an entity is entirely funded by core demand deposits given the rationale explained in paragraph 36(b).

38. Consider an entity that has CU 1,000 3-year fixed rate financial assets yielding 6.00% and CU 1,000 of zero cost core demand deposits. Consistent with the entity's risk management policies and procedures, the entity defines the financial assets as a portfolio within the asset profile and defines the portfolio of financial liabilities used to determine the target profile. The entity completes the necessary documentation requirements as follows:
- (a) how the financial assets and financial liabilities within the scope of the DRM accounting model satisfy the applicable qualifying criteria;
 - (b) the entity intends to manage 100% of interest rate risk within the defined portfolios and sets the designated percentage as 100%; and
 - (c) the entity's risk management strategy which in this case is to stabilise the net of interest income and expense over a 3-year period (ie the entity wishes to eliminate all exposure to changes in market rates until the end of 20X3)⁴.
39. As this entity's risk management strategy is to eliminate all exposure to changes in market rates until the end of 20X3, the CU 1,000 of existing core demand deposits are allocated to the CU 20X3-time bucket. In addition, it is highly probable that the entity will originate CU 100 of new core demand deposits and new 2-year floating rate financial assets at the beginning of 20X2, both arising from growth. Given the entity does not want any exposure to changes in market rates until the end of 20X3, the entity designates the highly probable growth of CU 100 within the asset and target profile at inception, ie beginning of 20X1. When incorporating the CU 100 of core demand deposits in the target profile, the entity would allocate them to the same 20X3 bucket in order to reflect the entity's risk management strategy. The CU 100 of new financial assets would be allocated to the float time bucket based on the entity's expectations regarding future transactions. The allocations to the respective time buckets within the asset and target profile do not reflect when the transactions are expected to occur. Rather they reflect the expected impact on the asset profile, and the objective the entity

⁴ As discussed in the March 2018 Board meeting, although core demand deposits are considered perpetual in nature, management chooses the time horizon over which the net of interest income and expenses will be managed. See paragraphs 61-65 of this paper for further discussion on core demand deposits.

wants to achieve. By allocating the core demand deposits to the 20X3 bucket, the entity is stating it does not want the net of interest income and expense exposed to changes in market rates until the end of 20X3, even for financial assets not yet originated.

40. The entity completes the necessary documentation requirements, including documenting how growth is determined to be highly probable, and begins applying the DRM accounting model to the formally designated portfolios. The tenor of asset profile and target profile before any derivatives are executed are as follows:

Chart 8

Scenario D	Float	20X1	20X2	20X3	Total
Asset Profile				1,000	1,000
Asset Profile – 20X2 Growth	100				100
Target Profile				1,000	1,000
Target Profile – 20X2 Growth				100	100
Difference	100			(100)	0

41. Per chart 8, the entity has not achieved alignment and therefore must execute derivatives to accomplish the risk management strategy. While the required derivatives are different given the forward nature of growth, the impact on the DRM accounting model will be similar as discussed in paragraphs 24 through 35.
42. When the entity reaches the beginning of 20X2, the future transaction designated within the asset and target profile will occur. As discussed in the February 2018 Board meeting ([Agenda Paper 4B](#)), when a designated future transaction occurs, the resulting financial asset must be allocated to a designated portfolio as long as it meets the qualifying criteria. Such updating would not represent a designation or de-designation event but instead a continuation of the existing relationship. The same requirements are equally applicable to defined and designated portfolios of

future transactions considered when determining the target profile.⁵ If the entity was successful in aligning the asset and target profiles at inception, then there will be no other change required when the future transactions occur.

43. As discussed previously, there should be no remaining balances in Other Comprehensive Income at the end of 20X3 as the derivatives required for alignment have matured.

Scenario D – Conclusion

44. This scenario highlights there should be limited impact from re-balancing when an designated growth occurs in both the asset and target profiles consistent with the entity’s expectations and documentation.

Question for the Board

Question for the Board
4) Does the Board have any questions regarding Scenario D?

Scenario E – Open Portfolios

45. The previous scenarios assumed a constant designated notional of the asset and target profile over time. While scenarios A through D demonstrate how the dynamic nature will affect the designated profiles through the passage of time, these scenarios were simplistic in that they did not allow for increases or decreases in size of the asset and target profile. As most entities applying DRM are commercial operations with a stated purpose to earn profit, it is likely that they will originate new financial asset and liabilities prior to the maturity of its existing financial asset and liabilities. It is also likely that entities will experience growth not designated as part of the portfolios at initial designation. The following scenario demonstrates how new originations will impact the asset and target

⁵ For further information, refer to the April 2018 Agenda Paper 4B *Target Profile: Designation and Qualifying Criteria*.

profile in conjunction with the passage of time, without the complications of growth as a designated future transaction.

46. As stated in paragraph 4, the changing nature of portfolios is a real economic phenomenon, and entities should recognise that fact when documenting their risk management policies and procedures. More specifically, portfolios and the risk management strategy should be defined and documented in a manner that accommodates the dynamic nature of portfolios while providing clarity as to which items are in scope and which are not. For example, a portfolio of financial assets could be defined as all residential mortgages on the balance sheet originated by a given operating segment. This indicates that the portfolio is comprised all residential mortgages from a particular operating segment and new mortgages are added once recognised on the statement of financial position, provided qualifying criteria are met.
47. To demonstrate the implications of the above, consider an entity that has CU 1,000 of 3-year floating rate financial assets yielding LIBOR +1.00% and CU 1,000 of 3-year fixed rate financial liabilities with a yield of 6.00% as at 20X1. Consistent with the entity's risk management policies and procedures, the entity defines the financial assets as a portfolio within the asset profile and defines the portfolio of financial liabilities used to determine the target profile. The entity completes the necessary documentation requirements and, in addition to the discussion in paragraph 46, the entity specifically documents the following:
- (a) the risk management strategy is a continuous strategy (ie the entity will continue to manage risk after the time horizon of the target profile ends. But, since the future has not yet been priced, no actions are currently required);
 - (b) new originations are subject to DRM once they are recognised in the statement of financial position; and
 - (c) the entities risk management strategy is to stabilise the net of interest income and expense over the life of the originated liabilities.
48. Having completed the necessary documentation requirements, the entity begins applying the DRM accounting model to the formally designated portfolios. The tenor of asset profile and target profile before and after derivatives are executed

are identical as indicated in paragraphs 11 – 13. Furthermore, identical to paragraph 13, the recognition of interest income and expense in 20X1, 20X2, and 20X3 will also be 1.00% after the entity has perfectly aligned.

49. At the beginning of 20X2, the entity successfully issues another CU 1,000 of 3-year fixed rate financial liabilities. However, given a change in market interest rates, these liabilities have a yield of 4.00%. Also, the entity successfully originates another CU 1,000 of 3-year floating rate financial assets yielding LIBOR +1.00%. The origination of the new financial assets and the issuance of the new financial liabilities were not anticipated nor documented within the DRM accounting model at inception.

50. As discussed in paragraph 18, the DRM model updates the asset and target profile to include the new financial assets and liabilities once they are recognised in accordance with IFRS 9 and provided the qualifying criteria are met. This is because:
 - (a) the newly originated financial assets and financial liabilities meet the definition of an already defined and designated portfolio; and
 - (b) designation is consistent with the entity’s documented risk management policies and procedures.

51. As discussed previously, these updates would be treated as a continuation of the existing relationship, consistent with the concept of rebalancing discussed in IFRS 9.

52. Updating the asset profile is straightforward as the contractual terms dictate the new financial assets should be allocated to the float tenor within the asset profile. Also, given the documented risk management strategy is to stabilise the net of interest income and expense and the entity has clearly documented the portfolios of financial liabilities used to define the target profile, the entity updates the target profile accordingly and allocates the additional CU 1,000 to the 20X4 time bucket as demonstrated in Chart 9 below.

53. The tenor of asset profile and target profile after the updates but before any new derivatives are executed are as follows:

Chart 9

Scenario E	Float	20X2	20X3	20X4	Total
20X1 Assets	1,000				1,000
20X2 Assets	1,000				1,000
20X1 Target Profile			1,000		1,000
20X2 Target Profile				1,000	1,000
Initial Difference	2,000		(1,000)	(1,000)	0
20X1 Receive Fix, Pay Float	(1,000)		1,000		0
Updated Difference	1,000	0	0	(1,000)	0

54. The updates mean the entity is no longer aligned and therefore the entity uses derivatives to transform the updated asset profile and eliminates the difference between the asset and target profile. In this example, the entity executes another CU 1,000 three year receive fix, pay float interest rate swap. The fixed leg of the interest rate swap has a stated coupon of 4.00% given market rates have changed since the inception of the DRM accounting model. The updated tenors are as follows:

Chart 10

Scenario E	Float	20X2	20X3	20X4	Total
20X1 Assets	1,000				1,000
20X2 Assets	1,000				1,000
20X1 Target Profile			1,000		1,000
20X2 Target Profile				1,000	1,000
Initial Difference	2,000		(1,000)	(1,000)	0
20X1 Receive Fix, Pay Float	(1,000)		1,000		0
20X2 Receive Fix, Pay Float	(1,000)			1,000	0
Updated Difference	0	0	0	0	0

55. Having achieved alignment, no further actions are required. However, recognition of interest income in the statement of profit or loss is complicated given the layered nature of both the target profile and the derivatives required for alignment. More specifically, the contractual terms of the 20X1 derivatives are different from the 20X2 derivatives. Therefore, the DRM accounting model must consider the difference in contractual terms when recognising interest income and expense in the statement of profit or loss. Otherwise, the DRM accounting model would not accomplish the objective of faithfully reflecting, in financial reporting, the impact of DRM on the entity's current and future economic resources.
56. Continuing the scenario where in both 20X3 and 20X4 the entity successfully issues an additional CU 1,000 of 3-year fixed rate financial liabilities with a yield of 3.00%. Also, the entity successfully originates another CU 1,000 of 3-year floating rate financial assets yielding LIBOR +1.00%. As these financial assets and liabilities meet the definition of an already designated portfolio and designation is consistent with the risk management strategy, the DRM model automatically updates the asset and target profile accordingly. As discussed previously, these updates would be treated as a continuation of the existing relationship, consistent with the concept of rebalancing discussed in IFRS 9.

57. The updated tenors are as follows after incorporating the updates to the asset profile, the target profile and the derivatives required for alignment:

Chart 11

Scenario E	Float	20X4	20X5	20X6	Total
20X1 Assets					
20X2 Assets	1,000				1,000
20X3 Assets	1,000				1,000
20X4 Assets	1,000				1,000
20X1 Target Profile					
20X2 Target Profile		1,000			1,000
20X3 Target Profile			1,000		1,000
20X4 Target Profile				1,000	1,000
Initial Difference	3,000	(1,000)	(1,000)	(1,000)	0
20X1 Receive Fix, Pay Float					0
20X2 Receive Fix, Pay Float	(1,000)	1,000			0
20X3 Receive Fix, Pay Float	(1,000)		1,000		0
20X4 Receive Fix, Pay Float	(1,000)			1,000	0
Updated Difference	0	0	0	0	0

58. The updates shown in chart 11 are very similar in nature to those illustrated in chart 10. However, the staff would highlight that the initially designated financial assets, liabilities and derivative matured at the end of 20X3. As discussed in paragraph 14, there should be no remaining balances in Other Comprehensive Income at the end of 20X3 related to those derivatives used to align the 20X1 assets because that is the end of the period over which the entity is managing interest rate risk for that defined layer of the target profile.

59. The staff will elaborate further on the operational mechanics of recycling given the layered of the target profile when the staff discuss performance at a future Board meeting and specifically the implications for tracking. The staff acknowledge layering as described above could be operationally complicated, however, while risk management is conducted on an aggregated basis, some specificity is required in order successfully manage interest rate risk. For example, as different derivatives are required for 5-year fixed rate financial assets versus 10-year fixed rate financial assets given the same target profile, it would be inappropriate to aggregate the fixed rate financial assets in a way that ignores the difference in tenor. Given it is required for accurate interest rate risk management; entities have developed policies and procedures that address the need for specificity.

Scenario E – Conclusion

60. This scenario highlights how the target profile will become layered over time as new financial assets and liabilities are originated and designated within the DRM accounting model. It highlights the importance of tracking when recognising interest income and expense in the statement of profit or loss and more specifically, recycling.

Question for the Board

Question for the Board

- 5) Does the Board have any questions regarding Scenario E?

Where the target profile reflects core demand deposits

61. The previous scenarios did not discuss where the entity's approach to core demand deposits is used to determine the target profile, apart from a brief discussion/introduction in Scenario D. As such, this section discusses how the DRM accounting model will accommodate the dynamic nature of portfolios where the target profile reflects core demand deposits.

62. The following were tentatively decided during the March 2018 Board meeting ([Agenda Paper 4B](#)):
- (a) the determination of the target profile should take into account the entity's risk management strategy which in turn is influenced by the entity's approach when core demand deposits are present;
 - (b) although core demand deposits are perpetual in nature and different from other forms of financial liabilities, when determining the tenor of the target profile, they are bucketed into specified time periods based on the entity's risk management strategy;
 - (c) while the tenor of the target profile is established by risk management when core demand deposits are present, the tenor remains the period over which the entity is managing interest rate risk; and
 - (d) the target profile will not differentiate between a core deposit with a tenor of 5-years based on the risk management strategy and a fixed rate financial liability with a contractual tenor of 5-years.
63. If the entity's risk management strategy treats core demand deposits as a 5-year fixed rate financial liability, the DRM accounting model will treat core demand deposits as a contractual 5-year fixed rate financial liability for the purpose of performance assessment but also when considering the impact from the dynamic nature of portfolios. On that basis, the discussion in paragraphs 6 through 60 are equally applicable to core demand deposits given their treatment within the DRM accounting model.
64. However, in contrast with the earlier discussions, core demand deposits, by nature, will not mature given they are effectively perpetual in nature. Therefore, unless the entity changes the definition of the portfolios designated within the DRM accounting model, the target profile will continue to reflect the core deposit notional. When completing the necessary documentation requirements, entities should indicate what will happen when the target profile's time horizon matures where core demand deposits are present. More specifically, the roll of the target profile should be documented when core demand deposits are initially designated in the DRM accounting model.

65. If the entity changes the portfolio definitions then this is a change in the entity's risk management policies and procedures as it implies a change in the scope of DRM. While these changes can occur, they should be rare. If they are not rare, consideration should be given to discontinuing the use of the DRM accounting model. This applies to all scenarios, not just the discussion in paragraphs 61 through 65.