

## STAFF PAPER

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REG IASB Meeting

Project	Dynamic Risk Management		
Paper topic	Summary of discussions to date		
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## Introduction

1. The objective of this paper is to summarise the Board's discussions to date related to the Dynamic Risk Management (DRM) project. This paper is structured as follows:
  - (a) Business context (paragraphs 2-3);
  - (b) Objective of the project (paragraph 4);
  - (c) The approach to meet the objective (paragraph 5);
  - (d) The plan to meet the objective (paragraphs 6 – 8) and
  - (e) Decisions to date (paragraph 9).

## Business context

2. The core economic activity of some financial institutions can be described as raising funds to provide longer-term loans to customers. An adverse change in market factors, such as interest rates, can negatively impact interest income and interest expense and thus the performance of the financial institution. DRM is the process that involves understanding and managing how and when a change in market factors can impact interest income and interest expense. In the context of

financial institutions, matching re-pricing dates of cash inflows and outflows is a common approach used to mitigate the impact that changes in market factors can have on interest income and interest expense.

3. Some sources of funding, specifically demand deposits, can be insensitive to changes in market factors, such as market interest rates. Consequently, because interest expense will remain stable regardless of changes in market rates for an extended period of time, these deposits effectively represent perpetual fixed rate funding. As fixed rate perpetual life loans do not exist in sufficient quantity to match the quantum of deposits, aligning the re-pricing of loans and deposits is difficult and perfect alignment may not be possible. In this situation, while the financial institution cannot eliminate the impact of market factors on interest income and interest expense, it can influence the speed at which those changes impact interest income and interest expense. The ability to accelerate or delay re-pricing, but not eliminate, forces management to decide whether they will be proactive and take action altering re-pricing or if they will accept re-pricing based upon the terms of the originated loans. If the financial institution decides, or is required, to proactively manage interest income and interest expense, it must decide how changes in market factors should influence interest income and interest expense. This decision reflects management's target profile. In practice, as management cannot force customers to originate loans that are convenient from a re-pricing perspective, derivatives are used to influence the speed of re-pricing. The derivatives transform loans such that the financial institution's cash inflows will react to changes in market factors based on management's target profile rather than the profile based on the loans originated by the financial institution.
4. The decision on how interest income and interest expense will re-price with interest rates over time future represents an entity's target profile. For the purpose of the DRM accounting model the target profile must be consistent with an entity's interest rate risk management objectives. As such, if the entity's risk management objective focused on discounted cash flows, the target profile should reflect that objective.

## Objective of the project

5. The objective of developing a new model is to improve information provided regarding risk management and how risk management activities affect the financial institution's current and future economic resources. A perfect and complete reflection of all risk management in financial reporting is an aspirational objective as 'financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need.'<sup>1</sup> The aim of the model is to faithfully represent, in the financial statements, the impact of risk management activities of a financial institution in the area of dynamic risk management rather than perfectly capture every aspect of the risk management activity. The staff believe that to achieve the above, the model should consider the four pillars outlined below:
- (a) **Transparency:** Details of the company's risk management objective and the implications for current and future economic resources is largely absent from financial reporting today. Increasing transparency would better enable users to evaluate management's approach and rationale for their decisions;
  - (b) **Eligible Items:** The interaction between the risk management activities and the existing eligibility criteria for hedge accounting within IFRS Standards can create tension when the derivatives required to accomplish the risk management objective exceed existing eligible hedged items. This has been deemed the '*Capacity Issue*';
  - (c) **Dynamic Nature:** On a daily basis, events alter the composition of the assets of financial institutions. These changes often mandate additional DRM actions. As IFRS 9 usually requires one-to-one designations between eligible hedged items and hedging instruments, the additional mitigating actions lead to an overly complex process of frequent de-designations and re-designations of hedge accounting relationships. Such operational challenges result from the application of IFRS 9 hedge accounting requirements to dynamic portfolios;

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<sup>1</sup> Paragraph OB6 of the Conceptual Framework.

- (d) Performance Measurement: Current financial reporting provides some information regarding the effectiveness of hedging programs. However, the current measures reflect the performance of one-to-one relationships. Providing a simple and understandable metric demonstrating if management was successful in achieving their risk management objective as desired would be relevant information for economic decision-making.

### **The approach to meet the objective**

6. At the November 2017 Board meeting<sup>2</sup>, the staff presented the outline of the proposed DRM accounting model considering the feedback received on the 2014 DP and the education sessions completed throughout 2017. The Board decided that the DRM accounting model should be developed based on the cash flow hedge mechanics. In particular, it was decided that, if derivative instruments are successful in aligning the asset profile with the target profile, changes in fair value of such derivative instruments would be deferred in Other Comprehensive Income and recycled to profit or loss as the asset profile affects the statement of profit or loss. In a situation of perfect alignment, interest income would reflect the entity's target profile.

### **The plan to meet the objective**

7. At the December 2017 Board meeting<sup>3</sup>, the Board decided the staff should develop the accounting model for DRM in two phases. The Board asked the staff to develop the 'core areas' that are central to the model and then seek external feedback on that core model. The staff would then develop areas that are extensions of concepts developed during the first phase. These core areas will shape the fundamentals of the proposed DRM accounting model. The first phase

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<sup>2</sup> For further information, refer to the November 2017 Agenda Paper 4 *Outline of proposed DRM accounting model and next steps*.

<sup>3</sup> For further information, refer to the December 2017 Agenda Paper 4 *Proposed project plan*.

should capture a significant portion of DRM activities to provide an adequate basis for an early and thorough assessment.

8. At the same meeting, the Board decided the following areas require further discussion to develop the core of the DRM accounting model:
  - (a) Asset profile;
  - (b) Target profile;
  - (c) Derivative instruments used for DRM purposes; and
  - (d) Performance assessment and recycling.
  
9. The non-core areas will be addressed prior to finalising the project as they influence risk management actions and therefore should be considered in a complete accounting model. However, these areas represent more an extension of the core model rather than a fundamental change. These non-core areas include but are not necessarily limited to:
  - (a) Financial assets at fair value through Other Comprehensive Income. While interest from such instruments will impact interest income, they represent a smaller proportion of the portfolios managed by the DRM function;
  - (b) DRM derivative instruments other than interest rate swaps, such as options. The use of such instruments, although not absent, is not widespread due to market constraints and increased complexity when compared with interest rate swaps; and
  - (c) Equity as a source of funding for the target profile. Again, whilst this is prevalent in certain jurisdictions it is not the key driver for funding the target profile.

## Decisions to date

10. At the February 2018 Board meeting, the staff plan to discuss the asset profile. In particular, the staff expect to debate the role of the asset profile within the dynamic risk management (DRM) model and gather the Board's feedback on

additional guidance in the form of qualifying criteria to ensure consistent application of the asset profile. At that meeting the staff also plan to discuss:

- (a) Designation and situations requiring de-designation of items within the asset profile; and
- (b) Documentation requirements.