STAFF PAPER

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IASB® meeting

Project	Dynamic Risk Management (DRM)	
Paper topic	Project Direction	
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Introduction

1. The purpose of this paper is to ask the IASB whether it agrees with the staff recommendation to move the DRM project from the research programme to the standard-setting programme. It is not possible to publish an Exposure Draft for a project that is on the research programme.

2. In considering whether to add a standard-setting project to the work plan, the IASB requires the development of a specific project proposal and an assessment against the project criteria outlined in paragraph 5.4 of the IFRS Foundation's Due Process Handbook (Due Process Handbook).

3. This paper provides:

   (a) a summary of staff recommendation and questions for the IASB;

   (b) background of the DRM project;

   (c) Due Process Handbook criteria for adding a project to the standard-setting programme; and

   (d) staff analysis.

Summary of staff recommendation and questions for the IASB

4. Based on the staff analysis of the criteria in the Due Process Handbook for adding a project to the standard-setting programme and the progress the IASB made on addressing the key challenges identified in the outreach, we are of the view that the DRM model provides a feasible solution to the deficiencies in current reporting and will address the needs of users of financial statements identified in the *Discussion Paper: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (2014 DP). We therefore recommend that the IASB:

   (a) moves the DRM project to its standard-setting programme; and

   (b) continues using the expertise of existing advisory bodies instead of establishing a dedicated consultative group for the project.

5. The staff would like to ask the IASB the following questions:

Questions for the IASB
1. Does the IASB agree with the staff recommendation to move the DRM project from the research programme to the standard-setting programme?
2. Does the IASB agree with the staff recommendation that a dedicated consultative group is not needed for this project? If not, why?

Background of the DRM project

6. The IASB began its deliberations on the macro hedging project in September 2010. The drivers for initiating the project were the difficulties associated with applying existing hedge accounting requirements to a dynamically managed portfolio with continuous or frequent changes in the risk positions that are being hedged. These constraints make it difficult to reflect dynamic risk management in financial statements. For these reasons, the IASB decided to consider a new accounting model for dynamic risk management.

7. In April 2014, the IASB issued the 2014 DP as the initial due process step. The IASB noted that the development of an accounting model for dynamic risk management was not a modification to hedge accounting requirements but that it would instead be a fundamental change in how risk management is considered for the purposes of financial reporting. Given the complexities involved, the 2014 DP allowed the IASB to seek feedback on a broader range of alternatives and variations.

8. Although the 2014 DP had been successful in terms of gathering views of respondents and confirming the need for the project, the IASB decided that the project should remain in the Research Programme.

9. Based on the feedback on 2014 DP, the IASB developed the core elements of the new DRM accounting model (DRM core model). During the period October 2020–February 2021, the IASB and staff conducted outreach with banks that manage interest rate risk using dynamic risk management strategies to assess the viability and operationality of the DRM core model (2020 outreach).

10. In principle, almost all participants to the 2020 outreach supported the objective of the DRM model to better reflect the interest rate risk management strategy and activities in the financial statements and acknowledged the significant benefits the DRM model would bring. However, they also identified three key challenges that were considered to be fundamental to the viability and operationality of the DRM model.

11. At its May 2021 meeting, the IASB decided to explore whether feasible solutions could be developed for these key challenges, before deciding on the project direction. The tentative decisions of the IASB at the November 2021 meeting, resulted in refinements to the DRM model that addressed two of the key challenges—incorporation of risk limits and designation of a portion of prepayable assets in the DRM model. At this meeting, the IASB will discuss potential further refinements to the model to address the third key challenge—accounting mechanics of the DRM model (see Agenda Paper 4A of this meeting).

12. In light of the IASB's activities described in paragraphs 7–11, we think it is appropriate for the IASB to move the DRM project from the research programme to the standard-setting programme, instead of publishing a second Discussion Paper. As noted in paragraph 4.12 of the Due Process Handbook, discussion papers and research papers (as the main output of the research programme) are designed to elicit comments from interested parties and typically include a comprehensive overview of the issues, possible approaches to addressing the issues and the preliminary views of the IASB.

13. As previously noted, the IASB developed the DRM model taking into account the feedback on the 2014 DP and then conducted the 2020 outreach to assess the viability and operationality of the model. Following the discussion of Agenda Paper 4A at this meeting, the IASB would have completed its deliberations on the three key challenges

identified during the 2020 outreach. Preliminary feedback received indicates that the refinements to the DRM model made to address these challenges represent significant improvements towards better reflection of an entity's risk management strategy in the financial statements. For these reasons, in our view, the IASB has already collected sufficient information that enables appropriate understanding of the problem and potential solutions, helping the IASB to decide whether to add a standard-setting project to the work plan.

14. If the IASB decides to move the DRM project to the standard-setting programme, the staff will present a detailed project proposal at a future IASB meeting, setting out the specific areas for deliberation and potential timeline. These areas would include remaining issues highlighted during the 2020 outreach (ie matters other than the three key challenges), items the IASB decided to discuss in the second phase of the DRM project and potential disclosures.

Criteria for adding a project to the standard-setting programme

15. The Due Process Handbook states that when adding a standard-setting project to its agenda or making major amendments to existing Standards, the IASB evaluates the merits of adding the project primarily on the basis of the needs of users of financial reports, while also taking into account the costs of preparing the information. When deciding whether a proposed agenda item will address the needs of users of financial statements, the IASB considers:

    (a) whether there is a deficiency in the way particular types of transactions or activities are reported in financial reports;

    (b) the importance of the matter to those who use financial reports;

    (c) the types of entities likely to be affected by any proposals, including whether

    (d) the matter is more prevalent in some jurisdictions than others; and

    (e) how pervasive or acute a particular financial reporting issue is likely to be for entities.[1]

[1] Due Process Handbook, paragraph 5.4.

16. The Due Process Handbook also states the IASB should only add a standard-setting project if it concludes that the benefits of the improvements to financial reporting will outweigh the costs.[2]

Staff analysis

17. In this section, we provide staff analysis on:

 (a) whether there is a deficiency in current reporting;

 (b) the importance of any deficiency to users of financial statements;

 (c) the types of entities likely to be affected by the proposals and the pervasiveness of the problem;

 (d) the costs and benefits of the proposals; and

 (e) whether a project consultative group should be established.

Deficiencies in current reporting

18. As set out in the 2014 DP and confirmed during the 2020 outreach, the limitations of the hedge accounting requirements in IFRS 9 and IAS 39 have led to many entities, especially banks, finding it difficult to faithfully present the outcome of their dynamic risk management activities in their financial statements. As a result, some do not apply hedge accounting, while others apply it selectively, or use proxy hedging techniques. The following are examples of such limitations:

 (a) *open portfolios*: it is difficult to reflect dynamic risk management within the current hedge accounting framework because of the requirement to link specific hedging instruments with specific hedged items. In practice, current hedge accounting requirements treat an open portfolio as a series of closed portfolios with a short life (ie by periodic discontinuation of the hedge accounting relationship for the previous closed portfolio and by designation of a new hedge accounting relationship for the revised closed portfolio). This gives rise to operational complexities because hedge accounting relationships need to be tracked and hedge adjustments need to be amortised. In addition,

[2] Due Process Handbook, paragraph 5.7

the requirement is often onerous to apply given the frequency with which the hedged portfolios are updated, or the hedging objective is changed. The hedge accounting requirements are viewed as artificial because they are not consistent with the risk management processes, which do not distinguish between 'old' and 'new' exposures. Consequently, the accounting results do not usually provide users of financial statements with information that is consistent with risk management. This limits the relevance of the resulting information.

(b) *risk management on a net basis*: it is common for exposures to particular types of risk to be managed on a net basis. For instance, banks usually make risk management decisions based on the net interest rate risk arising from a combination of financial assets and financial liabilities. Although the fair value hedge accounting for a portfolio hedge of interest rate risk requirements in IAS 39 acknowledge that interest rate risk is often managed on a net basis economically, portfolio hedges are required to be designated on a gross basis for hedge accounting purposes. Consequently, entities have to identify eligible assets or liabilities and designate them as hedged items on a gross basis to obtain hedge accounting. This can result in risk management being misrepresented, as hedged items have to be selected to achieve accounting outcomes rather than to fully reflect risk mitigation activity.

(c) *dual character of net interest rate risk position*: entities focus on mitigating the repricing risk of the net interest rate risk position, which arise from the combination of variable and fixed-rate exposures. Accordingly, the economic mismatch has both fair value and cash flow variability when interest rates change and entities try to mitigate both aspects economically.[3] However, current hedge accounting requires the designation of the hedging relationship as either a fair value hedge with the fixed rate item or as a cash flow hedge with the variable rate item, although neither would faithfully depict the complete economic phenomenon in financial reporting.

[3] See paragraph BC6.98 of Basis for Conclusions on IFRS 9 which refers to the dual character of such a (net) risk position.

(d) *demand deposits*: in a banking environment, it is common for customers to maintain demand deposit accounts for an extended period of time. Because of this customer behaviour, risk managers often identify a part of the demand deposit portfolio that is considered to be stable and treat that portion as a fixed interest rate liability (reflecting its ‘sticky’ economic nature) for risk management purposes. These are generally referred to as core demand deposits. Risk managers manage the deemed interest rate risk of core demand deposits based on the expected behaviour of depositors. However, in order for items to be eligible hedged items in a fair value hedge, the fair value of the hedged items must vary with the hedged risk. Because the fair value of demand deposits is deemed to be constant for accounting purposes, fair value hedge accounting is precluded. To address this issue, for accounting purposes, banks commonly identify alternative items that can be designated as hedged items—for example, suitable variable interest rate assets for which cash flow hedge accounting can be applied. Therefore, this inability to achieve hedge accounting for core demand deposits directly reduces the faithful representation of risk management in entities’ financial statements.

19. In our view, the IASB therefore has sufficient information from the feedback received on the 2020 outreach, 2014 DP and previous other consultations to conclude that there are deficiencies in current reporting in relation to accounting for dynamic risk management.

Importance to users of financial statements

20. Users of financial statements are affected by lack of alignment between financial reporting and the economics of dynamic risk management. Interest rate risk management is a very important part of risk management, in particular for entities such as banks. As discussed at the April 2021 IASB meeting, due to the disconnect with risk management, the resulting hedge accounting information in financial statements is currently complex to understand and makes it difficult to communicate to users of financial statements the underlying business context of hedge accounting designations.

21. For example, as noted in the 2014 DP, despite the fact that dynamic risk management activities are usually implemented in a comprehensive manner, the application of hedge accounting in a ‘patchwork’ manner or through proxy designations to account for

dynamic risk management has resulted in a lack of transparency of financial information. Also, hedge accounting may be applied but in a way that involves significant operational effort, focusing on reducing profit or loss volatility in a manner that may not fully portray the economics of dynamic risk management. As a result, information provided for regulatory purposes or non-generally accepted accounting principles (non-GAAP) information becomes in some cases the only source of relevant information to users of financial statements that seek to understand how successful an entity has been at achieving its risk management objectives.

22. In responding to the 2014 DP, users of financial statements supported a project about accounting for dynamic risk management that would achieve better alignment between financial reporting and dynamic risk management, thereby ultimately providing more useful information. They noted that because dynamic risk management is an important function for financial institutions, a better representation of DRM activities would provide useful information for financial statement users' decision-making. One of their key requirements was to be able to analyse a banks' net interest income by the profit source (or driver) and derivatives by their use.[4]

23. The IASB's objective in developing the DRM model is to better reflect entities' interest rate risk management strategies and activities in the financial statements. Following the 2020 outreach, the IASB has made refinements to the DRM model which aim to further improve alignment to risk management view, hence ultimately providing more useful information to users of financial statements.

Types of entities affected and the pervasiveness of the problem

24. Historically, financial institutions, and banks in particular those manage interest rate risk dynamically on an open portfolio basis, were most affected by the deficiencies in the current reporting requirements discussed in this paper. As the DRM model is further developed, one of the areas for consideration would be to determine whether the model is suitable to be applied to risks other than interest rate risk or by entities other than banks.

[4] Agenda Paper 4C of the February 2015 IASB meeting.

Costs and benefits

25. As discussed at the April 2021 IASB meeting, the 2020 outreach participants identified the main benefits of the DRM model as:

    (a) *better reflection of risk management view*: with the incorporation of risk limits and the adoption of an aggregated risk view on the net interest rate exposure, the DRM model has the potential of more faithfully reflecting the risk management view because it integrates the entity's risk management strategy and provides a clear link between financial reporting and the actual risk mitigation activities taken under dynamic risk management.

    (b) *eligible items*: the inclusion of core demand deposit and future transactions as eligible items in the DRM model would help to address the deficiency discussed in paragraph 18(d).

    (c) *transparency*: the performance reporting elements of the DRM model such as alignment and misalignment of the target profile would provide information in the financial statements about the extent to which the entity was successful in achieving its risk management strategy for interest rate risk management.

26. In the 2020 outreach, some participants mentioned the perceived operational complexity linked to the implementation of the DRM model, including costs associated with changing current processes. Many of the issues raised stemmed from the anticipated issues associated with the construction of benchmark derivatives and/or the reflection of unexpected change in the underlying portfolios. However, the DRM model could also potentially reduce the costs because it replicates the risk management activities of the entity so that there is no need to conduct proxy hedge accounting, which does not reflect the actual activities of the entity (see paragraph 18).

27. Consequently, our preliminary assessment, subject to a more detailed effects analysis which will be undertaken before issuing an Exposure Draft, is that the benefits of the improvements to financial reporting from this project are likely to outweigh the costs.

Project consultative group

28. The Due Process Handbook requires the IASB to consider whether it should establish a consultative group for each major project it adds to its standard-setting programme. The

objective of consultative groups is to give the IASB access to additional practical experience and expertise. The Due Process Handbook states that it is not mandatory to have such a group, but if the IASB decided not to have it, it must explain why on the project page and inform the Due Process Oversight Committee.[5]

29. We think there is no need for a dedicated consultative group for the DRM project because:

(a) a dedicated consultative group would provide the IASB with feedback based on research, experience or background, for example, in order to offer different perspectives on a given topic. Given the long history of this project, the IASB has obtained extensive feedback throughout previous consultations. A dedicated consultative group at this stage could require additional time and resources which may further slow down the progress on the project;

(b) during 2020, we have already undertaken targeted outreach where detailed specialist knowledge was obtained with regards to how entities do dynamic interest rate risk management and related accounting challenges. Further targeted outreach could be undertaken, if needed, for particular issues; and

(c) the IASB's existing consultative groups, including drawing on the expertise of relevant parties in their jurisdiction, collectively have the necessary practical experience and expertise on the accounting for dynamic risk management to advise on this project. We have consulted with ASAF throughout the project and plan to continue using the expertise within ASAF and CMAC to obtain advice on the project.

[5] Due Process Handbook, paragraphs 3.59-3.60.