Dynamic Risk Management – Outreach feedback[1]
Cover Note

Objective

1. The objectives of the session on DRM are twofold:
   a. to present to EFRAG Board the feedback from the outreaches conducted by the IASB staff and the EFRAG Secretariat on the core model outreach; and
   b. to propose the next steps in the project to the EFRAG Board.

Background

2. While IFRS 9 *Financial Instruments* have improved the hedge accounting requirements for general purpose hedging, this is not true where risks are managed dynamically (i.e., with frequent changes to an open portfolio of assets and liabilities).
3. Currently, in both IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 it is possible to hedge a static group of items as both the cash flow and fair value hedge accounting requirements refer to an individual item or a group of items. IAS 39 also allows the hedge accounting for portfolio hedging under the fair value hedging of interest rate risk. However, the revision of IFRS 9 did not cover the issue of dynamic hedging and there are various concerns about the status quo, as set out in paper *05-03 – An introduction (the Core Model and some key risk management practices)*. Therefore, the IASB is considering a new model to replace the current portfolio hedging.
4. The replacement is of interest to those in Europe using the EU carve out but also to those banks who currently apply the portfolio hedging option in IAS 39 as issued, who require improvement to the current model.

IASB project (2014 to now)

5. The IASB started its discussions on the current project in 2010. Below is some of the highlights in the IASB project, including EFRAG activities/reports.

Project stage / period	Further details/links	Reference
IASB DP 2014	• The IASB discussion paper: *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach* to Macro Hedging • EFRAG Final Comment Letter • IASB comment letter analysis • EFRAG feedback statement	

[1] The DRM team consists of the following members: Almudena Alcalá; Didier Andries and Fredré Ferreira (team leader). The EFRAG DRM team would like to thank the participants to the outreach for their valuable contributions – it was very informative. We also want to thank the IASB staff for the opportunity to attend the meetings as well as the work they have performed.

Project stage / period	**Further details/links**	**Reference**
IASB agenda consultation 2015	In May, the IASB decided that the active research section of workplan after Agenda consultation.	n/a
EFRAG outreach 2016/2017	EFRAG report on findings on its research on Dynamic risk management	Report
IASB Core Model 2015 – 2019	• IASB development of the Core Model • EFRAG TEG/CFSS: 25 September 2019 • EFRAG FIWG: 15 November 2019	Paper 05-03
IASB outreach 2020/2021	• IASB outreach on the Core Model in Q4 of 2020 and Q1 of 2021. • EFRAG attended the meetings with European banks (excluding UK) and reached out to additional EU banks.	Paper 05-03
IFRS 17 FEA	• Considerations around hedge accounting for insurance entities	Appendix 5 of Appendix III
This meeting	**Core Model Feedback**	**Papers 05-02 and 05-03**
Next steps	• The IASB will redeliberate certain topics at future meetings, please see paragraph 30 below. • For EFRAG next steps, see paragraphs 31 and 32 below.	

Previous EFRAG Board discussions

EFRAG Board 14 January 2020

6. The EFRAG Board received a project update and a summary of the discussions at EFRAG FIWG on the project.

Outreach on DRM core model (Q4 2020 and Q1 2021)

7 The IASB staff announced in 2020 that it would perform outreach on its core model of the Dynamic Risk Management proposal globally to understand the views of preparers on the feasibility and other aspects of the model.

8 The EFRAG DRM team attended these meetings with European banks as observer, where agreed by the participating bank. The EFRAG DRM team led two interviews with European banks that were not on the IASB's outreach list. The IASB staff observed these meetings.

9 In total, the EFRAG staff attended 17 meetings with European banks and received written answers from one bank. Apart from two banks (one non-EU), all of these participants use the carve out. The IASB indicated that they had 19 participants from Europe and 27 overall which means the EFRAG Secretariat was privy to approximately 60% of the total outreach.

High-level feedback

10. The core model would allow to represent risk management activities more faithfully than the current IAS 39 as issued, specifically for the direction taken on the designation of a net position and the expansion of eligible items (specifically core demand deposits).

11. The use of a cash flow hedging mechanism (i.e., changes of FV of the hedging derivatives recognised in OCI) is causing concerns around IFRS equity volatility and specifically in CET1.

12. The core model operates on the idea of a single desired outcome for risk management purposes, but banks operate within accepted risk ranges or limits.

13. Many European participants referred to the key benefit of the carve-out, i.e., the introduction of a bottom layer and concerns around ineffectiveness. These are not part of the current core model.

14 The transition requirements to be applied (not yet considered at this stage of the project) will have a key role in shaping the profit or loss profile going forward.

15. Further details about the outreach and the feedback can be found in paper 05-02.

EFRAG FIWG discussion (7 May 2021)

16. Members were asked to clarify the preference for a fair value hedge (FVH) mechanism. The following emerged:

    a) The feedback on the PRA has to be seen in the specific context of the concern at the time that the PRA would lead to full or nearly full fair value accounting of the banking book.
    b) Furthermore, while cash flow hedging mechanism may have been mentioned as a solution, it was not the top choice of preparers and was one of many possibilities.
    c) While one may focus on cash flows when considering what needs to be hedged, it does not necessarily translate to a cash flow hedge mechanism.
    d) While hedge accounting is just an accounting concept, OCI volatility would be hard to explain. The volatility in the 'basis adjustment for portfolio fair value hedges' in the context of total assets or total liabilities is not as significant as such adjustments in OCI that forms part of the equity line.
    e) There was a concern that regulators would not be satisfied with a prudential filter if there is a significant excess of CET 1 over IFRS equity.
    f) If the concern is transparency, alternative disclosure solutions could be investigated. For example, users find sensitivity to interest rate changes disclosures in IFRS 7 very useful.

EFRAG TEG discussion on the feedback (19 May 2021)

Directions of the project

17. Members welcomed the IASB's response to the messages from the EU participants.

18. Members noted that DRM seems to be more suited to interest rate risk and asked about equity and commodity risk. They noted that implications for other industries, specifically insurance[2] should be considered as well.

19. It was noted that banks have started favouring the carve out in the last decade. It was also noted that more banks seem to have adopted the carve out more recently also in connection with the low level of interest rates.

20. Several EFRAG TEG members mentioned a reassessment of the reasons that led to the carve out of IAS 39 as an alternative; however, one of them did not think it was a viable alternative.

21. It was mentioned that risk management does not mean the same thing for all the banks: for the Nordic countries locking the interest rate margin is considered to be opening a risk position, while other geographies may consider that it on the contrary reduces the risk.

---

[2] EFRAG has recently worked on applying hedge accounting to insurance liabilities in the context of the Endorsement activities of IFRS 17, see Appendix 5 of Appendix III of the final endorsement advice.

22. Linked to the point above, members discussed the ambitions of the project: Should risk management be reflected in accounting? Some considered that given the different perspectives of risk management (e.g., forward-looking) and accounting (e.g., backward-looking) this would not even be possible. Members suggested to focus on a realistic approach and considered that this project may be best placed to only deal with the issues that gave rise to the carve out.

23. EFRAG TEG members noted that the focus on a single outcome as opposed to working with risk limits is as a big obstacle in regard to the core model as proposed.

Hedge accounting mechanics (FVH or CFH)

24. Different members supported FVH mechanism, as being easier to explain to CFH mechanism due to the natural off-setting achieved in profit or loss.

25. It was noted that OCI volatility is a serious concern for French banks even if a prudential filter is agreed and the concern is shared by strongly capitalised entities.

Other points

26. PRA: Members questioned why the PRA (Portfolio Revaluation Approach) would result in volatility. EFRAG TEG members suggested reconsideration of the PRA but only for risk mitigated positions.

27. The question of treatment of internal transactions was raised.

28. It was also noted that equity (being defined as a residual) as a hedged item was a difficult concept from an accounting perspective.

29. Members noted that users would know the accounting issues that matter for their entities, but not necessarily the technical details of hedge accounting.

The IASB's project plan

30. The IASB agreed at its meeting on 24 May 2021 to the following re-deliberation plan:

Indicative timeline	***Topics***
Q3 2021	Interaction between risk limits and target profile (see paragraph 10)
Q4 2021	Designation of a proportion of prepayable assets (see paragraph 13)
Q1 2022	Recognising changes in fair value of derivatives in OCI (see paragraph 11)
H1 2022	Decide on project direction

Proposed next steps

31. At its meeting of 19 May, EFRAG TEG has indicated that it considers the following steps as important:

    a. After 15 years of continuing use, investigate the perception of the current carve out, including in outreaches with auditors, investors and regulators. Do users get sufficient and reliable information? Do they understand what the entity is doing?

    b. Investigate current market practices, including how significant is the group of European banks that do not use the carve out.

    c. Consider education sessions on risk management strategies and approaches. Consider outreach with users regarding risk management.

32. The EFRAG Secretariat will also follow the IASB re-deliberations and continue the dialogue with EFRAG FIWG, TEG and Board.

Questions for EFRAG Board
33. ***Agenda paper 05-02***: Does EFRAG Board have comments or questions on the feedback from the outreach?
34. Does EFRAG Board have comments on the proposed next steps above?

Agenda Papers

35. In addition to this cover note, agenda papers for this session are:

    a. Agenda paper 05-02 – Feedback from the Core Model Outreach;

    b. Agenda paper 05-03 – An introduction (the Core Model and some key risk management practices).