

Dynamic risk management

An introduction to the DRM Model

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OVERVIEW

Introduction

The DRM core model

Background – risk management strategies





Introduction

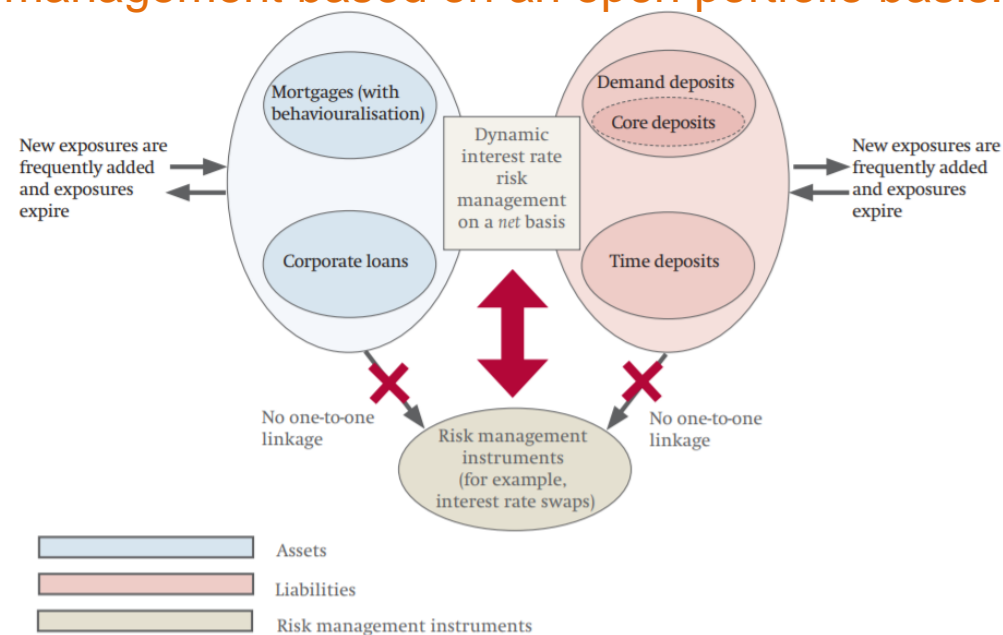
Why a change is needed

Introduction

- Risk management is a common activity that is applied by many entities - often managed dynamically

Banks often apply interest rate risk management based on an open portfolio basis.

- Exposures in these portfolios change frequently
- DRM is often performed on a net basis (entities assess the net risk position(s) arising from open portfolio) but not always.



IASB [Snapshot](#) on PRA

Why a change is needed

Current challenges under IAS 39 and IFRS 9

- One-to-one linkage between what is being hedged and the hedging derivative does not accommodate the dynamic nature of risk management
- Can only accommodate open portfolios by treating them as a series of closed portfolios with short lives. Is operationally challenging
- Can only indirectly accommodate risk management on a net basis through gross designation
- Allow for a limited degree of behaviouralisation of exposures (for example, prepayable mortgages)
- Limitations make it difficult to align with a risk management focus or systems
- Eligible hedged items excludes core demand deposits (based on interaction with IFRS 13)

The carve out

Description

- The carve-out therefore adjusts the IAS 39 fair value portfolio hedging to:
 - Relax effectiveness testing so that under-hedging does not lead to ineffectiveness (in practice banks usually apply the bottom layer approach to reflect the net risk position - i.e., a nominal value proportion (or synthetic risk position) of the portfolio instead of the entire portfolio)
 - Allow hedging of interest rate component of a portfolio core deposits
 - Today, many European banks apply the carve out.



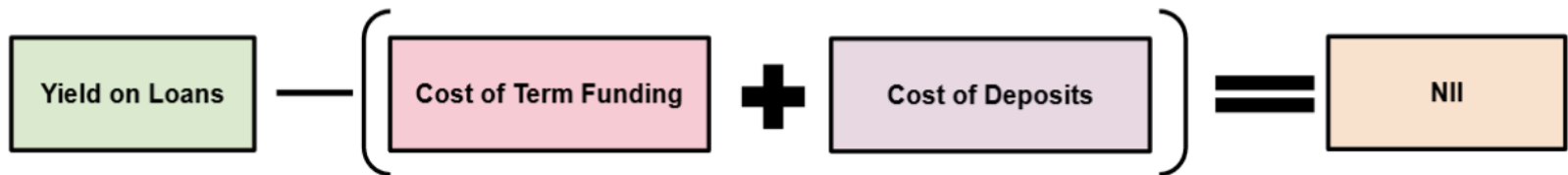


The DRM core model

The DRM core model

The core economic activity of some financial institutions can be described as raising funds to provide longer-term loans to customers.

The difference between yield on loans (interest revenue) and cost of funding (interest expense) represents the financial institution's net interest income (NII).



DRM is the process that involves understanding and managing **how and when a change in interest rates can impact NII**. As NII is the net of interest revenue and interest expense, a change that has an equal impact on both inflows and outflows would not impact NII.

Consequently, one of the best ways to prevent NII from changing is to match the re-pricing dates of financial instruments that give rise to interest revenue and expense.

The DRM accounting model aims to capture this activity in the financial statements.

Source: IASB

The DRM core model

Objectives

- To conclude the replacement of IAS 39 with the development of a macro hedge accounting model
- To improve information provided regarding risk management and how risk management activities affect a bank's current and future economic resources

Phases:



Why deposits?



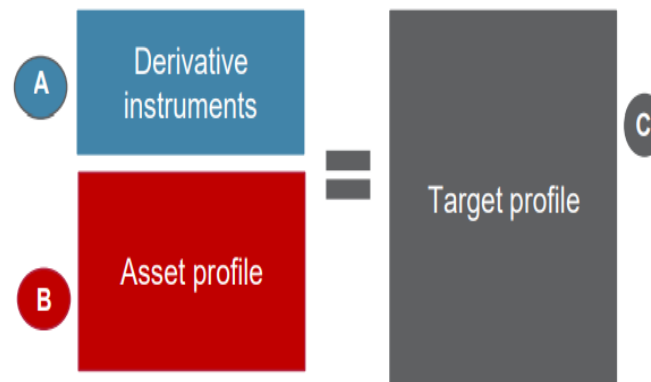
Capacity issue

The DRM core model

When derivative instruments (A) are perfectly successful in aligning the asset profile (B) with the target profile (C), changes in fair value of such derivatives are deferred in OCI.

In such circumstances, the results reported in the statement of profit or loss should reflect the entity's target profile. This in conjunction with the designated liabilities will ensure the net of interest income and expense will reflect the risk management strategy. Deferral and reclassification are the mechanisms by which the DRM accounting model achieves the above.

Assuming perfect alignment:



Source: IASB

The DRM core model

Asset profile

The asset profile allocates designated financial assets (FA) into time buckets based on their **re-pricing dates** (in contrast a balance sheet lists financial assets and liabilities at **a point in time**)

At a minimum, portfolios should comprise of FA of the same currency and with similar prepayment features.

Qualifying criteria:

- FA are measured at amortised cost under IFRS 9
- Future transactions (FT) are highly probable and will result in FA measured at amortised cost
- Items within the asset profile are managed on a portfolio basis for interest rate risk
- Items already designated in a hedge accounting relationship for interest rate risk are not eligible under the DRM model (cannot double hedge)*
- The effect of credit risk does not dominate the value changes.

Target profile

The target profile could be described as the funding profile adjusted for the entity's risk management strategy and approach regarding core deposits.

At a minimum, portfolios should comprise of liabilities of the same currency and core deposits are separated from other liabilities.

Qualifying criteria:

- Financial Liabilities (FL) are measured at amortised cost
- Future Transactions are highly probable and result in FL measured at amortised cost
- FL and FT are managed on a portfolio basis for interest rate risk; and
- FL and FT are not designated in a hedge accounting relationship for interest rate risk.

* It is not clear how de-designation under IAS 39/IFRS 9 and designation under the DRM model would work as this forms part of transition which will be considered later

The DRM core model

Benchmark vs. Designated derivatives

- **Benchmark derivative** is the theoretical derivative that would perfectly transform the asset profile into the target profile
- **Designated derivatives** within the DRM model are expected to be successful in meeting the same alignment target
- Qualifying criteria:
 - There is an **economic relationship** between the target profile, the asset profile and the derivatives designated within the DRM model
 - Any designation **does not reflect an imbalance** that would create misalignment that could result in an accounting outcome inconsistent with the purpose of the DRM accounting model.



The DRM core model

Core Demand Deposits

- Stabilising the Net Interest Income (NII) when the asset profile is entirely funded by core demand deposits raises complications as core demand deposits represent perpetual funding

Key features of core demand deposits

- *Demand feature (contractually repayable on holder's request)*
- *The notional of demand deposits treated as core and the associated tenor must be based on reasonable and supportable information*
- *The interest rate paid can only change at the discretion of the deposit issuer. The entity cannot be contractually obligated to change the interest rate paid when market interest rates change*

The DRM core model

Performance

- The aim of the DRM model is to faithfully represent the impact of a financial institution's risk management activities
- An entity perfectly achieves its risk management strategy. The model should reflect its risk, in the statement of profit or loss

Perfect Alignment

- *Achieved when the asset profile, in conjunction with the designated derivatives, equal the target profile*
- *These derivatives are called the benchmark derivative in the model*

Imperfect Alignment

- *Achieved when the designated derivatives are different from the benchmark derivative*
- *The effects of imperfect alignment on the entity's current and future economic resources*

Information provided:

- Assessing the entity's prospects for future cash flows; and
- Predicting how efficiently and effectively management will use the entity's economic resources in future periods



Background

Background

Approval and changes in risk management strategy

- Mostly set by Board of directors or delegated executive committee (ALCO)
- Changes: mostly on annual basis
- Monitoring daily, adjustments
 - Ad hoc – risk for breaching limits
 - Some frequently, intra-day
 - Some use « sweetspot » within the limit

Risk management levels

- Mostly have an aggregated IRM strategy across group (consolidated)
- Few, use decentralised way on subsidiary basis

Background

Risk metrics for assessing interest rate risks

- Using both EVE (long term) and NIM (short term)
- Different risk metrics used

Range of acceptable risk limits

- Range, not a single point
- Varies between banks, however regulatory backstop

Risk aggregation and time horizon

- Mostly internal fund pricing
 - Interest rate benchmark or proxy
 - Loan/deposit position between business unit and treasury
- Few include full coupon



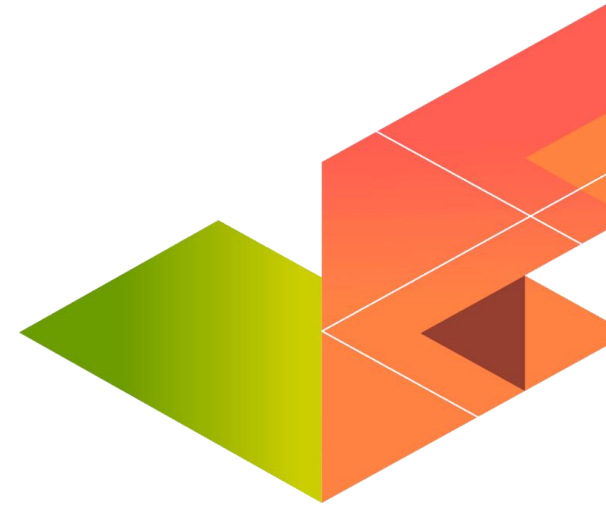
Background

Scope of assets and liabilities

- Defined by risk management
- Banking book positions
- Deemed exposures such as equity

Behaviouralisation methodologies

- Use of expected rather than contractual cash flows
- Variety of behaviouralisation methods used





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