IFRS Accounting

Staff paper

Agenda reference: 4A

IASB® meeting

Date	**July 2024**
Project	**Dynamic Risk Management**
Topic	**Applicable risk management activities for the DRM model**

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Introduction

1. While the DRM model has been developed with a focus on interest rate risk management in the banking industry, there has been acknowledgement throughout the project that the DRM model is an activity-based and not an industry-based model. At its October 2023 meeting, the IASB discussed the types of risk management activities that would be consistent with the IASB's objective for the DRM model—to better reflect an entity's dynamic interest rate risk management strategies and activities in the financial statements.

2. The IASB was not asked to make any decisions at the October 2023 meeting but the staff analysis about potential characteristics of risk management strategies and activities applicable to the DRM model are summarised in paragraph 24 of Agenda Paper 4 for that meeting.

3. One of the open questions with regards to the DRM model is whether there are entities other than banks that have dynamic interest rate risk management strategies, and if there are, to what extent their risk management activities are consistent with the preliminary activities discussed in October 2023.

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4. The purpose of this paper is to further discuss the applicable risk management activities for the DRM model and to summarise the discussions the staff had with a number of insurance entities to better understand their risk management strategies and activities.

5. This paper is structured as follows:

   (a) staff recommendations and the question for the IASB;

   (b) applicable risk management activities for DRM model; and

   (c) risk management strategy and activities of insurance entities.

6. In Agenda Paper 4B of this meeting we discuss whether the application of the DRM model is to be mandatory or optional.

Staff recommendations and the question for the IASB

7. Based on the analysis included in this paper, we recommend that the DRM model is only applied when an entity:

   (a) carries out business activities that lead to the recognition of financial assets and financial liabilities that generate and bear interest at different rates and over different maturities, which expose the entity to repricing risk;

   (b) adopts a dynamic risk management strategy that has a dual risk mitigation objective (ie both stabilising net interest income and economic value of equity) based on an aggregated (ie combined or net) repricing risk over a pre-determined period;

   (c) operates an established and systematic process to determine the net repricing risk exposures based on a specified managed rate, and make adjustments to the risk mitigation activities on a dynamic basis; and

   (d) has free access to a liquid market that enables the entity to raise funding or invest excess cash at the prevailing benchmark interest rate if and when needed.

8. We also recommend the IASB include a specific question in the Exposure Draft to obtain further input with regards to the business activities of insurers.

Question for the IASB
1. Do the IASB members agree with the staff's recommendations included in paragraphs 7 and 8 of this paper?

Applicable risk management activities for the DRM model

9. As discussed in Agenda Paper 4 for October 2023 IASB meeting, the applicable risk management activities for the DRM model, is a combination of an entity's business activities that give rise to the interest rate repricing risk exposure and the risk management strategy an entity undertakes to identify, monitor, mitigate and measure interest rate repricing risk.

10. Although the risk management strategies and the detailed risk management activities may differ between different entities, the following common characteristics/activities were observed among the entities that manage interest rate repricing risks dynamically:

    (a) business activities that lead to the recognition of financial assets and financial liabilities that generate and bear interest at different rates and over different maturities, which exposes the entity to interest rate repricing risk;

    (b) a dynamic risk management strategy that has a *dual* risk mitigation objective (ie both stabilising net interest income and economic value of equity) based on an aggregated (ie combined or net) repricing risk over a pre-determined period;

    (c) an established and systematic process to determine the net repricing risk exposure based on a specified *managed rate,* and make adjustments to the risk mitigation activities on a dynamic basis; and

(d) free access to a liquid interbank market or money market that enables the entity to raise funding or invest excess cash at the prevailing benchmark interest rate if and when needed.

11. Although the DRM model is not an industry-specific standard that is exclusive for use by the banks, the model elements are nevertheless closely aligned with the risk management strategies and activities that are currently most applicable by the banking industry. As a result, the application of the DRM model may not be appropriate (that is, may not provide useful information) unless an entity have a similar combination of business and risk management activities.

12. The combination of risk management strategies and activities, set out in paragraph 10 of this paper, help ensure that applying the DRM model better reflects how an entity is managing interest rate repricing risk in its financial statement, and that the entity does not simply apply the DRM model to achieve a particular accounting outcome.

13. However, we also think it is important to ensure that the DRM model is only applied when an entity's risk management strategy has a *dual* purpose, that being to reduce variability in both future earnings and economic value of equity. This dual purpose (or objective) is fundamental to the DRM model's recognition and measurement requirements.[1] For example, if an entity's risk management strategy was to mitigate either the changes in fair value or the variability in cash flows alone, the general hedge accounting requirements under IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and measurement* might be more appropriate than applying the DRM model.

14. Moreover, the existence of a specified managed rate is also an important characteristic of the applicable risk management activities because it is fundamental to each element of the DRM model. The managed rate refers to the particular benchmark interest rate(s) that an entity uses to aggregate and mitigate its interest rate repricing risk

[1] The dual purpose of the dynamic risk management activities was discussed in detail in Agenda Paper 4A of May 2022 IASB meeting.

exposure in accordance with the entity's risk management strategy. In our view, applying the DRM model when an entity does not actually manage the net repricing risk exposure holistically on such a basis would be inconsistent with the objectives of the DRM model. Furthermore, such application might give rise to artificial accounting results that neither faithfully represent the economic phenomenon of dynamic risk management activities nor provide relevant information.[2]

Risk management strategy and activities of insurance entities

15. Throughout the development of the DRM model, the IASB has been committed to obtain input from insurance entities about how they manage interest rate risk, and to assess whether the risk management strategy and activities of insurance entities could also be better reflected in financial statements using the DRM model. During the first half of 2024, the staff and some IASB members had targeted discussions with seven insurance companies, an insurance industry group, two auditor firms, and a national standard setter. These meetings helped us better understand how interest rate risk exposures arise from insurance activities, and how insurance entities manage and mitigate their interest rate risk exposures.

16. Some insurance entities are following the DRM project closely and consider that the application of the DRM model, with subject to some refinement (for example insurance liabilities being eligible for designation), could appropriately reflect how they manage interest rate risk. Others do not expect the model to be applicable to their risk management activities and therefore need more time to assess the potential implications of applying the DRM model.

17. In summary, we were told that:

    (a) Interest rate risk management is essential to insurance entities' business activities, and they are also closely monitored by regulators to ensure their

[2] The economic phenomenon of dynamic risk management activities are summarised in paragraphs 6 to 10 of Agenda Paper 4A of May 2022 IASB meeting.

ability to discharge their insurance liabilities are not significantly impacted by fluctuations in market interest rates.

(b) Although financial assets could be interest-generating, insurance liabilities typically do not bear interest—they neither have a fixed nor floating interest rate (ie do not give rise to interest rate repricing risk). However, the exposure to interest rate risk arises mainly because of discounting long-dated insurance liabilities. Therefore, although insurance entities are required to explain the relationship between insurance finance income or expenses and investment income, they do not typically monitor or communicate performance metrics that are similar to net interest income.

(c) Given the importance of the regulatory framework, the focus of insurance entities' risk management strategy is primarily on the net *fair value variability* of their financial assets and insurance liabilities as per their regulatory requirements (such as Solvency II in Europe). As a result, the risk management strategy of many insurance entities we have spoken with is driven primarily from the variability in economic value of equity (EVE) and does not appear to feature a *dual* purpose of mitigating variability in both net interest income (NII) and economic value of equity (EVE). Furthermore, although interest rate risk could be a significant contributor to fair value variability, it is sometimes not separated from other risks for risk management purposes. Instead, the interest rate risks are commonly managed together with other risks.

(d) Many insurance entities measure a significant portion of their financial assets at fair value through profit or loss (FVPL), which means the effects of interest rate changes are already recognised in profit or loss.

(e) Insurance entities might mitigate the duration gap by using derivatives to extend the asset duration. However, given the balance sheet structure of insurance entities (particularly in respect to predominantly long-dated insurance liabilities), risk management activities are less dynamic in terms of determining the desired risk mitigation intentions.

(f) Insurance entities generally have more flexibility with regard to the type of assets they invest in, including the currency, maturity, and other economic features of these assets, compared to the limited flexibility with regard to their insurance liabilities that are mainly customer driven. Therefore, some insurance entities prefer and have the ability to directly adjust the duration of financial assets they choose to hold, instead of relying extensively on the use of derivatives to manage their net interest rate risk exposures. For example, some insurers said they would invest in bonds with different maturities to extend or reduce the overall duration of their financial assets in order to manage the duration gap with their insurance liabilities..

18. Based on the above analysis, we think there are some similarities in how the interest rate risk exposure for insurance entities arises compared to the applicable risk management activities for the DRM model, but there also appear to be differences in many other areas. However, we acknowledge that we have only received input from a limited number of insurance entities and that many other insurance entities have not been involved in, or may not even be aware of, the DRM project to date.

19. Furthermore, most insurance entities have only recently applied IFRS 17 *Insurance Contracts* and IFRS 9 for the first time and therefore entities might still be in the process of understanding the effects of these IFRS Accounting Standards on their financial statements. They will therefore need more time to determine whether applying the DRM model would provide a faithful representation of their risk management activities in the financial statements.

20. Consequently, in our view, there is no sufficient basis to conclude that applying the DRM model to insurance business activities will provide useful information, as insurers generally pursue a different risk management strategy compared to the applicable activities for the DRM model—such as a stable solvency ratio instead of a stable net interest margin or economic value of equity of the underlying assets and liabilities.

21. We think it would be more efficient to progress the DRM model towards an Exposure Draft based on the business and risk management activities set out in paragraph 10 of this paper. In our view, the consultation period on the Exposure Draft will provide insurance entities with the best opportunity to become more familiar with the DRM model and provide their input and views. We therefore recommend including a question specific to insurance entities in the upcoming Exposure Draft.

22. However, with regard to the qualifying items for determining the current net open risk position, we acknowledge that the current requirements would exclude insurance liabilities as they are not measured at amortised cost. We therefore also recommend that for the purposes of responding to the Exposure Draft, insurance entities assume that insurance liabilities measured in accordance with IFRS 17 are eligible for designation in the current net open risk position.