IFRS Accounting

Staff paper

Agenda reference: 4B

IASB® meeting

Date	**July 2024**
Project	**Dynamic Risk Management**
Topic	**Optional application of the DRM model**
Contacts	Alev Halit Ongen (alev.halitongen@ifrs.org) Zhiqi Ni (zni@ifrs.org) Matthias Schueler (mschueler@ifrs.org) Riana Wiesner (rwiesner@ifrs.org)

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (IASB). This paper does not represent the views of the IASB or any individual IASB member. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS® Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB® *Update*.

Introduction

1. The IASB will decide on the applicable risk management activities for which the application of the Dynamic Risk Management (DRM) model would be appropriate and provide useful information, as set out in Agenda Paper 4A for this meeting.

2. The IASB tentatively decided in July 2019 that the application of the DRM model is to be optional. The purpose of this paper is to analyse whether the optional application of the DRM model remains appropriate, following the tentative decisions taken to further develop the DRM requirements since July 2019.

3. This paper is structured as follows:

   (a) staff's recommendation and the question for the IASB;

   (b) background and a reminder of the IASB's previous tentative decision;

   (c) summary of recent feedback; and

   (d) staff analysis and conclusion

The International Accounting Standards Board is an independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRS Standards. For more information visit www.ifrs.org.

Staff's recommendation and the question for the IASB

4. Based on the analysis included in this paper and the IASB's tentative decision of July 2019, the staff recommend that the application of the DRM model remains optional.

Question for the IASB
1. Do the IASB members agree with the staff's recommendation included in paragraph 4 of this paper?

Background and a reminder of the IASB's previous tentative decision

2014 DP

5. In relation to the application of the portfolio revaluation approach (PRA), question 16 of the Discussion Paper: *Accounting for Dynamic Risk Management – a Portfolio Revaluation Approach to Macro Hedging* that was published in 2014 (2014 DP) asked for comments on the following two questions:

   (a) Do stakeholders think that the application of the PRA should be mandatory if the scope of application of the PRA were focused on *dynamic risk management*? Why or why not?

   (b) Do stakeholders think that the application of the PRA should be mandatory if the scope of the application of the PRA were focused on *risk mitigation*? Why or why not?

6. The corresponding feedback was analysed in Agenda Paper 4B of the IASB's February 2015 meeting. Most respondents favoured the optional application of PRA regardless of the scope alternatives and said that:

   (a) optional application of PRA would be consistent with the general hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and*

measurement and IFRS 9 *Financial Instruments* which are applied on an optional (and a hedge-by-hedge) basis.

(b) entities should have the flexibility to choose from various accounting methods (fair value hedging, cash flow hedging, PRA, fair value option) to best represent their business and risk management activities.

7. Only a few respondents mentioned disadvantages such as reduced comparability. A few prudential and securities regulators noted the potential inconsistency that could arise from the optional application of the hedge accounting requirements in IAS 39 and IFRS 9. They considered that the mandatory application of DRM could improve comparability and reduce inconsistent hedge accounting practices. However, they suggested that if optional application of PRA is permitted, then safeguards are required to be put in place that ensure consistent application and prevent selective accounting practices that are solely applied for achieving favourable accounting results.

Tentative decision of 'optional application'

8. In July 2019, the IASB tentatively decided that the application of the DRM model is to be optional. At the time, the IASB considered, based on the analysis in Agenda Paper 4D of that meeting, that application of the hedge accounting requirements in IAS 39 and IFRS 9 are exceptions to the normal recognition and measurement requirements in IFRS Accounting Standards. An entity is permitted to apply these exceptions if, and only if, all the qualifying criteria are met.

9. This would also be true for the DRM model, and the existence of the qualifying criteria might make the mandatory application irrelevant. For example, in order to qualify for the DRM model and meet its performance requirements, there must be an economic relationship between the underlying items (financial assets and financial liabilities) and the designated derivatives. Regardless of whether applying the DRM model was mandatory, entities that fail to demonstrate such a relationship would not

qualify. Therefore, the mandatory application requirement, in addition to the strict qualification and performance requirements, would become irrelevant.

10. The IASB also considered at the time that the sophistication required in modelling and risk management systems could impose high costs on entities, especially those that are not equipped for such processes.

11. The IASB acknowledged that making the DRM model optional could reduce comparability, as different entities could choose whether to apply the DRM model or not. However, because of the differences in dynamic risk management strategies and approaches even among entities within the same industry, in many cases, making a principle-based DRM model mandatory would not achieve full comparability.

Summary of recent feedback

12. As discussed in Agenda Papers 4B and 4C of the IASB's June 2024 meeting, the staff and some IASB members discussed potential presentation and disclosure requirements of the DRM model with users of financial statements and preparers from the banking industry.

13. Although it was not necessarily the topic of discussion, preparers expressed strong views that applying the DRM model should remain optional. This is also consistent with the results of the survey conducted by Ernst & Young on behalf of The International Swaps and Derivatives Association (ISDA) that were published in May 2024 (see page 24 of the results). ISDA also prefer optional application (as outlined on page 11 of their white paper, published in May 2024) because in their view, this accommodates potential differences between the requirements of the DRM model and an entity's risk management practices and strategy.

14. On the other hand, most users of financial statements did not specifically comment on whether the DRM model is to be optional or mandatory. However, one equity analyst for the banking industry said that optional application of the DRM model might pose

challenges in achieving comparability amongst entities that manage their net interest rate risk exposures holistically and dynamically.

Staff analysis and conclusion

15. The IASB has further refined the recognition and measurement requirements of the DRM model since its tentative decision of July 2019 that allowed the optional application of the model. However, the objective of the DRM model and the intended applicable business and risk management activities for the DRM model have not changed since then.

16. In November 2017, the IASB tentatively decided that the objective of the DRM model is to better reflect the effects of dynamic risk management activities of an entity in its financial statements. To achieve this objective, applying the DRM model must provide useful information that will enable users of the financial statements to understand:

    (a) the entity's interest rate risk management strategy and how it applies this strategy to manage its interest rate risk;

    (b) how the entity's interest rate risk management activities may affect the amount, timing and uncertainty of its future cash flows; and

    (c) the effect that applying the DRM model has had on the entity's financial position and financial performance.

17. As discussed in both Agenda Paper 4 of the IASB's October 2023 meeting and in Agenda Paper 4A of this meeting, application of the DRM model would only be appropriate when an entity engages in business activities that expose the entity to interest rate repricing risk.[1] The DRM model would only apply when an entity's risk management strategy is based on managing an aggregated/net exposure from the

[1] Repricing risk refers to the risk that, when financial assets or financial liabilities reprice at different times, changes in interest rates result in variability in the net interest income or the fair value of underlying items in the current net open risk position.

financial assets generating interest income and financial liabilities generating interest expense.

18. Although there might be some common industry or jurisdiction specific characteristics, each entity's business and risk management activities are unique. In order for the application of the DRM model to be mandatory, the IASB would have to define and prescribe the exact dynamic risk management strategies and activities that would lead to the application of the DRM model. This would be difficult because of the diversity in the risk management strategies and activities in practice, and would be inconsistent with the objectives of a principle based approach. Providing such prescriptive definition would not be consistent with the objective of the DRM model either—to better reflect the effects of an entity's own dynamic interest rate risk management activities.

19. To illustrate, an entity might have the appropriate combination of business activities that give rise to interest rate repricing risk exposure and dynamic risk management activities (see Agenda Paper 4A of this meeting). However, by nature, the DRM accounting model might not be fully aligned with how an entity manages repricing risk, given the eligibility criteria for items to be included in the current net open risk position (eligibility criteria that was tentatively agreed by the IASB is summarised in Appendix A of Agenda Paper 4 of this meeting). Therefore, it would not always be appropriate to require an entity to apply the DRM model, as this might result in unintended consequences.

20. Furthermore, some entities might choose to accept the accounting volatility that arises from their interest rate risk exposure in full, or they might consider alternatives to the DRM model (or to other hedge accounting approaches under IFRS 9) that could achieve a similar outcome. For example, one of these alternatives involves designating the underlying exposures at fair value through profit or loss to reduce the accounting mismatch arising from measuring the financial instruments used for risk management at fair value through profit or loss.

21. The staff also agree with the previous analysis included in paragraph 8 of this paper and the feedback included in paragraph 6(a) of this paper that it is important to maintain a consistent approach between the application of the DRM model and the general hedge accounting requirements in IAS 39 and IFRS 9. The hedge accounting requirements in IAS 39 and IFRS 9, and the DRM model, are exceptions to the normal recognition and measurement requirements in IFRS Accounting Standards, and entities are only permitted to apply these exceptions subject to robust safeguards.

22. In the staff's view, it would be difficult to justify mandating the application of the DRM model for entities that have a significant exposure to interest rate repricing risk, such as banks and other financial institutions, whilst not mandating the application of a particular risk mitigation model (for accounting purposes) to other risks that might be equally significant to an entity's business activities.

23. In addition, the DRM model remains complex, and the sophistication required in modelling and risk management systems could impose high costs on entities, especially those not equipped for such processes.

24. As discussed in Agenda Paper 4A for the November 2021 meeting, the IASB expressed preliminary views not to allow optional discontinuation of the DRM model, and that the discontinuation of the model is only appropriate when there are changes to an entity's risk management strategy, meaning entities cannot voluntarily discontinue the model.[2] The optional application of the model would mean that entities that do not have a stable and long-term risk management strategy (ie when their risk management strategy is subject to frequent and substantial changes) would not have to apply the model. They would therefore be able to avoid incurring the unnecessary costs associated with implementation and discontinuation of the model when their risk management strategy changes substantially.

[2] In addition, as summarised in the Agenda Paper 4A for the April 2019 meeting, the IASB expressed preliminary views not to allow optional de-designation of financial assets or financial liabilities within the DRM model when the risk management objective remains the same and the financial assets or financial liabilities continue to meet the qualifying criteria. In addition, the IASB tentatively decided that the DRM model should not allow optional de-designation of a derivative when the risk management objective for that particular derivative remains the same. The IASB will further deliberate when the discontinuation of the DRM model occurs and what type of changes lead to discontinuation of the model at a future date.

25. The staff is doubtful whether mandating the application of the DRM model would enhance comparability between entities. In our view, because each entity's risk management strategy, level of risk appetite and risk tolerance, internal risk and cashflow models and processes are different, mandating the application of the DRM model would not necessarily achieve enhanced comparability.

26. We also note that, as summarised in Agenda Paper 4B for the June 2024 meeting, the IASB tentatively decided that the DRM adjustment and its unwinding are both required to be presented in separate line items in the primary financial statements. In our view, this will already enhance the comparability between entities that apply the DRM model and those that do not.

27. The staff might further explore whether the users of financial statements would also benefit from the disclosure of an entity's interest rate risk management strategy and how it applies this strategy to manage its interest rate risk, in cases when the entity does not apply the DRM model. Such disclosures might further improve comparability and understandability of different risk management activities of entities with significant exposure to interest rate risk, regardless of if and how they mitigated this risk.

28. The staff concludes that the incremental benefits, if any, of the mandatory application of the DRM model would be insignificant and outweighed by the implementation and ongoing application costs. Therefore, the staff recommend that the application of the DRM model remains optional and the IASB's tentative decision of July 2019 remains appropriate.