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## **Dynamic Risk Management – Outreach feedback Cover Note**

### **Objective**

1. The objective of the session on DRM is to provide feedback to EFRAG TEG and obtain its views on the feedback from the IASB staff and the EFRAG Secretariat on the core model outreach.

### **Background**

2. While IFRS 9 *Financial Instruments* is considered to generally have improved the hedge accounting requirements for general purpose hedging, this is not the case 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, there are various concerns about the status quo as set out in paper 05-04 – *An introduction to DRM core model*. Therefore, the IASB is considering a new model to replace fair value portfolio hedging under IAS 39.
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.

<b><u>Project stage / period</u></b>	<b><u>Further details/links</u></b>	<b><u>Reference</u></b>
<b>IASB DP 2014</b>	<ul style="list-style-type: none"> <li>• <a href="#">IASB Discussion Paper: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging</a></li> </ul>	Paper 06-04

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<sup>1</sup> 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 – we learned a lot. We also want to thank the IASB staff for the opportunity to attend the meetings as well as the work they have performed.

	<ul style="list-style-type: none"> <li>• EFRAG <a href="#">Final Comment Letter</a></li> <li>• IASB <a href="#">comment letter analysis</a></li> <li>• EFRAG <a href="#">feedback statement</a></li> </ul>	
<b>IASB agenda consultation</b> 2015	In May, the IASB decided that the active research section of workplan after Agenda consultation.	n/a
<b>EFRAG outreach</b> 2016/2017	EFRAG <a href="#">report</a> on findings on its research on Dynamic risk management	Paper 06-03
<b>IASB Core Model</b> 2015 – 2019	<ul style="list-style-type: none"> <li>• IASB development of the Core Model</li> <li>• EFRAG <a href="#">TEG/CFSS</a>: 25 September 2019</li> <li>• EFRAG FIWG: 15 November 2019</li> </ul>	Paper 06-04
<b>IASB outreach</b> 2020/2021	<ul style="list-style-type: none"> <li>• IASB outreach on the Core Model in Q4 of 2020 and Q1 of 2021.</li> <li>• EFRAG attended the meetings with European banks (excluding UK) and reached out to additional EU banks.</li> </ul>	Paper 06-04
<b>This meeting</b>	<b>Core Model Feedback</b>	<b>Papers 06-02 and 06-03</b>
<b>Next steps</b>	<ul style="list-style-type: none"> <li>• The IASB will discuss plans for redeliberating the significant topics at its next meeting.</li> <li>• Depending on the outcome of this meeting, the EFRAG Secretariat will either revert to FIWG or report to the EFRAG Board.</li> </ul>	

*Previous EFRAG discussions*

*EFRAG TEG-CFSS 25 September 2019*

6. The discussion focussed on aspects that should be considered when determining the participants in the outreach.

*EFRAG FIWG 15 November 2019*

7. The IASB Staff presented the IASB’s proposal and representatives of the EBF and the ESG were invited as observers with speaking rights.
8. The following key messages resulted from the discussion at the FIWG meeting:
- members expressed appreciation that the project is to reflect practices by banks, e.g., inclusion of core demand deposits in the scope;
  - members expressed concerns about the additional material volatility resulting in OCI from revaluation of the risk-mitigating derivatives. This would be difficult to explain and its treatment for prudential purposes uncertain;
  - the model introduces the new concepts such as “asset profile” and “target profile”. The model assumes that the bank has a specific target level for the risk management metrics, while in practice banks define “risk appetite”, i.e., range of possible values, which is not subject to frequent changes although the position in such a range will change regularly;
  - the DRM project has to consider the current practices of the banks that apply the carve-out. The driver of the application of the carve-out is not a specific

risk management approach but rather the structure of the balance sheet. The carve-out is applied by the following two categories of banks:

- i. banks need to be able to directly hedge their core deposits (as allowed by the carve-out);
  - ii. banks that have fixed rate loan exposures which they manage on a bottom layer basis for prepayment risk. This means banks only designate the stable part of their mortgage portfolio (“bottom layer”). This means prepayments do not affect the hedge unless their volume is so high that it hits the designated bottom layer amount (as allowed by the carve-out).
- e. members considered that the IASB should illustrate the proposed model for a bottom layer approach under the carve-out. IFRS 9 paragraph BC6.439(b), acknowledges that “hedging layers of groups of items (for example, a bottom layer) is a common risk management strategy”. Therefore, this risk management practice should be reflected in the DRM.

*EFRAG Board 14 January 2020*

9. The EFRAG Board received a project update, including a description of the IASB project as well as a summary of the discussions at EFRAG FIWG on the project. EFRAG Board members emphasised the need for a wide range of participants in the outreach given differences in exposures and risk management strategies.

*EFRAG FIWG 22 January 2020*

10. An update was provided about the outreach plan.

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

11. 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.
12. It was agreed that the EFRAG DRM team would attend meetings with the IASB staff, where agreed by the participating bank, as observer. Furthermore, 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.
13. In total, the EFRAG staff attended 17 meetings with European banks and received written answers from one bank. Two of these are public banks funded by issued debt whereas the rest are primarily funded by deposits. 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*

14. 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.
15. 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, although it could be retained if the IASB agrees to the introduction of a bottom layer.
16. Use of a cash flow hedging mechanism and resulting concerns around IFRS equity volatility and specifically in CET1.
17. There was feedback that the core model represents risk management activities more faithfully, specifically the designation of a net position is aligned with risk management strategies; the expansion of eligible items (specifically core demand deposits); and covering the hedging of equity to rather be included in phase 1 than later as planned.

18. The transition requirements to be applied (not yet considered at this stage of the project) will have a key role in shaping the P&L profile going forward.
19. Further details about the outreach and the feedback can be found in paper 06-02.

**Questions for EFRAG TEG**

20. **Agenda paper 06-02:** Does EFRAG TEG have comments or questions on the feedback from the outreach?
21. **Agenda paper 06-02:** Does EFRAG TEG envisage any further steps to be undertaken by EFRAG at this stage?
22. **Agenda paper 06-02:** Does EFRAG TEG have any specific questions for EFRAG FIWG about the Core Model and the outreach?
23. **Agenda paper 06-03:** Does EFRAG TEG have observations or questions on the risk management practices as described?

**Agenda Papers**

24. In addition to this cover note, agenda papers for this session are:
- a. Agenda paper 06-02 – Feedback from the Core Model Outreach;
  - b. Agenda paper 06-03 – Risk management practices by banks in Europe; and
  - c. Agenda paper 06-04 – An introduction to DRM Core Model – for background only.
  - d. Agenda paper 06-04A – the *IASB's DRM Scenario pack* is provided for those who want to see how DRM would perform in a variety of scenarios.

**Meeting preparation:**

The EFRAG Secretariat suggests to EFRAG TEG members with less experience or knowledge on the topic to start with agenda paper 06-04 on the introduction of the DRM core model. Secondly, agenda paper 06-03 describes the risk management practices around interest rate risk that the DRM intends to portray. These two papers will be briefly covered at the meeting. Lastly, agenda paper 06-02 provides the feedback on the outreach. This paper will form the basis of the discussion.