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Dynamic risk management: Equity and notional alignment – Issues Paper

Objective

- 1 The objective of the session is to update EFRAG FR TEG on the November 2022 IASB tentative decisions on the Dynamic Risk Management ('DRM') project related to the discussion on whether:
 - (a) equity should be eligible to be included in the current net open position; and
 - (b) the requirement for notional alignment of designated assets and liabilities should be reconsidered.

November 2022 IASB tentative decisions – Managing equity

What is done in practice as per the IASB Staff paper

- 2 Entities currently use different ways to reflect equity in their risk management activities. Generally, entities either include:
 - (a) equity equal to the excess of the designated interest-generating assets over the interest-bearing liabilities; or
 - (b) all the entity's equity.

The extent to which equity is included in risk management activities	How treated?
Equity equal to the excess of the designated interest-generating assets over the interest-bearing liabilities	<ul style="list-style-type: none"> - The gap between the designated assets and liabilities is included in the dynamic interest rate risk management process, via the use of 'replicating portfolios'. - Treated as a fixed rate liability, e.g., similarly to core demand deposits, at effectively 0% interest rate.
All the entity's equity	<ul style="list-style-type: none"> - Notionally determine a base return on their own equity similar to interest. - As a result, these entities include all the entity's equity as fixed interest rate risk exposures at the target base return they try to achieve. - The maturity profile of equity is determined based on the entity's risk management strategy.

IASB Staff analysis

- 3 Consideration on whether equity representing the funding gap between the assets and liabilities should be eligible for designation in the DRM model, requires an analysis of whether equity is exposed to variability in economic value and/or net interest income when market interest rates change.

Does equity give rise to variability in economic values?

- 4 The IASB Staff are of the view that including equity as a 'deemed' fixed rate liability does not represent the actual variability in economic value.

- 5 Reasons provided include:

- (a) For example, if an entity uses its equity to fund variable rate assets, any changes in interest rate would not change the fair value of the variable rate asset attributable to interest rate risk, which would stay close to the par value. On the other hand, equity is defined as the residual interest in the assets of the entity and this does not change in fair value in this example when benchmark interest rates change. Therefore, economically there would be no variability in economic value for the entity to mitigate in this case, and hence including equity as a 'deemed' fixed rate liability may not faithfully represent the economic phenomenon.
- (b) In the IASB Staff's view, unlike a fixed rate liability, equity does not give rise to variability in economic value due to changes in benchmark interest rates, therefore, it is difficult to justify the use of derivatives to mitigate interest rate risk.
- (c) Based on the example in paragraph (a), by trading a receive-fixed, pay-variable vanilla swap the entity creates exposure to EVE¹ as the fair value of the swap will fluctuate over time (and hence affects the overall residual value of the entity).

Does equity give rise to variability in net interest income?

- 6 The IASB Staff are of the view that equity in itself does not give rise to variability in net interest income.

- 7 Reasons provided include:

- (a) Any distribution of dividends or repayment of capital is recognised in the statement of changes in equity. As a result, equity in itself does not directly give rise to variability in an entity's net interest income.
- (b) To the extent that an entity uses equity to fund its designated assets, the overall variability in the entity's net interest income is determined by the portion of assets funded by equity. Equally, only the portion of equity used to fund the variable rate assets would give rise to repricing risk.
- (c) When all interest-generating assets and interest-bearing liabilities are designated in the DRM model, an entity would have already captured all the variability in net interest income.

- 8 It is acknowledged, however, that if an entity uses equity to fund part of the designated assets, excluding equity from designation in the DRM model while including the assets, would lead to notional misalignment. This is discussed as from paragraph 14 onwards below.

¹ Economic Value of Equity which is calculated as the present value of all asset cash flows less the present value of all liability cash flows

IASB Staff recommendations

- 9 The current net open risk position in the DRM model is determined by including all eligible assets and liabilities and future transactions, which would give rise to all the variability in net interest income and/or economic value when the benchmark interest rates change. Including equity as a 'deemed' fixed rate liability in the DRM model would not faithfully represent the actual variability in the economic value of equity.
- 10 Therefore, in the IASB Staff's view, designating equity is not necessary in the DRM model in order to reflect the actual repricing risk exposures, and the IASB Staff did not recommend the IASB to include equity as an eligible item in the DRM model.

November 2022 IASB tentative decisions

- 11 The IASB tentatively decided that in determining an entity's current net open risk position, the inclusion of equity is not necessary, and therefore, equity is not an eligible item for the purpose of the DRM model. All 11 IASB members agreed with this decision.
- 12 IASB members generally agreed with the IASB Staff's recommendation. Many supported the view that the exposure arises from financial assets and liabilities with one IASB member saying that using equity would be inconsistent with the Conceptual Framework.
- 13 It was noted that some banks are currently including equity and how this would affect them. The IASB Staff replied that they are using equity as a proxy but they could just as well use financial assets and liabilities, so it should not be too onerous for them.

November 2022 IASB tentative decisions – Notional alignment of designated assets and liabilities

IASB Staff proposal

- 14 When the IASB deliberated on the DRM core model in March 2018, the asset profile was defined as a combination of designed financial assets and eligible future transaction, while the target profile was the re-pricing dates for the asset profile based on an entity's risk management strategy.
- 15 A that time, the IASB tentatively decided that the notional amount of the asset profile should be the same as the notional amount of the target profile. In the IASB view, the potential misalignment would have implied:
 - (a) the target profile represents something other than specified re-pricing dates for items designated within the asset profile based on an entity's risk management strategy (e.g., leverage within the target profile);
 - (b) financial assets within the asset profile are funded by financial liabilities that are outside the scope of the entity's DRM policies and procedures. This would imply the risk management objective is not to manage the net of interest income and expense but merely interest income.
- 16 In November 2021, the key elements of the DRM model were redefined. In particular, the IASB tentatively decided to:
 - (a) revise the definition of the target profile as the range (risk limits) within which the current net open risk position can vary while still being consistent with the entity's risk management strategy;
 - (b) introduce the risk mitigation intention as a new single outcome element to the DRM model, representing the portion of the current net open risk position the entity intends to mitigate through the use of derivatives.

- 17 In November 2022, the IASB Staff recommended the IASB to amend its original tentative decision to no longer require the notional of eligible assets, liabilities and future transaction for designation in the current net open position to be the same.
- 18 The main reasons behind this proposal are:
- (a) feedback received from several participants highlighted that alignment would not be possible in practice (e.g., when equity is used as source of funding or when there is a mismatch in currencies between financial assets and financial liabilities);
 - (b) achieving notional alignment by excluding the excess amount of assets or liabilities would pose some practical challenges. Namely:
 - (i) requiring notional alignment would have been inconsistent with the definition of risk mitigation intention;
 - (ii) decisions about which assets or liabilities to exclude would have been completely arbitrary and could have create opportunities for cherry picking exposure to achieve particular accounting outcome;
 - (c) achieving notional alignment by requiring the shortfall to be treated as a deemed floating or fixed rate exposure would have created artificial presence or absence of variability in the net interest income and would have resulted in misleading information to users of financial statements;
 - (d) notional misalignment allows entities to choose their interest rate risk management priority between mitigating variability in term of net interest income or economic value, in line with the dual objective of the DRM model.

November 2022 IASB tentative decisions

- 19 The IASB tentatively decided that in determining an entity's current net open risk position, notional alignment is not required between the designated assets and liabilities. All 11 IASB members agreed with this decision.
- 20 The IASB members noted that it was consistent with the considerations and decision made regarding equity as eligible item.

EFRAG FIWG discussion (January 2023)

- 21 Members raised more concerns and possible proxy hedging 'solutions' than during the FIWG June 2022 discussion about the initial IASB discussions on the topic. There was concern that this would deviate from current risk management practices (although members acknowledged the conceptual reasons) and members asked for more guidance and illustrative examples to further understand whether the 'solutions' proposed would fit with the final requirements.
- 22 One member did not agree with the IASB Staff that equity does not give rise to variability in economic values and in net interest income and provided the following two examples:
- (a) Listed hybrid² instruments with fixed interest rates that are classified as equity (and so do not qualify for the DRM): the values of those instruments change daily.
 - (b) Plan assets in a pension plan, whereby if the pension plan holds interest bearing securities this results in variability in equity through OCI for the employer. If the value of the plan assets change, as interest is calculated on the net asset or liability there is an effect in profit or loss as well. In some

² These are generally instruments that pay coupon linked to an index or at a fixed rate, but which is payable at the discretion of the entity. Generally, from market participants' perspective, these are liabilities which 'change in nature to equity' as and when an entity approaches or enters insolvency. However, given the issuer's discretion, these are treated as equity for accounting purposes under IAS 32.

cases, local legislation prevents the pension plan from entering into derivative contracts. However, as the hedged item impacts equity the entity may not be able to hedge account for any hedging instruments which may be unattractive to users which would result in an unhedged position.

- 23 The member added that there was a need to look holistically at the risks related to equity which may include foreign currency risk such as hybrids issued in USD / GBP rather than functional currency. Where this is not the case, i.e., the item is only exposed to interest rate risk, the DRM model as currently conceived (no equity as eligible item and no notional alignment for designated assets and liabilities) could work.
- 24 Some members raised the issue that the IASB also needed to consider its tentative decisions in the context of these instruments including with respect to foreign exchange risk in addition to interest rate risk (also in the context of the FICE project).
- 25 One member stated that for Additional Tier 1 (AT1) instruments, if they have a call option, they have to be treated as liabilities with respect to the standard outlier EVE test, for regulatory purposes (for the interest rate risk calculation in the banking book). These instruments would not be able to be included in the DRM model, but for some regulatory purposes are treated as if they have a profit and loss impact.
- 26 One member illustrated a possible solution to include equity in the DRM model in line with the current IASB tentative decisions. He suggested that if equity is used as a source of funding, it can be treated as a fixed rate liabilities in the selected time bucket and matched with the corresponding fixed rate assets. Therefore, no derivatives are necessary for this portion of assets and the assets matching the equity could be kept in isolation. The DRM model can be applied to the other of the assets. As a result of this suggestion, the IASB's approach could lead to a practicable proxy solution to align the DRM model with the risk management activities.
- 27 Another member questioned the proportion of pure equity and hybrid instruments with exposure to interest rate risk. If equity is not included in the DRM model, focus should be on the floating rate gap. Then, the focus would be on the assets backed by equity rather than the equity itself and the fixed rate gap would change into a floating rate one. However, this is not the current way of thinking by banks. Also, as the examples used for the outreach focussed on the EVE approach and should now be reworked to show how it would work for interest rate margin management approach.

EFRAG Secretariat assessment

- 28 EFRAG Secretariat acknowledges the importance of having equity as eligible item for European constituents to ensure that the model is fully aligned with risk – management strategy and practices.
- 29 On the other hand, EFRAG Secretariat is aware of the challenges that the IASB would face in defining equity as an eligible item in the DRM model with a principle – based guidance (e.g., which components of equity should be allowed as eligible item – common shares, preference shares, retained earnings, revaluation reserves, foreign currency translation reserves, equity instruments that have characteristics similar to the debt instruments, etc.).
- 30 In addition, EFRAG Secretariat agrees with the IASB Staff conclusion that, from an accounting point of view, equity *per se* do not have direct exposure to changes in interest rates. Furthermore, from an accounting perspective given the discretion around payment, it does not give rise to variability in either economic value or net interest income.

- 31 Therefore, EFRAG Secretariat considers the IASB decision to no longer require the notional alignment of eligible assets, liabilities and future transaction (even if equity is not an eligible item) as a good compromise between accounting rules, the Conceptual Framework and the risk management practices. However, the EFRAG Secretariat wants to understand whether the tentative decisions of the IASB could create conceptual or practical problems, especially from those who currently consider/treat equity as an eligible hedged item for risk management purposes.

Questions for EFRAG FR TEG

- 32 Does EFRAG FR TEG agree with the IASB's tentative decision to not include equity as an eligible item in the DRM model in light of the IASB tentative decision to not require the notional of eligible assets, liabilities and future transaction for designation in the current net open risk position to be the same? Please explain.
- 33 Does EFRAG FR TEG have any other comments on the IASB's tentative decisions?