EFRAG

Financial reporting

EFRAG FR TEG meeting
7 October 2024
Paper 03-01
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Dynamic risk management

Cover note

Objective

1 The objective of this session is to provide an update to and to obtain feedback from EFRAG FR TEG members on the IASB's latest tentative decisions on DRM (the June and July 2024 IASB meetings) as well as the related discussions at the IASB and a summary of the recent discussions at EFRAG FIWG and IAWG over these issues.

Project status

2 At its June 2024 meeting, the IASB discussed and made tentative decisions on the following areas of the DRM:

(a) Capacity assessment;

(b) Presentation requirements;

(c) Disclosure requirements (discussions only, no tentative decisions were made).

3 At its July 2024 meeting, the IASB discussed and made tentative decisions on the following areas of the DRM:

(a) Applicable risk management activities for the DRM model;

(b) Optional application of the DRM model.

4 These subjects have been discussed at EFRAG FIWG meeting on 2 September 2024 (agenda papers of this meeting are uploaded as background information). Also, feedback on some of these topics, notably applicable risk management activities for the DRM model was received at EFRAG IAWG meeting on 9 September 2024 where the IASB DRM team presented the DRM model and the current status of the project to EFRAG IAWG members.

5 At its September 2024 meeting, the IASB discussed and made tentative decisions on the following areas of the DRM:

(a) Disclosure requirements;

(b) Discontinuation of the DRM model.

6 At its October 2024 meeting, the IASB is expected to discuss the remaining issues of the DRM, including transition requirements.

7 The issues from the September and October 2024 IASB meetings will be discussed at EFRAG FIWG and IAWG meetings and the results of these discussion will be brought to the attention of EFRAG FR TEG members at a later meeting.

8 The IASB is expected to publish the exposure draft late in H1 2025.

The IASB's tentative decisions and summary of discussions at the IASB, EFRAG FIWG and IAWG meetings

Capacity assessment

The IASB's tentative decisions (the IASB's June 2024 meeting)

9 The IASB tentatively decided that:

(a) an entity shall measure the maximum future economic benefit of its current net open risk position at the reporting date based on the present value of that position.

(b) an entity that has recognised a capacity shortfall in the DRM adjustment in profit or loss shall be required to recognise the unwinding of that shortfall in future periods on either a straight-line basis or on another systematic and rational basis over the risk-management time horizon.

(c) an entity shall not be permitted to reverse any capacity shortfalls it has previously recognised in profit or loss.

10 All 14 IASB members agreed with these decisions.

EFRAG Secretariat assessment

11 *General comment* – The IASB staff paper and the February 2023 IASB tentative decisions refer to **expected benefits** (in the form of reduced variability in earnings or economic value) represented by the DRM adjustment or to future **economic benefits** of the CNOP. The EFRAG Secretariat notes that these benefits are not the same as the economic benefits in the definition of the asset since the DRM adjustment does not meet the definition of asset or liability as per the Conceptual Framework. The benefits in terms of the reduced variability in earnings or economic value cannot conceptually be an argument for defending the value of the DRM adjustment.

12 *Measuring the CNOP for the capacity assessment* – Referring to paragraph 5 above, the assets and liabilities that are included in the CNOP are already recognised in the financial

statements. The EFRAG Secretariat assumes that it is the present value of all the expected future cash flows from these assets and liabilities discounted with the managed interest rate less the recognised value of those assets and or liabilities which would be used to compare with the DRM adjustment at the end of the reporting period for the capacity assessment.

13 *Effects of capacity shortfalls* – The proposed arbitrary recognition of the unwinding of the capacity shortfall must be accepted to make the model work in practice. With this acceptance, there is an acceptance that there is no rational basis for the recognised DRM adjustment after initial recognition.

14 *Reversing the effects of capacity shortfalls* – The EFRAG Secretariat concurs with the IASB staff's arguments leading to the conclusion that an entity shall not be permitted to reverse any capacity shortfalls it has previously recognised in profit or loss.

EFRAG FIWG meeting on 2 September 2024

15 Members, in general, were not clear on the mechanics of the capacity assessment and had several questions. For example, there were questions on:

(a) whether the mechanics of the capacity assessment focussed on net interest income ('NII') or economic value of equity (EVE), or both, and how would the capacity assessment work depending on the entity's risk management strategy;

(b) some concepts needed to be further articulated and explained; and

(c) how does the capacity assessment interact with the 'lower-of' test.

16 One member considered that it would be very complex to implement as the entity would need to keep track of all the historic fixed rates of the current net open risk position ('CNOP'). The capacity assessment may result in shortfalls which are not aligned with economic reality. CNOP has a higher sensitivity to changes in interest rates due to its size compared to the derivatives.

Presentation requirements

The IASB's tentative decisions (the June 2024 IASB meeting)

17 The IASB tentatively decided that an entity be required:

(a) to present the unwinding of the DRM adjustment recognised during the reporting period as a net amount in a separate line item in the statement of profit or loss;

(b) to present any misalignment (between the net gains or losses from designated derivatives and the DRM adjustment) recognised during the reporting period together with the fair value gains or losses from other derivatives; and

(c) to present the DRM adjustment as a net amount in a separate line item in the statement of financial position at the end of the reporting period.

18 All 14 IASB members agreed with these decisions.

The June 2024 IASB meeting – discussions

19 Some IASB members noted that the requirement to present the unwinding of the DRM adjustment as a separate line within the net interest income subtotal in the statement of profit or loss may be too prescriptive (there may be situations, e.g. consolidated financial statements of holding companies or conglomerates, where the NII subtotal will not be used in providing the useful structured summary as required by IFRS 18). Consequently, **the IASB's tentative decision requires its presentation as a net amount in a separate line item in the statement of profit or loss without explicitly referring to the NII subtotal**.

20 Some IASB members mentioned that **presenting the amount of misalignment together with the fair value gains or losses from other derivatives** may obscure this important item. The IASB staff emphasised that this issue **will be addressed via disclosure requirements** so that sufficient information is disclosed in the notes rather than presented on the face of the statement of profit or loss.

21 Some IASB members noted that 'gross' presentation of the DRM adjustment on the face of the statement of financial performance (i.e., presenting the gross amounts of the DRM adjustment as separate assets and liabilities instead of presenting a single net amount as either an asset or a liability) has its merits, provided that they result from completely unrelated CNOPs. E.g., one IASB member explained that presenting significant gross amounts of the DRM adjustment assets and liabilities (instead of a small net amount) may be indicative of the volume of the related risk management activities. The IASB staff noted that **further information needs, including disaggregation of the DRM adjustment asset/liability, will be addressed via disclosure requirements** and provided an analogy to accounting for hedging reserves (which is presented as a single net amount).

EFRAG Secretariat assessment

22 The EFRAG Secretariat agrees with the IASB's tentative decisions on the presentation requirements of the DRM model:

(a) The EFRAG Secretariat considers that the explicit requirement to present the unwinding of the DRM adjustment recognised during the reporting period as a net amount in a separate line item in the statement of profit or loss, will improve comparability between the financial statements of entities applying the DRM model. At the same time, removing the reference to the NII subtotal from this requirement may be helpful to address cases (which will likely be relatively rare) where such a subtotal will not be included in the useful structured summary. However, where the NII subtotal is included in the useful structured summary, this separate line item should be presented within this subtotal. Therefore, the EFRAG Secretariat highlights the importance of the final wording in the Exposure draft.

(b) The EFRAG Secretariat considers the presentation of the misalignment in the statement of profit or loss together with the fair value gains or losses from other derivatives as a balanced solution, provided that sufficiently disaggregated information is disclosed in the notes to the financial statements. Therefore, the EFRAG Secretariat highlights the importance of the disclosure requirements in this area.

(c) The EFRAG Secretariat also agrees with the IASB's tentative decision to present the DRM adjustment asset/liability as a single net amount on the face of the statement of financial position, rather than presenting separately gross amounts of the related assets and liabilities, provided that sufficiently disaggregated information is disclosed in the notes to the financial statements. Therefore, the EFRAG Secretariat highlights the importance of the disclosure requirements in this area.

EFRAG FIWG meeting on 2 September 2024

23 EFRAG FIWG members generally agreed with the EFRAG Secretariat views reflected in the agenda paper, i.e. supporting the IASB's tentative decisions on the DRM presentation requirements while emphasising the importance of the related disclosures. In particular, some EFRAG FIWG members highlighted their agreement with the presentation of the DRM adjustment as a single net item, either asset or liability, on the face of the balance sheet/statement of financial position.

Disclosure requirements

The June 2024 IASB meetings – discussions (no tentative decisions were taken)

24 The IASB was not asked to make any tentative decisions on the subject but rather to comment on the summary of feedback received and the preliminary views of the IASB staff.

25 The following are some of the key areas discussed during the meeting:

(a) Some members referred to commercial sensitivity of the information to be disclosed as one of the key concerns which needs to be further investigated;

(b) Level of disaggregation of the information to be disclosed was mentioned as another key concern where further agreement would be needed;

(c) Potential overlap with regulatory requirements should further be investigated, also keeping in mind that regulatory requirements may differ by jurisdiction;

(d) Disclosing unwinding of the aligned portion of the DRM adjustment was mentioned as a significant area by several members. In this context, several members referred to a broader issue of whether reconciliations, including in tabular format, should be required for this and potentially other important elements of the DRM model;

(e) Scope of the disclosures – will they only apply to the entities who choose to apply the DRM model or, to a certain extent, to other entities, who do not apply the DRM model but use similar risk management practices;

(f) Disclosing a coherent picture of the entity's risk management where the DRM model is applied together with other hedge accounting methods, e.g., with cash flow hedging.

EFRAG Secretariat assessment

26 The EFRAG Secretariat generally agrees with the proposed approach to the disclosure requirements of the DRM model, i.e. aligning those requirements with the existing general hedge accounting requirements of IFRS 7, while further adapting them to the particularities of the DRM.

27 The EFRAG Secretariat notes that additional DRM risk management related disclosures should consider existing disclosure requirements in paragraph 31, 33 and 34 of IFRS 7.

28 The EFRAG Secretariat notes the importance of some issues discussed in the IASB staff's paper and further raised at the IASB June 2024 meeting:

(a) Volume of disclosures to be required is to be agreed upon in order to avoid disclosure overload and, at the same time, provide the information which is really necessary for the users;

(b) The level of flexibility to be provided to the preparers is to be taken into account in order to, on the one hand, avoid boiler plate disclosures and assure that the disclosures are entity-specific and, on the other hand, achieve a necessary degree of comparability between entities;

(c) Disclosing commercially sensitive information is a valid concern which should be addressed. Therefore, key elements of such information are to be identified and taken into account when proposing the disclosure requirements;

(d) Further analysis of a potential overlap with regulatory requirements may be useful to avoid excessive costs for the preparers where similar information can be obtained elsewhere (e.g., via regulatory reporting), keeping in mind that regulatory requirements differ by jurisdiction, as noted during the IASB meeting, which limits the usefulness of such an alignment;

(e) Single location of the disclosure is a significant merit of the disclosures, which will address the concern of some users that the necessary information is currently scattered in multiple sources;

(f) Whilst disaggregation in the notes is, definitely, important for the users, it should be identified which disaggregated information, indeed, has a significant value for the users in order to avoid excessive costs for the preparers;

(g) The EFRAG Secretariat agrees that reconciliation, including in tabular format, may be useful for some items, e.g. the unwinding of the aligned portion of the DRM adjustment. However, to avoid excessive costs for the preparers, benefits of such requirements should be assessed vs their costs.

EFRAG FIWG meeting on 2 September 2024

29 Several EFRAG FIWG members mentioned that the focus of the DRM disclosure requirements should be on the possible mismatches resulting from the application of the DRM model. Members referred to a significant volume of information on interest rate risk management, which is already disclosed, e.g. in Pillar 3 reports.

30 Several EFRAG FIWG members referred to the disclosure of the future effects of the DRM adjustment (i.e., unwinding the DRM adjustment) as one of the key disclosure elements. They emphasised that simply disclosing the unwinding of the DRM adjustment in the future periods by time buckets will not be sufficient. Instead, the disclosures should provide a comprehensive view of the impact of the unwinding on the future performance of the entity and how that links to an entity's strategy.

31 EFRAG FIWG members gave several examples of commercially sensitive information (e.g., model assumptions, horizons of hedging, interest rate positions). The information is generally considered as sensitive if it has an impact on pricing and could help competitors set their pricing in an aggressive way or to 'reverse-engineer' the products. Therefore, a general way to mitigate possible concerns about commercial sensitivity of the information to be disclosed is providing it in an as less granular manner as possible to still result in relevant information.

Applicable risk management activities for the DRM model

The IASB's tentative decisions (the July 2024 IASB meeting)

32 The IASB tentatively decided that an entity would only be able to apply the DRM model if it:

(a) has business activities that expose it to interest rate repricing risk arising from financial assets and financial liabilities;

(b) adopts a dynamic risk management strategy with a dual objective that aims to mitigate the variability of both the net interest income and the economic value of equity, based on an aggregated (combined or net) repricing risk over a predetermined period;

(c) uses a systematic process to determine the net repricing risk exposure based on a specified managed rate and frequently adjusts its risk mitigation activities; and

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

33 The IASB also tentatively decided to include a specific question for insurers in the prospective DRM exposure draft to collect more information about their risk management strategies and activities.

34 All 14 IASB members agreed with these decisions.

EFRAG Secretariat assessment

35 The IASB in 2017 did not want to delay publication of IFRS 17 *Insurance Contracts* and considered that accounting for risk mitigation activities should be part of a broader project.

36 The following is noted in the Basis for Conclusions of IFRS 17, paragraphs BC54 and BC55.

BC54 Some stakeholders noted that the approach to accounting for risk mitigation activities in IFRS 17 does not fully eliminate accounting mismatches. In particular:

…

(b) some noted that the Board is researching a model for dynamic risk management, and suggested aligning the projects …

BC55 … the Board concluded that it would not be appropriate to develop a bespoke solution for all hedging activities for insurance contracts, noting that such a solution should form part of a broader project. The Board did not want to delay the publication of IFRS 17 pending finalisation of that broader project. …

37 The EFRAG Secretariat cannot at this point in time see that the statement “there is no sufficient basis to conclude that applying the DRM model to insurance business activities will provide useful information” is generally a valid statement. The EFRAG Secretariat intends to better understand the risk management activities of insurers in order to respond to the IASB’s specific question for insurers in the Exposure Draft.

38 The EFRAG Secretariat questions why a DRM model should only be developed for entities “with a **dual objective** that aims to mitigate the variability of **both the net interest income and the economic value of equity**, based on an aggregated (combined or net) repricing risk over a predetermined period” (our emphasis - see paragraph 10(b)). The EFRAG Secretariat expects a DRM model to be appreciated also by European entities only managing variability in economic value of equity (EVE).

39 The EFRAG Secretariat questions why a DRM model should only be developed for entities which “has **free access** to a liquid market that enables it to raise funding or invest excess cash at the prevailing benchmark interest rate” (our emphasis - see paragraph 10(d)). The EFRAG Secretariat expects a DRM model to be appreciated also by European entities that **use economic resources** to get access to a liquid market that enables it to raise funding or invest excess cash **with a discount or premium to** the prevailing benchmark interest rate.

40 The EFRAG Secretariat sees some possible concerns that the DRM model is being developed for a very limited number of entities.

EFRAG FIWG meeting on 2 September 2024

41 On the criterion that a dynamic risk management strategy has a dual risk mitigation objective (i.e. both stabilising net interest income (‘NII’) and economic value of equity (EVE)), members were of the view that it should be sufficient if an entity manages variability in NII **or** EVE <u>and not both</u>. One member indicated that due to regulatory requirements, banks needed to report on variability with respect to NII and EVE.

<u>Risk management strategy and activities of insurance entities</u>

42 One member considered that the criterion in order to apply the DRM model, relating to financial assets and financial liabilities generating and bearing interest at different rates and over different maturities, which expose the entity to repricing risk, may not work for insurers. Insurance liabilities are not contractually interest bearing but are exposed to interest rate changes and there is no explicit interest rate management.

43 This member indicated that insurers focussing on their risk management strategy which is based on their regulatory requirements was similar to banks managing variability in EVE.

44 Another member considered that the criterion on an entity having free access to a liquid market that enables it to raise funding or invest excess cash should be removed as it did not have a major impact on the risk management strategy but rather on costs that an entity would incur. The IASB staff explained that access to an active market was evidence of high probability that the necessary funding would be raised.

EFRAG IAWG meeting on 9 September 2024

45 Many EFRAG IAWG members indicated that the IASB approach to the DRM project should be changed in order to take into account the key concerns of insurers before the Exposure draft ('the ED') is published. The insurers, on their side, indicated their readiness for the necessary cooperation with the IASB staff.

46 Several EFRAG IAWG members (preparers, users and auditors) emphasised the strategic importance of the DRM model for the insurance industry and insisted on giving more priority to the issues raised by the insurance industry in this context. They also expressed concerns about possible negative consequences of the DRM model being introduced without addressing in advance the concerns of the insurance industry, including:

(a) Introduction of the DRM model would result in discontinuation of the IAS 39 hedge accounting practice without providing an expected replacement and questions on the impact of the IAS 39 carve-out;

(b) Interaction of the DRM model with the existing hedge accounting models under IFRS 9, as well as with accounting treatments for the insurance contracts under IFRS 17 (the VFA, in particular) are to be further analysed.

47 The IASB staff indicated that the DRM model was focusing on risk management activities which have specific characteristics, and they agreed that further investigation would be needed in these areas. For possible adjustments to the model to make it applicable for the insurers, the IASB DRM team acknowledged that further analysis is needed, notably to conclude whether including insurance liabilities in the list of items eligible for the DRM would be sufficient to address the key concerns of the insurance industry and suggested that such a solution would likely not be sufficient. The IASB had agreed to include a question in the ED to gather more information on insurers' risk management activities.

48 Some members did not consider that the IASB staff's preliminary input from insurers represented the insurance industry:

(a) Several EFRAG IAWG members noted that, contrary to banks, insurance entities, generally, do not manage the interest rate risk on the daily basis which does not preclude their risk management practices to be considered as dynamic;

(b) One member who applies IAS 39 hedge accounting (cash flow hedge) indicated that the DRM model may not completely address their risk management activities;

(c) The UK market typically classify financial assets at fair value through profit or loss which was not the case for intercontinental Europe that applied fair value through comprehensive income; and

(d) One member noted that in many cases, insurance liabilities bear contractual interest, even if such interest is zero, which may have an impact on their assessment of their eligibility for the DRM model.

Optional application of the DRM model

The IASB's tentative decisions (the July 2024 IASB meeting)

49 The IASB tentatively decided to make applying the DRM model optional for entities with applicable risk management activities.

50 Thirteen of 14 IASB members agreed with this decision.

EFRAG Secretariat assessment

51 In previous meetings, both EFRAG FR TEG and EFRAG FIWG had concerns that the DRM model would be mandatorily applied for reasons elaborated in the IASB staff's agenda paper for the July 2024 IASB meeting.

52 Therefore, the EFRAG Secretariat agrees with the IASB's tentative decision to make application of the DRM model optional.

53 The EFRAG Secretariat agrees that comparability between entities may be affected since some entities will apply the DRM model and some not. However, the EFRAG Secretariat is of the view that additional disclosures would help with comparability.

EFRAG FIWG meeting on 2 September 2024

54 Members were supportive of the tentative decision to have the application of the DRM model optional. Banks with sophisticated interest rate risk management systems may want to apply the DRM model while less sophisticated lenders may not. Members also questioned how the future DRM model would co-exist with other existing hedge accounting models (e.g., portfolio fair value hedging).

Questions for EFRAG FR TEG

55 Do you have any comments or questions regarding the actual status of the DRM project?

56 Do you have any comments or questions with regards to the tentative decisions taken by the IASB and the observations of the EFRAG Secretariat and EFRAG FIWG and IAWG members (for each of the topics separately)

Next steps

57 The EFRAG Secretariat will continue to monitor the IASB developments on the project and provide update to the EFRAG FIWG, EFRAG IAWG, EFRAG FR TEG and EFRAG FRB.

Agenda papers

58 In addition to this cover note, the following papers are uploaded for this session as background information:

(a) Agenda paper 03-02 – AP4: Cover note (the IASB's agenda paper for the September 2024 meeting – summary of the IASB's tentative decisions to date, as background information only).

(b) Agenda paper 03-03 – Capacity assessment (the paper for the EFRAG FIWG meeting on 2 September 2024, as background information only);

(c) Agenda paper 03-04 – Presentation requirements of the DRM model (the paper for the EFRAG FIWG meeting on 2 September 2024, as background information only);

(d) Agenda paper 03-05 – Disclosure requirements of the DRM model (the paper for the EFRAG FIWG meeting on 2 September 2024, as background information only);

(e) Agenda paper 03-06 – Applicable risk management activities for the DRM model (the paper for the EFRAG FIWG meeting on 2 September 2024, as background information only);

(f) Agenda paper 03-07 – Optional application of the DRM model (the paper for the EFRAG FIWG meeting on 2 September 2024, as background information only).