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Capacity assessment

Issues Paper

Introduction and Objective

1 The objective of this session is to obtain EFRAG FIWG's views on the June 2024 IASB's tentative decision relating to capacity assessment.

2 The IASB staff's paper can be found here.

3 In February 2023, the IASB tentatively decided to require an entity to assess whether the current net open risk position at the end of the DRM assessment period can realise the expected benefits (in the form of reduced variability in earnings or economic value) represented by the DRM adjustment (capacity assessment). The related IASB staff paper can be found here. They did not discuss how this capacity assessment should be done or how to calculate the fair value or maximum future economic benefit of the current net open risk position[1] ('CNOP'). The June 2024 IASB staff paper addresses this.

IASB staff's analysis and recommendation

Purpose of the capacity assessment

4 The capacity assessment is based on the entity's CNOP at the reporting date to ensure that the realisation of the DRM adjustment into profit or loss is supported by appropriate balance sheet positions.

5 It ensures that the DRM adjustment is not recognised at an amount higher than the maximum expected benefits of reduced variability to be realised in the future[2]. Any excess of the DRM adjustment over the CNOP valuation at the reporting date, is recognised in profit or loss immediately.

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[1] The EFRAG Secretariat does not understand the concept of "maximum [or minimum] future economic benefit of the current net open risk position" and how this might differ from the fair value [or more accurate: the fair value less the recognised value] of the financial assets and or financial liabilities that makes up the CNOP.

[2] The EFRAG Secretariat notes that the "maximum expected benefits of reduced variability to be realised in the future" must be entity specific dependent upon an entity's utility model and that the value must be expected to differ from the value of the DRM adjustment.

Measuring the CNOP for the purposes of the capacity assessment

6 The CNOP, by definition, is the net interest rate risk exposure at a particular point, based on the repricing risk in the dynamically managed underlying positions. At the end of the reporting period, a comparison needs to be made between the DRM adjustment and the value of the assets and liabilities that are included in the CNOP at that date.

7 To determine the value of the CNOP at the reporting date, the entity assumes that no new underlying items are added until the end of the risk management time horizon (i.e. assumes run-off of the underlying designated portfolios). This provides a comparable view at the reporting date of the amount, timing and uncertainty of the future cash flows included in the CNOP.

8 Any valuation technique to determine **the present value of the CNOP** should reflect the entity's exposure to repricing risk originating from the managed rate. Therefore, the **discount rate would be the managed rate**.

Determining the present value of the CNOP

9 By nature, applying a present value technique means that the cash flows from fixed rate underlying items would be the main cause of changes in the overall present value of all underlying items. In comparison, variable rate items would usually have cash flows that are directly linked to a benchmark interest rate and therefore would usually be stable in present value terms regardless of the changes in the benchmark interest rate.

10 Therefore, to the extent that the **notional amounts of fixed and variable items** included the CNOP **are the same**, **the interest rates on the fixed rate positions could be used as a proxy** for the effect of the interest rate changes on the variable rate positions.

11 However, **if there is a notional mismatch between fixed and variable items, additional adjustments are required** to reflect the maximum future economic benefit inherent in the variable rate positions. This is because the present value of the excess variable rate positions in the CNOP is close to par and so do not lead to changes in the present value of the CNOP.

(a) A proxy rate should be determined to ascertain the presently available maximum capacity of future economic benefits stemming from the excess variable rate positions. To achieve this, the expected cash flows from the notional-misaligned portion of the variable rate position would be based on a replicating portfolio, assuming maximum possible risk mitigation by the entity from the reporting date going forward. This would result in a blended fixed rate for the variable net exposure position.

(b) A present value technique could then be applied to the cash flows to quantify the adjustment, which will be added to the present value of the expected cash flows from underlying items determined using the historic fixed rate information only.

(c) The IASB staff paper has an example in Appendix A of one of many possible ways in which such an adjustment could be calculated.

Effects of capacity shortfalls

12 In the event of a capacity shortfall, i.e., if the DRM adjustment amount is higher than the present value of the CNOP at the end of the reporting period, any excess of the DRM adjustment is recognised in profit or loss in the period of the assessment.

13 When a capacity shortfall occurs, the entity effectively accelerates the recognition of the DRM adjustment into profit or loss because the underlying financial assets and financial liabilities in the CNOP are not sufficient to realise the DRM adjustment in full. Therefore, when there is a capacity shortfall, **it would no longer be appropriate to continue recognising the DRM contribution to NII based on the lower of the designated derivatives and the benchmark derivatives** (‘lower of test’). This is because:

(a) the amount of the capacity shortfall cannot be related to particular underlying items and to what extent those items were included in the risk mitigation intention, therefore it is not possible to adjust the historic benchmark derivatives accordingly.

(b) applying the lower of test would entail extensive tracking of how the CNOP and Risk Mitigation Intention (‘RMI’) has developed over time and what the relevant historic market interest rates were at those times and this would increase complexity of the DRM model.

(c) Since the capacity assessment is based on the present value of the CNOP, by definition, it combines the valuation impact across all risk points (i.e. time periods), and therefore cause difficulties in determining the accurate time periods in which a capacity shortfall would unwind.

14 For example, when an entity accumulates CU100 worth of DRM adjustment, this CU100 would unwind back to profit or loss based on the lower of the accrual profile of the benchmark derivatives and the designated derivatives. If there is a capacity shortfall of CU30, the resulting DRM adjustment of CU70 would be used as a basis for future DRM contribution to NII rather than unwinding CU100.

15 The IASB staff therefore considered that, following the recognition of a capacity shortfall, **an adjustment based on a systematic and rational basis can be sufficient** to determine a reasonable and supportable adjustment to DRM contribution to NII in the periods.

16 A straight-line basis over the entity's documented risk management time horizon would be acceptable to balance the need for useful information with maintaining the operability and practicality of the DRM model.

17 In the example in paragraph 14 above, in applying a straight-line method, the entity would unwind the CU30 effect of the capacity shortfall proportionately over five years if its risk management time horizon is five years, and adjust the DRM contribution calculated using the original benchmark derivatives by CU 6 per year.

Reversing the effects of capacity shortfalls

18 The question arises about whether subsequent changes in the present value of the CNOP could lead to a reversal of previously recognised capacity shortfalls (akin to the reversal of an impairment loss).

19 The IASB staff are of the view that **reversal of a capacity shortfall recognised in previous periods should not be permitted** for the following reasons:

(a) Recognition of a capacity shortfall in the first place is due to the occurrence of significant unexpected changes to the CNOP that may significantly change the present value or future NII from the underlying items. However, increases in the present value of CNOP in subsequent periods are likely to be a result of a variety of factors, for example, new financial assets originated, new financial liabilities issued or subsequent favourable changes in the market rates of interest.

(b) If permitted or required, there is a risk of potential earnings management. For example, if an entity recognised a capacity shortfall in the statement of profit or loss, there might be an incentive to reduce the RMI in future periods (to leave more 'headroom' in valuation) in the hope to get a reversal of the write-down of the DRM adjustment.

(c) Reversal of a capacity shortfall would not provide useful information as the reversal would be based on management actions rather than reinstatement of the original risk positions. In some cases, it may also lead to a continuous recognition and reversal of DRM write-downs which could be misleading to the users of the financial statements; and

(d) It is consistent with prior reasoning of the IASB to prevent reversals of impairments of available-for-sale assets under IAS 39 (paragraph BC130 of IAS 39).

IASB staff recommendation

20 The IASB staff recommended that:

(a) the maximum future economic benefit of the CNOP at the reporting date is measured based on the present value of the CNOP.

(b) when a capacity shortfall in the DRM adjustment is recognised in profit or loss, the unwind of that shortfall in future periods is recognised on a systematic and rational basis over the risk management time horizon. In the absence of a systematic and rational basis, the shortfall is recognised on a straight-line basis.

(c) the reversal of capacity shortfalls previously recognised in profit or loss is not permitted.

June 2024 IASB tentative decision

21 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.

22 All 14 IASB members agreed with these decisions.

EFRAG Secretariat analysis

23 *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.

24 *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.

25 *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.

26 *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.

Questions for EFRAG FIWG

27 Does EFRAG FIWG agree with the IASB's tentative decision in paragraph 21 above?