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Disclosure requirements of the DRM model

Issues Paper

Objective

1 The objective of this session is to obtain EFRAG FIWG's views on the observations and the proposed presentation requirements of the DRM model summarised in the IASB staff's paper and discussed at the IASB's June 2024 meeting.

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

Summary of the IASB staff's outreach activities

3 The IASB tentatively decided in July 2019 that the areas of focus for disclosure should be those that assist users of financial statements to:

(a) understand and evaluate an entity's risk management strategy;

(b) evaluate management's ability to achieve that strategy;

(c) understand the effect on current and future economic resources (ie the amount, timing and uncertainty of future cash flows); and

(d) understand the effects applying the DRM model have on an entity's financial statements.

4 Given the progress the IASB has made on the various elements of the DRM model, the IASB staff and some IASB members consulted informally with a diverse group of users of financial statements from a number of jurisdictions, including banking analysts from both buy-side and sell-side institutions and credit rating agencies. The following were the two key questions:

(a) how investors analyse an entity's interest rate risk management practices and the types of information they use; and

(b) based on the elements of the DRM model, what information investors need about the amounts presented in the financial statements to understand how an entity has applied the DRM model.

Investors' need for more useful information and areas of focus for investors' analysis

5 Almost all investors who were contacted said that understanding a bank's interest rate risk exposure and net interest income (NII) is a significant part of their analysis but currently

there is only limited information available in the financial statements that is directly relevant to their analysis, which makes them rely on other sources of information, such as regulatory capital disclosures, result announcements, or direct enquiries with senior management. However, the investors had different perspectives about what information is important to their analysis and potential areas on which disclosure requirements could focus.

6 Almost all investors said it is important **to understand an entity's interest rate risk management strategy, and how the entity would systematically and dynamically respond to a changing interest rate environment**. They said that for this information to be useful to their analysis, **they need both qualitative and quantitative information about**:

(a) **how an entity identifies its interest rate risk exposures;**

(b) **the sources of interest rate risk exposure; and**

(c) **how an entity monitors and mitigates its interest rate risk exposures**.

7 **Importantly, this information must be entity-specific rather than generic or boiler plate**.

8 In the IASB staff's view, with regards to NII, investors want to understand the potential drivers for NII variability and how protected (or not) an entity's net interest margin is against the changes in interest rates.

9 The investors expressed mixed views about the usefulness of the current regulatory capital disclosures, such as the Interest Rate Risk in the Banking Book (IRRBB) disclosures (e.g, including sensitivity analyses on net interest income and economic value of equity (EVE) based on pre-defined scenarios), noting, in most cases, that they represent the most useful source of information they currently have.

10 Another area that most investors commented on is **the information on the amount and timing of the unwinding of the DRM adjustment over the risk management time horizon**. While they consider the DRM adjustment in the statement of financial position to be useful information, they also **need to understand how the DRM adjustment would affect the statement of profit or loss over time**.

11 Some investors specifically welcomed the inclusion of core demand deposits and expected cash flows from prepayable financial assets in the current net open risk position (CNOP) and noted that that it would be important to their analysis, to have an understanding of the internal models and assumptions an entity has used to calculate the interest rate risk exposures of these instruments.

12 Investors provided mixed feedback on whether disclosure of the risk limits is needed. While some welcomed such a disclosure as useful, others focused less on the risk limits, but more on the risk mitigation outcome in the form of 'residual risks' and the effects of the entity's risk management activities.

Disclosing information in a useful way

13 Overall, investors said they prefer the disclosed **information not to be too technical or over-complicated** because a large volume of detailed disclosures that involve complex assumptions and methodologies to analyse, might lead to an information overload. However, some acknowledged that pursuing information that depicts a perfect projection of NII would not be possible in practice and therefore **their focus is on understanding the drivers (ie sources) of an entity's NII**, and back-testing their predictions against reported results. In general, they are more interested in information that provides early warnings on potential 'tail risk'; in other words, **significant impact to an entity's NII in worst-case scenarios caused by a rare or systematic event**.

14 The challenge, as mentioned by a few investors, is that even when there is some relevant information available, they are **scattered around in various places,** for example throughout the annual report, the Pillar 3 disclosures of banks, results announcements and other management communications.

15 Investors also noted that information about interest rate risk management is not standardised, because different entities have different risk appetites and risk management strategies. Some investors said that **ideally, this information would be provided on a comparable basis across entities, although they fully acknowledged that the DRM disclosures would be most useful if the information is provided on an entity- and model-specific basis.**

16 Investors consider it important to **understand the composition of CNOP**, i.e. which financial assets and financial liabilities (including off-balance sheet items where relevant) are included in the CNOP, as well as what the characteristics of the interest rate exposure (fixed or floating or mixed) and average maturity of items are. A few investors further commented that disclosures about the misalignment of the DRM model are less important than understanding the composition of the CNOP and emphasised instead the importance of the sensitivity analysis of an entity's future NII or EVE.

17 In conclusion, a few investors said that the DRM **disclosures need to focus on the outcome of applying the model** (for example, the sensitivity in NII or EVE, or the amount of expected cash flows in the CNOP as determined by the entity's internal models or assumptions) **rather than the detailed processes or assumptions used in achieving that outcome**. In

their view, not many investors would have the time to review or challenge an entity's modelling assumptions. For example, with regards to the modelling of cash flows from core demand deposits, information about the internal models and inputs would not be useful to understand an entity's risk management activities. It would be more useful if the entity provides information about the extent to which deposits are included in the CNOP as a fixed rate exposure and the average time over which they are managed (ie the duration of the deposit hedge), as those would help investors better understand the entity's risk management.

Diversity between jurisdictions

18 Many investors noted that the quantity and quality of information provided by entities vary significantly across jurisdictions. For example, in some jurisdictions prudential or financial reporting regulators mandate disclosure of additional information beyond what is required by IFRS 7, whereas in other jurisdictions it is common for entities to provide only minimum information.

19 In general, most of the investors said the European banks, in particular UK banks, are more transparent in communicating how interest rate risks are managed. There is more detailed information about structural hedge strategies and deposit compositions available to investors from banks in these jurisdictions, and clearer management explanations about these disclosed data. However, challenges remain with regards to the robustness/validity of the information disclosed, as it is difficult for investors to verify the information provided by the management outside the financial statements prior to getting the actual results.

20 Investors noted that, given the importance of interest rate risk management to banks, prudential regulators usually have a strong influence on how interest rate risk is managed by banks in the jurisdictions they supervise (e.g., through requirements over the size of the open interest rate risk positions). Some investors also mentioned that the regulatory treatment of the DRM adjustment and its impact (if any) on a bank's Common Equity Tier 1 (CET1) ratio might also affect the scope and extent of a bank's risk management activities.

Cost and commercial sensitivity

21 In general, investors agreed that any proposed disclosure requirements need to achieve a balance between the potential cost to preparers of providing the information and the benefit to users of financial statements.

22 In terms of potential commercial sensitivity, many investors appreciated that there could be proprietary information that is commercially sensitive with regards to an entity's dynamic risk management activities. However, these investors explained that, in their view,

current disclosures could be enhanced with additional useful information without providing commercially sensitive information.

23 Investors said that, in their view, many elements of the dynamic interest rate risk management might have become less sensitive than previously, and disclosures around those elements would provide useful information to them. Investors emphasised that the current practice of providing limited information about dynamic interest rate risk management might have been developed and accepted because of lack of better alternatives.

Feedback from preparers

24 In addition to its previous outreach activities during the comment period of 2014 DP, more recently, the IASB staff also had informal discussions with a limited number of preparers from the banking industry to obtain their preliminary views on some of the disclosure elements identified by investors as well as their views of the investors' information needs.

25 The preparers, while acknowledging the importance of providing relevant information about how they have applied the DRM model, also raised concerns about the costs involved in preparing such information, and the risk that some of the required information could potentially be commercially sensitive in nature. For example, some preparers said the residual interest rate risk is considered to be highly sensitive information and should not be considered as a possible DRM disclosure. In their view, a sensitivity-based analysis, similar to those required by the IRRBB disclosures, would be more appropriate.

26 Some other preparers are of the view that, although not necessarily disclosed in the financial statements, entities already provide a significant volume of information about their interest rate risk management activities. Therefore, in their view, DRM disclosure requirements should leverage from the information currently provided as much as possible, such as the Pilar 3 disclosures. They are concerned that disclosing detailed quantitative information might lead to a disclosure overload and would provide very little useful information to investors.

27 The IASB staff also referred to the results of a survey conducted by Ernst & Young on behalf of The International Swaps and Derivatives Association (ISDA) that were published in May 2024. Most of its participants were of the view that the **DRM disclosures need to be entity specific, and aligned with the entity's risk management strategy and objectives**. They also suggested that the **disclosures need to be aligned as far as possible with the prudential frameworks and permit cross-referencing to the relevant IRRBB disclosures and not duplicate information**.

IASB staff's preliminary views

28 On the basis of the feedback received from the users and the preparers, the IASB staff identified a number of potential disclosure items.

Potential disclosure objectives

29 As previously discussed in paragraph 11 of Agenda Paper 4A for the May 2022 meeting, the application of the DRM model should provide information that enable users of financial statements to understand:

(a) **an entity's dynamic interest rate risk management strategy and how it is applied to manage repricing risk;**

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

(c) **the effect the entity's dynamic interest rate risk management activities have on the statement of financial position and statement of profit or loss.**

30 The IASB staff noted the similarity of these disclosure objectives to those related to general disclosure objectives of hedge accounting (paragraph 21A of IFRS 7) and also with the areas of focus summarised in paragraph 3 of this paper. Therefore, they consider these disclosure objectives to be appropriate.

31 Based on the input from investors and consistent with the current requirements in paragraph 21B of IFRS 7, the IASB staff is also of the view that:

(a) **the required disclosures are provided in a single note or separate section in the financial statements**;

(b) **information could be incorporated by cross-reference from the financial statements to another statement** that is available to users of the financial statements on the same terms as the financial statement and at the same time;

(c) **DRM disclosures are provided on a basis that is consistent with how an entity applied the DRM model** (e.g., in case of multiple DRM models applied, the required information is to be disclosed separately for each DRM model); and

(d) where relevant, the information provided in the notes to the financial statements should **enable users of financial statements to identify (and reconcile to) the relevant line item in the primary financial statements.**

Disclosure about dynamic interest rate risk management strategy

32 In the view of the IASB staff, the disclosure requirements concerning dynamic interest rate risk management strategy could be similar to those concerning the general hedge accounting set out in paragraphs 22A-22C of IFRS 7, their purpose being to enable users of financial statements to evaluate:

(a) how each risk arises;

(b) how the entity manages each risk;

(c) the extent of risk exposures that the entity manages.

33 In addition, in the context of the DRM model, information about an entity's risk management strategy should enable users of financial statements to understand for example:

(a) **how the entity's exposure to repricing risk arise** including, for example, a description of the underlying financial assets and financial liabilities included in the CNOP and the nature of the repricing risk (fixed vs floating);

(b) **the levels at which repricing risk is managed** (ie an entity-wide level or lower level);

(c) **how the entity identifies, aggregates, monitors and manages its repricing risk** including the risk metrics the entity uses and the frequency with which the CNOP and risk mitigation intention is determined; and

(d) **the managed rate, time horizon over which repricing risk is mitigated** and if the entity is allocating its risk exposures to time buckets, an indication of the time buckets used.

34 The IASB staff assesses that providing **such information would not result in significant additional costs and would not be commercially sensitive for the preparers**.

Disclosure on the amount, timing and uncertainty of cash flows

35 The IASB staff refers to paragraphs 23A–23F of IFRS 7 which set out the information an entity is required to disclose about the amount, timing and uncertainty of future cash flows for each risk category, including quantitative information that enable users of financial statements to evaluate the terms and conditions of hedging instruments and how they affect the future cash flows of the entity.

36 In the context of the DRM model, the IASB staff expects the information to be provided about the designated derivatives to be similar to the current IFRS 7 requirements. In particular, a profile of the timing of the nominal amount of these designated derivatives

(eg nominal amount by maturity bucket) and the average fixed rate of these derivatives could enable users of financial statements to understand the extent to which an entity is economically protected from future interest rate movements, and how the DRM adjustment would unwind to profit or loss over time. The DRM disclosures on the designated derivatives would therefore increase the transparency of how an entity has eliminated the variability in EVE and NII.

37 With regards to the CNOP, many users said quantitative information about an entity's interest rate risk exposures and hedged rates would enable them to predict the future performance of the entity, while most preparers commented that such disclosures could potentially result in the disclosure of forward-looking information that could put them at an unfair disadvantage compared to their competitors who do not apply dynamic interest rate risk management or do not report under IFRS.

38 Similarly to the general hedge accounting disclosure requirements, the IASB staff does not think it would be appropriate to require entities to disclose information about the CNOP on a total or residual risk exposure basis. However, in their view, some disclosures about the amount, timing and uncertainty relating to the cash flows of the underlying items (which are used for determining the CNOP) are needed for the DRM model, if such information can be disclosed in a way without jeopardising commercial sensitivity. E.g., this could be done in a form of sensitivity analysis. In addition, in the IASB staff's view, the aggregate nature of the DRM model, and therefore the aggregate nature of such disclosures would help mitigate the risk of requiring the disclosure of commercially sensitive information, contrary to many cases of the general hedge accounting disclosures. Also, according to the IASB staff's assessment, most banks are disclosing similar information under the Pillar 3 disclosure requirements without having to disclose commercially sensitive information.

Disclosure of the effects on financial position and performance

Disclosures about the underlying financial instruments

39 In the IASB staff's view, given the nature of the DRM as an accounting model, any information about the underlying items that are included in the CNOP, must be provided based on amounts in the financial statements rather than risk-based information, and could be a combination of qualitative and quantitative information. Such disclosures could include:

(a) the carrying amounts at the reporting dates or the notional amounts of unrecognised assets or liabilities;

(b) the line items in the statement of financial position in which the underlying items are included;

(c) the inputs, assumptions and estimation techniques used to determine the expected cash flows; and

(d) information about any hedged exposures that are included in the CNOP.

Disclosure about designated derivatives

40 The IASB staff expects the potential disclosures for the designated derivatives to be similar to the current requirements for hedging instruments in IFRS 7. Therefore, they could include:

(a) the carrying amount of the designated derivatives;

(b) the line item in the statement of financial position that includes the designated derivatives;

(c) the change in fair value of the designated derivatives used as the basis for measuring the DRM adjustment; and

(d) the nominal amounts of the designated derivatives.

Disclosure about the performance of the DRM model

41 In the IASB staff's view, information about the DRM adjustment would be needed, with a sufficient level of disaggregation, in the notes to the financial statements, for users of financial statements to understand the potential effect on future NII and economic value variability. Such information could include:

(a) fair value gains or losses recognised as part of the DRM adjustment during the reporting period and how the entity incorporated the effect of unexpected changes in the CNOP during the period;

(b) the amount of misalignment (both cumulative and the effect in the current reporting period) and the line items in which the misalignment is recognised in the statements of profit and loss;

(c) the expected profile for the unwinding of the DRM adjustment into the statement of profit or loss (ie future 'protection' against NII variability); and

(d) the amount of any write-down of the DRM adjustment at the reporting date and its expected effect on the unwinding of the DRM adjustment.

Discussions at the June 2024 IASB meeting

42 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.

43 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.

44 The IASB will continue its discussions on the disclosure requirements at its later meetings.

EFRAG Secretariat analysis

45 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.

46 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.

Questions for EFRAG FIWG

47 In general, what are your views on the proposed approach to the disclosure requirements on the DRM model?

48 How do you see the cost/benefit balance of the future disclosure requirements and their alignment with other information disclosed outside of the financial statements?

49 Which of the above-mentioned proposed disclosure areas do you consider as more important (e.g., disclosures on the CNOP) or less important (e.g, disclosures on the misalignment)?

50 In your view, are there any proposed disclosure elements which contain commercially sensitive information and for this reason, should be excluded from the disclosure requirements?