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Paper 06-05
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Applicable risk management activities for the DRM model

Issues Paper

Objective

1 The objective of this session is to obtain EFRAG FIWG's views on the July 2024 IASB's tentative decision relating to the applicable risk management activities for the DRM model.

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

IASB staff's analysis and recommendation

3 The IASB staff have analysed whether there are entities other than banks that have dynamic interest rate risk management strategies. They had discussions with a number of insurance entities to better understand their risk management strategies and activities.

Applicable risk management activities for the DRM model

4 The following common characteristics/activities were observed among the entities that manage interest rate repricing risks dynamically:

(a) business activities that lead to the recognition of financial assets and financial liabilities that generate and bear interest at different rates and over different maturities, which exposes the entity to interest rate repricing risk;

(b) a dynamic risk management strategy that has a dual risk mitigation objective (i.e. both stabilising net interest income ('NII') and economic value of equity ('EVE')) based on an aggregated (i.e. combined or net) repricing risk over a pre-determined period;

(c) an established and systematic process to determine the net repricing risk exposure based on a specified managed rate, and make adjustments to the risk mitigation activities on a dynamic basis; and

(d) free access to a liquid interbank market or money market that enables the entity to raise funding or invest excess cash at the prevailing benchmark interest rate if and when needed.

Risk management strategy and activities of insurance entities

5 During the first half of 2024, the staff and some IASB members had targeted discussions with seven insurance companies, an insurance industry group, two auditor firms, and a national standard setter.

6 The following is a summary of the discussions:

(a) Interest rate risk management is essential to insurance entities' business activities and regulators monitor this to ensure that the insurer can fulfil their insurance liabilities without significantly being impacted by market interest rate fluctuations.

(b) Although financial assets could be interest-generating, insurance liabilities typically do not bear interest—they neither have a fixed nor floating interest rate (i.e. do not give rise to interest rate repricing risk)[1]. The exposure to interest rate risk arises mainly because of discounting long-dated insurance liabilities.

(c) The focus of insurance entities' risk management strategy is primarily on the net fair value variability of their financial assets and insurance liabilities as per their regulatory requirements (such as Solvency II in Europe). As a result, the risk management strategy of many insurance entities we have spoken with is driven primarily from the variability in EVE and does not appear to feature a dual purpose of mitigating variability in both NII and EVE. Also, interest rate risks are commonly managed together with other risks.

(d) Many insurance entities measure a significant portion of their financial assets at fair value through profit or loss (FVPL), which means the effects of interest rate changes are already recognised in profit or loss[2].

(e) Risk management activities are less dynamic in terms of determining the desired risk mitigation intentions due to the long-dated insurance liabilities.

(f) Some insurance entities prefer and have the ability to directly adjust the duration of financial assets they choose to hold, instead of relying extensively on the use of derivatives to manage their net interest rate risk exposures.

7 The IASB staff considered that there is no sufficient basis to conclude that applying the DRM model to insurance business activities will provide useful information, as insurers

[1] One might note that if a liability bears no interest, it has a fixed rate interest of zero percent. Thus, the statement in paragraph 6(b) may be considered factual incorrect.

[2] Again, this may be considered factual incorrect as the effect on liabilities is not recognised in profit or loss.

generally pursue a different risk management strategy compared to the applicable activities for the DRM model—such as a stable solvency ratio instead of a stable net interest margin or economic value of equity of the underlying assets and liabilities.

IASB staff recommendation

8 The IASB staff recommended that the DRM model is only applied when an entity:

(a) carries out business activities that lead to the recognition of financial assets and financial liabilities that generate and bear interest at different rates and over different maturities, which expose the entity to repricing risk;

(b) adopts a dynamic risk management strategy that has a dual risk mitigation objective (i.e. both stabilising NII and EVE) based on an aggregated (i.e. combined or net) repricing risk over a predetermined period;

(c) operates an established and systematic process to determine the net repricing risk exposures based on a specified managed rate, and make adjustments to the risk mitigation activities on a dynamic basis; and

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

9 The IASB staff also recommended that the IASB include a specific question in the Exposure Draft to obtain further input with regards to the business activities of insurers.

July 2024 IASB tentative decision

10 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.

11 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.

12 All 14 IASB members agreed with these decisions.

EFRAG Secretariat analysis

13 The IASB 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.

14 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. …

15 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.

16 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).

17 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.

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

Questions for EFRAG FIWG

19 Does EFRAG FIWG agree with the IASB's tentative decision in paragraphs 10 and 11 above? Please explain.