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Introduction

1. The objective of this paper is to discuss the role of the asset profile within the dynamic risk management (DRM) model and provide additional guidance in the form of qualifying criteria to ensure consistent application of the asset profile. This paper also discusses:

   (a) Designation and situations requiring de-designation of items within the asset profile; and

   (b) Documentation requirements.

2. This paper is structured as follows:

   (a) Background (paragraphs 3 – 5);

   (b) Next steps (paragraph 6);

   (c) The role of the asset profile within the DRM model (paragraphs 7 – 35);

   (d) Designation of financial assets and future transactions (paragraphs 36 – 48);

   (e) Interaction between designation and the dynamic nature of portfolios (paragraphs 49 – 70);

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(f) De-designation of financial assets and future transactions (paragraphs 71 – 75);

(g) Documentation requirements (paragraphs 77 – 77); and

Background

3. At the December 2017 Board meeting[1], the Board decided the staff should develop the accounting model for DRM in two phases. The Board asked the staff to first develop the following 'core areas' that are central to the model and will shape the fundamentals of the proposed DRM accounting model:

   (a) Asset profile;

   (b) Target profile;

   (c) Derivative instruments used for DRM purposes; and

   (d) Performance assessment and recycling.

4. Because performance assessment focuses on an entity's ability to align the asset profile with the target profile using derivative financial instruments, the Board decided that the elements subject to performance assessment should be discussed first followed by a discussion on performance assessment and recycling.

5. The staff acknowledge that the dynamic nature of the asset profile interacts with other core areas of the DRM accounting model, such as performance assessment, the target profile and derivatives used for interest rate risk management. While this paper focuses on the dynamic nature of designated portfolios from the perspective of the asset profile only, further interactions will be discussed at future Board meetings as the staff develop the other core areas of the DRM model.

Next steps

6. The staff plan to discuss the target profile at the next Board meeting.

[1] For further information, refer to the December 2017 Agenda Paper 4 *Proposed project plan*.

The role of the asset profile within the DRM model

7. Lending and funding activities are generally the main contributors to a financial institution's interest income and interest expense. An adverse change in market factors, such as interest rates, can negatively impact the difference between interest income and expense and thus performance of the financial institution. As a result, financial institutions undertake risk management activities to reduce the exposure to changes in interest rates in the banking book[2], where assets and liabilities related to these lending and funding activities are often held. In particular, derivatives are used to transform the profile[3] of financial assets in the banking book such that interest income reacts to changes in market factors as defined by an entity's target profile.

8. As discussed at the November 2017 Board meeting[4], the aim of the DRM accounting model is to faithfully represent, in the financial statements, the impact of such dynamic risk management activities undertaken by a financial institution. In particular, the model proposes that, if derivative instruments are successful in aligning the asset profile with the target profile, changes in fair value of such derivative instruments would be deferred in Other Comprehensive Income and recycled to profit or loss as the asset profile affects the statement of profit or loss. In a situation of perfect alignment, interest income would reflect the entity's target profile.

9. Consistent with this, the role of the asset profile within the DRM accounting model is to identify the items that have an economic relationship with the derivatives used to manage interest rate risk. This will allow for the assessment of whether the derivative instruments used for DRM purposes were and will continue to be effective in aligning the asset profile with the target profile. In other words, the asset profile defines which items are dynamically managed for

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[2] While banking book is not a term defined in the IFRS Standards, it is generally accepted that the banking book is mostly comprised by financial instruments measured at amortised cost. This is further discussed in paragraphs 18 to 19 of this paper.

[3] In this paper, a profile represents the expected timing and amount of future cash flows arising from a financial instrument or a portfolio of financial instruments.

[4] For further information, refer to the November 2017 Agenda Paper 4 *Outline of proposed DRM accounting model and next steps*.

interest rate risk and therefore are subject to performance assessment under the DRM accounting model.

10. To play its role within the DRM accounting model, the staff believe that the DRM accounting model should provide additional guidance in the form of qualifying criteria. This is because these criteria will allow for clear identification of which items are dynamically managed for interest rate risk. This is particularly important in the context of performance assessment, since the asset profile defines which items are subject to performance assessment under the DRM accounting model. Furthermore, qualifying criteria will help the DRM accounting model to achieve its objective to faithfully represent, in the financial statements, the impact of DRM activities. For example, because DRM is performed at a portfolio level, these criteria would preclude designation of items where interest rate risk is managed on an individual basis. In other situations, the effect of credit risk can be of such a magnitude that it dominates the changes in a financial asset's expected cash flows. Consequently, qualifying criteria would aim to preclude the designation of financial assets under such circumstances. Finally, as the DRM accounting model proposes a deviation from the normal accounting for derivative financial instruments under IFRS 9: *Financial Instruments* (IFRS 9), the staff believe that qualifying criteria are needed to ensure consistent application of the DRM model.

11. It is important to note that an asset profile is determined by assets and their corresponding profiles (ie expected timing and amount of future cash flows). In this context, the proposed qualifying criteria will help an entity to determine which items, and not profiles, can be designated as part of the DRM model. This is because the profile of a financial asset is already determined on the basis of existing contractual terms and prepayment assumptions, while the profile of a future transaction is based on management's expectations of highly probable contractual terms. The staff acknowledge that the profile of certain financial assets will be on an expected rather than strictly contractual basis considering the potential impact of prepayments. As these prepayment assumptions can change, the implications for performance will require discussion. This will take place at a future Board meeting as part of the performance assessment discussions.

12. The staff believe that hedged items and hedging instruments already designated in a hedge accounting relationship for interest rate risk should not be eligible for the

DRM accounting model. This is because designation of such items under the DRM model would result in deferring gains or losses in Other Comprehensive Income for items already considered in a hedge accounting relationship and, therefore, could result in double counting.

13. The staff recognise the objective of the model is not to govern or restrict risk management, but reflect the impact of risk management activities in financial reporting. While introducing qualifying criteria could create tension with that objective, the staff will endeavour to prioritiseconsistency between the DRM accounting model requirements and an entity's risk management objectives, whenever possible.

14. When considering which items should be included within the asset profile, the staff considered the nature of DRM and its objectives. Accordingly, the staff considered the following elements as the basis for determining the asset profile qualifying criteria.

Financial assets

15. DRM is a process that involves understanding and managing how and when a change in market factors will impact interest income and interest expense. As interest income is calculated by applying the effective interest method to financial assets, the staff believe that the asset profile should comprise financial assets. However, as discussed at previous Board meetings[5], the model proposes a new type of relationship, based on derivatives used to transform a portfolio of financial assets such that they align with a target profile. This type of relationship is not a hedge of the exposure to changes in fair value of fixed-rate financial assets as required by IFRS 9 for designating a fair value hedge accounting relationship. Furthermore, it is not a hedge of the exposure to variability in cash flows associated with floating-rate financial assets as required in a cash flow hedge relationship under IFRS 9. Asset transformation focuses on derivatives used to transform an entity's asset profile to a defined target profile, regardless of whether these financial assets are fixed or floating rate. Consequently, the staff believe that

[5] For further information, refer to Board meetings held in May 2017, June 2017 and September 2017.

the asset profile should allow for designation of both fixed and floating-rate financial assets.

16. While DRM is focused on interest income and interest expense, the asset profile comprises items that could affect interest income only. This is because financial liabilities (ie exposures that affect interest expense) are considered in the DRM accounting model when an entity determines its target profile. As agreed at the December 2017 meeting, the role of the target profile within the DRM model will be discussed at future Board meetings.

Amortised cost

17. Interest income on financial assets is recognised in profit or loss using the effective interest method that is applied to financial assets measured at amortised cost. Because DRM focuses on interest income and interest expense, the staff believe that financial assets measured at amortised cost should be the starting point to determine which items should be within the scope of the DRM accounting model.

18. DRM of interest rate risk is generally undertaken for the banking book of a financial institution. While banking book is not a term defined in IFRS Standards, it is generally accepted that the banking book mostly comprises by financial instruments measured at amortised cost. According to IFRS 9, amortised cost provides relevant information when a financial asset has contractual cash flows that are solely payments of principal and interest and the financial asset is held in a business model where collecting contractual cash flows is integral to achieving its objective[6]. This, in general, is consistent with financial assets subject to DRM activities.

19. In particular, because IFRS 9 requires derivative financial instruments be measured at fair value, restricting the asset profile to financial assets measured at amortised would also ensure the DRM accounting model addresses one of the main concerns raised by constituents. Specifically, situations where financial assets within the banking book are measured at amortised cost and derivatives

[6] See paragraph 4.157 of the Basis for Conclusions of IFRS 9.

used to manage interest rate risk are measured at fair value through profit or loss, giving rise to an accounting mismatch in the statement of profit or loss.

20. As agreed at the December 2017 Board meeting, the accounting model for DRM will be developed in two phases. The first phase will focus on developing the 'core areas' that are central to the model while the second phase will address areas that are extensions of concepts developed during the first phase. While the statement of profit or loss also provides amortised cost information for assets measured at the fair value through Other Comprehensive Income, these assets represent a smaller proportion of the portfolios managed by the DRM function. In addition, these financial assets are held within a business model where the objective can be achieved by selling financial assets, which is different than holding financial assets to collect contractual cash flows. As a result, the staff will consider financial assets at fair value through Other Comprehensive Income during phase 2 prior to finalising the project.

21. Nonetheless, the staff believe using financial assets measured at amortised cost as a starting point to determine the asset profile would ensure that the DRM accounting model captures a significant portion of items dynamically managed for interest rate risk.

22. Because DRM is generally performed on a collective and not an individual basis, the staff believe that allowing financial assets managed on an individual basis as part of the asset profile would be inconsistent with the DRM accounting model's objective to faithfully represent, in the financial statements, the impact of DRM activities undertaken by an entity. Consequently, only financial assets where risk is managed on a portfolio basis should be eligible for inclusion within the model.

23. In addition, in some situations the effect of credit risk can be of such a magnitude that it dominates the changes in the financial asset's expected cash flows. In this scenario, although there is an economic relationship between a derivative and the financial asset managed for interest rate risk, the level of alignment with the target profile might become erratic due to the effect of credit risk. Consequently, the staff believe that the qualifying criteria should consider credit risk.

Future transactions

24. In practice, DRM considers present and future interest rate risk exposures. For example, in addition to exposures already recognised in the statement of financial position, financial institutions often manage exposures associated with future transactions that are expected to affect future interest income and expense. These future transactions are generally associated with the expected growth of a portfolio or reinvestment of proceeds from maturing financial assets. The staff believe that allowing these future exposures for designation within the asset profile is needed to accomplish the DRM accounting model's objective to faithfully represent, in the financial statements, the impact of DRM activities undertaken by an entity.

25. In this context, the staff considered three types of transactions that can create exposure to interest rate risk and therefore form a part of an entity's risk management activities. These three types of transactions are:

    (a) Pipeline transactions;

    (b) Firm commitments; and

    (c) Highly probable forecast transactions.

a) Pipeline transactions

26. Pipeline transactions is a colloquial expression used in the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach for Macro Hedging*, published by the IASB in April 2014 (the '2014 DP') to describe the forecast volume of drawdowns of fixed-rate products at advertised rates. Because entities often take these transactions into account as part of their risk management activities, the 2014 DP discussed whether pipeline transactions should be included in the Portfolio Revaluation Approach (PRA)[7]. According to paragraph 3.2.2 of the 2014 DP:

> In a typical pipeline transaction, neither a bank nor its customer yet has a contractual commitment; however, a bank may consider such offers to be binding for reputational

[7] *Portfolio Revaluation Approach* was the name attributed to the accounting model proposed in the 2014 DP.

> or other reasons. This may be on the basis of an advertised offer to both current and future customers (for example, a fixed interest rate mortgage or deposit product). […] For dynamic risk management purposes, that bank may estimate the likely volume of customer balances to be drawn down using the free option on a behaviouralised basis and manage the resultant fixed interest rate risk attached to it.

27. These transactions are not necessarily 'highly probable' as defined in IFRS 9. However, because these transactions have been offered to customers at advertised fixed interest rates, financial institutions may or may not consider them to be binding for reputational or other reasons.

b) Firm commitments

28. A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.[8] One of the key characteristics that distinguishes firm commitments from pipeline and highly probable forecast transactions is the existence of a binding agreement specifying the terms of a transaction. A typical example in the context of DRM is a loan commitment to provide credit under pre-specified terms and conditions (ie a commitment to make a loan at a specified interest rate for a specified period of time).

c) Highly probable forecast transactions

29. According to IFRS 9, a forecast transaction is an uncommitted but anticipated future transaction. Although not contractual, these transactions are expected to occur with a high degree of probability in specified future periods. From a DRM perspective, when highly probable forecast transactions result in financial assets measured at amortised cost, an entity might consider them for interest rate risk management purposes before becoming a party to the contract. This is because the resulting financial asset can affect the entity's future interest income.

30. As opposed to pipeline transactions, which are restricted to advertised fixed-rate products (ie future transactions that attract fair value risk), highly probable

[8] See Appendix A of IFRS 9.

forecast transactions can result in fixed or floating-rate financial assets. This is particularly important because, as discussed in paragraph 15, the DRM accounting model proposes a new type of relationship focused on the use of derivatives to transform an entity's asset profile to a defined target profile, regardless of whether these financial assets are fixed or floating rate.

Staff analysis

31. Pipeline transactions were considered for inclusion in the PRA because they are deemed to attract fair value risk prior to an entity becoming party to a contract. In particular, the 2014 DP argues that fair value risk arises due to: i) fixed interest rates at which these products are advertised; and ii) a commitment that may or may not be considered to be binding for reputational or other reasons as fixed-interest rates are advertised to customers.

32. While the details of performance assessment will be discussed at a later Board meeting, the entity's ability to forecast future transactions will play a role in performance assessment as future transactions will have an impact on interest income and are considered by risk management. The staff are concerned that allowing pipeline transactions to form part of the asset profile could result in frequent changes to the asset profile due to transactions not occurring. Frequent changes to the asset profile under such circumstances could result in performance assessment reflecting management's frequent changes to their forecasts and an inability to predict future transactions accurately, instead of focusing on the entity's ability to align the asset profile with the target profile using derivative financial instruments. In addition, the proposed DRM accounting model does not restrict the asset profile to fixed-rate financial assets. In fact, financial institutions often forecast the levels of both fixed and floating interest rate exposures and manage the associated interest rate risk that arises, as acknowledged in the 2014 DP. For example, regardless of whether they will result in fixed or floating-rate financial assets, future transactions might be forecasted as a result of expected growth of a portfolio of loans or reinvestment of proceeds from maturing financial assets. Therefore, because pipeline transactions are restricted to fixed interest rate transactions and are not necessarily highly probable, the staff believe that pipeline transactions should not be included as part of the asset profile.

33. Highly probable forecast transactions, conversely, are expected to occur with a high degree of probability in specified future periods. In particular, these transactions can result in fixed or floating-rate financial assets, which is consistent with the new type of relationship proposed by the DRM accounting model based on asset transformation. Furthermore, IFRS Standards already provide guidance on how an entity should perform the assessment of the likelihood that a forecast transaction will take place. Similarly, because firm commitments are binding agreements with specified terms and conditions, there is sufficient specificity regarding the timing and amount of cash flows from the future transaction. As a result, the staff believe that both types of future transactions can provide sufficient specificity and avoid the issues noted in paragraph 32 above.

34. The combination of forecast transactions and firm commitments that are highly probable to occur are hereinafter referred to in this paper as 'future transactions'. On the basis of the rationale noted in paragraphs 31 to 33, the staff believe that only future transactions that result in financial assets measured at amortised cost should be eligible as part of the asset profile.

Staff view

35. In view of the above reasons, the staff believe future transactions that result in financial assets measured at amortised cost should be allowed in the asset profile In addition, based on the above discussion, it is the view of the staff that items would qualify as part of the asset profile only if all the following criteria are met:

    (a) Financial assets must be measured at amortised cost under IFRS 9;

    (b) The effect of credit risk does not dominate the changes in expected future cash flows;

    (c) Future transactions must be highly probable;

    (d) Future transactions must result in financial assets that are classified as subsequently measured at amortised cost under IFRS 9;

    (e) Items already designated in a hedge accounting relationship are not eligible under the DRM accounting model; and

    (f) Items within the asset profile must be managed on a portfolio basis for interest rate risk management purpose.

Question for the Board

Question for the Board
1) Does the Board agree with the staff view in paragraph 35?

Designation of financial assets and future transactions

36. As noted in paragraph 15, the DRM accounting model proposes a new type of relationship based on asset transformation (derivatives used to transform a portfolio of financial assets such that they align with the target profile). In this context, the role of designation and de-designation within the DRM model is to define what is subject to performance assessment (ie not only items that comprise the asset profile, but also derivatives used for the purpose of interest risk management as well as the entity's target profile).

37. The staff believe that requiring formal designation will provide clarity regarding which items are in scope of the DRM accounting model. Furthermore, designation will play a critical role in the context of future transactions. As achieving the target profile is partially dependent upon an entity's ability to forecast and manage future transactions, the accuracy of the entity's forecasts will form part of performance assessment. Designation and documentation are the mechanisms by which an entity will demonstrate sufficient specificity to enable performance assessment in this regard.

38. Further consideration will be required regarding whether designation of items should be optional or mandatory provided they meet the asset profile qualifying criteria. Because this would ultimately result in discussing whether the DRM accounting model should be an accounting policy choice or a required accounting practice, the staff believe this discussion should take place during a future Board meeting, once the complete core version of the DRM model has been developed by the staff and agreed with the Board. However, included in this paper is a discussion on whether an entity should be able to voluntarily de-designate items within the asset profile.

39. Assuming the Board agrees with the proposed asset profile qualifying criteria (paragraph 35), the question that follows is when and how items are designated as part of the asset profile and when they should be de-designated.

Designation of financial assets and future transactions

40. The staff have considered two alternatives with respect to designation of financial assets and future transactions as part of the asset profile. The first alternative suggests designation at the transaction level (Approach 1), while the second alternative proposes designation on a portfolio basis (Approach 2).

Approach 1 – Designation on an individual basis

41. Designation of individual assets would retain the existing requirements for designating a hedge accounting relationship. In particular, this would require individual designation and corresponding documentation for specific items that meet the asset profile qualifying criteria.

42. Future transactions would also be designated and documented on an individual basis. This is not intended to be different from the current requirements for designating highly probable forecast transactions as hedged items in a cash flow hedge accounting relationship.

Approach 2 – Designation on a portfolio basis

43. Considering DRM is undertaken at a portfolio level, under Approach 2 an entity identifies financial assets dynamically managed for interest rate risk as per the entity's risk management policies and procedures. These assets are then designated as part of the asset profile, collectively, as a portfolio under the DRM accounting model, subject to the financial assets meeting the qualifying criteria. Regarding future transaction, under Approach 2 an entity would identify future transactions that are within scope of the entity's risk management policies and procedures and designate these future transactions as a portfolio within the DRM accounting model.

44. While a portfolio should be defined consistently with the entity's risk management policies and procedures, the staff think portfolios of assets should share similar risk characteristics where that same risk is managed on a collective

basis. Assets with different risk characteristics, such as currency or the existence of a prepayment option, often require different mitigating actions in order to achieve the target profile, which implies the nature of the risk is different. As such, the staff believe that, at a minimum, financial assets denominated in different currencies should be allocated to separate portfolios. In addition, financial assets with prepayment features should be separated from those without. These requirements are also applicable when an entity defines portfolios of future transactions.

45. The staff considered if financial assets with different interest rate basis (such as 1M versus 3M versus 6M Libor) should be separated into different portfolios. The staff noted that fluctuations in interest income and interest expense will occur over time if the interest basis of assets and liabilities are not aligned. However, differences in interest rate basis simply imply a difference in the re-pricing frequency of a financial asset. In that manner, interest rate basis is simply another required consideration when managing interest rate risk, much like different maturity dates is a required consideration. As such, while the risk management policies and procedures should define the entity's target interest rate basis, the staff do not think there should be any requirement to separate portfolios by interest rate basis.

46. Financial assets and future transactions that meet the qualifying criteria are allocated to the defined portfolios and designated as part of the asset profile. Also, when a designated future transaction results in a financial asset, it must be allocated to an existing portfolio.

47. Application of the DRM model takes effect from the date the specific portfolio has been formally designated (ie from the date an entity has completed the necessary documentation to designate the specific portfolio of financial assets).

Staff view

48. The staff think that Approach 2 will simplify the designation process, as financial assets that meet the asset profile qualifying criteria are allocated to a designated portfolio and therefore will be considered as part of the asset profile without the need for frequent designation and de-designation on an individual basis. This is consistent with one of the goals of the DRM accounting model which is to reduce

operational complexities associated with the application of the current hedge accounting guidance to dynamic portfolios. The staff believe Approach 2 would allow for a faithful representation of DRM in the financial statements. In particular, Approach 2 would align the designation mechanics with the way risk management considers interest rate risk. The staff would highlight the concept of an asset profile is implicitly a portfolio concept, and therefore this approach would result in alignment between the DRM accounting model and risk management. For the reasons stated above, the staff prefer Approach 2.

Question for the Board

Question for the Board
2) Does the Board agree with the staff view in paragraph 48?

The interaction between designation and the dynamic nature of portfolios

49. Assuming the Board supports Approach 2, it proposes formal designation of defined portfolios as part of the asset profile. However, portfolios are constantly changing as new assets are added and existing assets mature. As such, the staff have considered how the model should address the dynamic nature of designated portfolios.

50. Risk management is often conducted assuming the entity is a going concern. As such, when portfolios are defined and the risk management policies set for those portfolios, the risk management objective does not solely focus on existing assets, but considers what will happen at maturity of those financial assets and considers the re-investment of the returned loan principal. Since risk management is focused on understanding how interest income and expense will be impacted by interest rates over time, risk management will consider how interest income can change when maturing assets are re-invested.

51. However, simply because risk management considers the re-investment of financial assets, this does not mean the risk management objective is to eliminate

all re-pricing risk. In fact, as discussed during the Board education sessions and the November 2017 Board meeting, an entity cannot perpetually avoid re-pricing of assets and the risk management objective often defines the time horizon over which the entity wants re-pricing to take place. The staff would like to highlight certain implications the above has on the designation of future transactions and the dynamic nature of portfolios.

52. For example, an entity's risk management objective is to have the entire defined portfolio fixed for five years, i.e., the entity wants 100% of the defined portfolio to re-price at market rates after five years have passed. Assuming the entity achieves the risk management objective, at the end of year 5; l00% of the defined portfolio will mature and be re-invested. Re-investment will take place at the then prevailing market interest rates consistent with the risk management objective. As such, while the amount and timing of re-investment of the maturing financial assets could be considered highly probable within the context of the DRM model, the time horizon is beyond the scope of the risk management objective and thus they would not form part of the designated portfolios.

53. In contrast with the above example, a different entity's risk management objective is to have its entire designated portfolio of financial assets fixed for ten years even though the existing financial assets will mature after five years. While the entity can achieve the risk management objective using derivatives[9], the entity must re-invest the maturing assets after five years at the then prevailing market rates to accomplish its objective. As such, in this example, the risk management objective explicitly considers the future transactions. Therefore, that portfolio of future transactions, subject to meeting the qualifying criteria, should be designated. Similar to the previous example while the entity could consider the re-investment of the re-investment after ten years have passed, given its stated time horizon, it would not do so. In this way, the risk management objective defines the relevant time horizon.

54. The examples discussed in paragraphs 52 and 53 highlight that different risk management objectives imply differences in the designation of future transactions.

[9] For further information, refer to Case Study #1 from the May 2017 Agenda Paper 4 *Education Session: Dynamic Risk Management*.

Consequently, an entity's risk management objective will define whether or not, at initial designation of a portfolio of financial assets, future transactions (ie re-investments and growth) associated with that portfolio are designated as part of the asset profile. Therefore, the staff are of the view that an entity has this choice based on its risk management objective only at initial designation (ie whether or not to designate future transactions to be part of the asset profile). However, any such choice has to be consistent with the entity's risk management strategy.

55. It is important to note that an entity's risk management objective can change and thus it is possible that an entity could state that new financial assets will no longer be managed, implying the portfolio or a subset of the portfolio would go into wind down. Such a change implies a change in the entity's risk management policies and procedures and furthermore, a change in the scope of risk management. The staff expect such changes to occur infrequently. If the scope of risk management changes frequently, this lessens the usefulness of information provided by the DRM accounting model. If there are frequent changes to the scope of risk management, consideration should be given to discontinuing the use of the model. The staff believe that the above restrictions would also preclude changes in the entity's risk management policies and procedures designed solely to achieve an accounting outcome.

56. Once portfolios are identified and designated as part of the asset profile, new financial assets become part of the asset profile as they are recognised in the statement of financial position in accordance with IFRS 9. Likewise, financial assets are de-designated as they are derecognised under IFRS 9 or meet any of the other de-designation criteria discussed in paragraph 71. If a portfolio of future transactions is designated as part of the asset profile, when the future transactions occur and result in a financial asset, the financial asset must be allocated to a designated portfolio of financial assets. As time passes, future transactions are de-designated as future transactions occur, while new future transactions are designated as part of the asset profile as long as they meet the qualifying criteria and designation is consistent with an entity's risk management policies and procedures.

57. As portfolios change, an entity will update the asset profile accordingly. Such updating would not represent a designation or de-designation event but instead a

continuation of the existing relationship. This is consistent with the rebalancing concept in IFRS 9, where such changes are treated as adjustments to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with IFRS 9 hedge effectiveness requirements.

58. Although designation of individual assets is not required, one could argue the application of the quality criteria will lead to the designation on an asset by asset basis. The staff would highlight that the individual assessment required by the qualifying criteria (ie that the asset be measured at amortised cost) is already required by IFRS 9 and as such the DRM model does not require an additional assessment. Compared with the current one-to-one designation requirements, the staff believe Approach 2 will reduce complexity and operational burden.

59. The staff acknowledge that the dynamic nature of designated portfolios has an interaction with other areas, such as the target profile, derivatives used for interest rate risk management and performance assessment. While this paper addresses the dynamic nature of designated portfolios from the perspective of the asset profile, as the staff develop the other core areas of the DRM model this interaction will be further discussed at future Board meetings.

Staff view

60. The staff are of the view that an entity should have a choice to designate future transactions to be part of the asset profile but only at initial designation, provided designation is consistent with the entity's risk management strategy. In addition, the staff are of the view that changes to designated portfolios resulting in updates to the asset profile should not represent a designation or a de-designation event but instead a continuation of the existing relationship.

Designation of proportions

61. The staff considered whether the DRM accounting model should permit the designation of a percentage of a portfolio. While the scope of DRM is often the entire banking book, and thus designation of 100% of the managed portfolios in the DRM accounting model would be ideal, there could be valid reasons for

managing a percentage of a portfolio. Provided that percentage is consistent with the entity's risk management policies and procedures, the staff believe the model should not prohibit the designation of a percentage of a portfolio. As such, an entity may choose to designate a percentage of the portfolio that is consistent with the entity's risk management policies and procedures. The designated percentage must be consistently applied to all expected cash flows within the portfolio, since designation of different proportions of financial assets within the same portfolio implies these assets are managed on an individual instead of a collective basis. While an entity can change this percentage, the change can only occur if there has been a change in the entity's risk management policies and procedures. As a change in the designated percentage implies a change in the scope of risk management, the staff expect such changes to occur infrequently. This is another example of a change in the scope of risk management as discussed in paragraph 55 and similar restriction would apply.

62. The staff believe that if an entity designates a percentage of a portfolio of financial assets, the same percentage must be applied to a related portfolio of future transactions. For example, if the risk management objective dictates 50% of a portfolio be designated within the DRM accounting model and that same risk management objective requires the entity to designate the re-investments of maturing assets as future transactions, the entity cannot designate an amount inconsistent with the risk management objective. As a result, a percentage other than 50% would not be permitted as it would imply a future change in the scope of risk management. Restrictions to changes in the scope of risk management are discussed in paragraph 55.

63. The staff also considered if the model should permit designations of proportions in other manners as allowed by IFRS 9 (i.e., partial term, etc.). The staff note that many of these designations accommodate risk management strategies that are appropriate and relevant when managing risk on an individual basis. However, DRM is a process that involves understanding and managing, on a portfolio basis, how and when a change in interest rates will impact interest income and interest expense. Consequently, the staff are of the view that such complex designations would not appropriately reflect the overall objective of DRM, nor are they

required. Consequently, the staff believe that such complex designations should not be eligible for the purpose of the DRM accounting model.

Staff view

64. The staff are of the view that the DRM accounting model allows for designation of a percentage of a portfolio, provided that:

    (a) The designated percentage is consistently applied to all expected cash flows within the portfolio;

    (b) The same percentage of a portfolio of financial assets is applied to a related portfolio of future transactions; and

    (c) Designation of a percentage of a portfolio is consistent with an entity's risk management strategy.

Growth

65. Regarding future transactions related to growth, it is important to note that growth (i.e., originations in excess of maturities) implies an increase in the notional of the asset profile. For the asset profile to increase in notional, the entity would require additional funding. As discussed in paragraphs 15 and 16, while DRM is focused on understanding and managing the potential impact of interest rates on interest income and interest expense over time, the staff will discuss financial liabilities and their role within the target profile in a future Board session. However, it is important to note that if an entity wishes to align when interest rate are determined for financial assets and liabilities, if neither has been originated, then future pricing will take place at market rates for both. Therefore, no mitigating actions are required because there would be no exposure to interest rate risk. In other words, it is common for entities to not manage growth as both the future asset and the future liability will be originated at future market rates and therefore, pricing is already aligned.

66. However, if the liabilities are expected to grow because of core deposits where the future price is known, most likely at or near zero, a mismatch in re-pricing does exist. This is because the interest rate for growth assets is unknown and will change with interest rates, whereas the interest rate for growth deposits is known

and will not change. Consequently, an entity may or may not actively manage this component of growth in their risk management strategy. Entities choosing not to actively manage growth accept it will result in some variability over time and incorporate that in their risk management objective. An entity that incorporates growth in their risk management objective is explicitly forecasting an increase in financial liabilities. As discussed in paragraph 16, the staff will consider financial liabilities as part of the discussion on the target profile.

67. Consequently, the staff believe an entity should be permitted to designate a percentage for future transactions related to growth that is different from the percentage designated for the associated portfolio of financial assets, provided this consistent with the entity's risk management policies and procedures. The staff recognise this may add operational complexity, however, if an entity actively manages growth, the entity should already have systems, policies and procedures in place for tracking and disaggregation. In addition, the staff would like to note that this is a choice and does not prevent an entity from designating the same percentage, as long as it is consistent with the entity's risk management policies and procedures.

68. For the reasons discussed above, the staff believe the considerations for incorporating growth as part of a designated future transaction are unique compared with designating the re-investment of a maturing financial asset. As such, the staff believe while designating growth as a future transaction is permitted, subject to meeting the qualify criteria, allocating growth and other future transactions into separate portfolios may assist with tracking and performance assessment.

Staff view

69. The staff think an entity should be permitted to designate a percentage of a portfolio if that is consistent with the entity's risk management objective. That percentage must be consistently applied to all cash flows in the portfolio and also related portfolios of future transactions necessary to achieve the risk management objective. As discussed in paragraph 63, the staff think designation of proportions in other manners is not appropriate for the DRM accounting model.

70. Additionally, an entity may choose to designate growth as a future transaction, however, given growth requires different considerations from other future transactions, the staff think growth could be designated and tracked separately. An entity may designate a different percentage of portfolios related to growth for the reasons states in paragraphs 65 through to 68. As discussed throughout the paper, designation should be consistent with the entity's risk management policies and procedures.

Question for the Board

Question for the Board
3) Does the Board agree with the staff views in paragraphs 60, 64, 69 and 70?

De-designation of financial assets and future transactions

71. Financial assets and future transactions should be de-designated from the asset profile when one of the following events take place:

    (a) Financial assets are derecognised in accordance with IFRS 9. This is because when a financial asset is derecognised – whether through prepayment, sale or write-off from impairment – that financial asset ceases to create interest rate risk;

    (b) The effect of credit risk dominates the changes in expected future cash flows. This is consistent with one of the qualifying criteria discussed in paragraph 23;

    (c) Future transactions are no longer highly probable. This is because a future transaction must be highly probable in order to qualify as part of the asset profile (see paragraph 35).

72. The staff have also considered whether an entity should have a choice to de-designate a portfolio that is part of the asset profile. During its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB discussed

whether an entity should have a choice to revoke the designation of a hedging relationship. Those who supported a choice raised the concern that voluntary discontinuation was an important tool in IAS 39: *Financial Instruments: Recognition and Measurement* (IAS 39) hedge accounting model for financial institutions that normally run hedging programs based on portfolios of items on a macro basis. Those portfolios were subject to constant changes and entities removed the hedge designation with the aim of adjusting the hedging relationship for new hedged items and hedging instruments.

73. However, according to paragraph 6.319 of the Basis for Conclusions of IFRS 9, this would allow hedge accounting to be discontinued even if the entity for risk management purposes continued to hedge the exposure in accordance with its risk management objective. The Board considered that, in such situations, voluntary discontinuation of hedge accounting would be arbitrary and unjustifiable. The Board also noted that the risk management objective had not changed and the other qualifying criteria for hedge accounting were still met, the ability to discontinue hedge accounting would undermine the aspect of consistency over time in providing information about that hedging relationship. Hence, the IASB decided to prohibit a free choice to revoke the designation of a hedging relationship.

74. In addition, the argument noted by some constituents that voluntary discontinuation would be an important tool for financial institutions that manage portfolios of items on a macro basis is not applicable under the DRM accounting model, since items are designated as part of the asset profile on a portfolio and not on an individual basis as required by IFRS 9.

Staff view

75. Consequently, considering the reasons exposed above, the staff are of the view not to allow voluntary de-designation of portfolios within the asset profile when the risk management objective for a particular portfolio of financial assets remains the same and all other qualifying criteria are still met. Also, the staff are of the view that financial assets and future transactions should be de-designated as described in paragraph 71.

Question for the Board

Question for the Board
4) Does the Board agree with the staff view in paragraph 75?

Documentation requirements

76. The staff are of the view that formal documentation of items designated within the asset profile should be required. In particular, an entity should document the following upon designation:

    (a) The portfolio(s) of financial assets designated as part of the asset profile under the DRM accounting model. The level of detail of the documentation should provide sufficient specificity such that when new financial assets are acquired or originated it is clear to which portfolio they should be allocated.

    (b) The methodology used by the entity to determine the amount of future transactions and how designation as part of the asset profile is consistent with risk management policies and procedures. For example, if the entity designates future transactions due to growth and reinvestment, the entity should document the methodology used to forecast the amount considered highly probable and how the designated level of future transactions is consistent with the entity's risk management objectives.

    (c) Evidence supporting the high probability of future transactions occurring. For example an entity may prepare a cash flow maturity schedule, including the effects of the resetting of interest rates for assets and liabilities, showing that there are sufficient levels of expected cash flows to establish that the future transactions are highly probable to occur. This schedule can be supported by past practice of reinvesting cash inflows and refinancing cash outflows as well as observable data used to estimate the expected growth of a designated portfolio. In

addition, the time period during which the portfolio of future transactions is expected to occur should be documented within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing performance.

77. The staff believe that documentation provided for the purpose of the DRM accounting should be supported by an entity's risk management procedures and objectives. The staff expect that changes in documentation should be infrequent and consistent with the entity's risk management practices.

Question for the Board

Question for the Board
5) Does the Board agree with the staff view in paragraphs 76 and 77?

Disclosures

78. The DRM accounting model will provide comprehensive disclosures regarding the asset profile, the target profile and the derivatives used for alignment. However, these disclosures will be discussed in aggregate once the Board have finished discussing the asset profile, target profile, and associated derivatives.