STAFF PAPER

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Project	**Dynamic Risk Management**		
Paper topic	Certain Strategies and the Target Profile		

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Introduction

1. The purpose of this paper is to discuss whether the Dynamic Risk Management (DRM) model should preclude an entity from designating certain types of strategies within the target profile.

2. This paper is structured as follows:

   (a) Summary of staff recommendations (paragraph 3);

   (b) Background (paragraphs 4 – 10); and

   (c) Qualifying criteria to be applied when determining the target profile (paragraphs 11 – 31).

Summary of staff recommendations

3. In this paper the staff recommend additional qualifying criteria for determining the target profile. More specifically:

   (a) Negative balances within the target profile should not be permitted within the DRM model;

   (b) While changes to the risk management strategy and the target profile are permitted, such changes must occur infrequently; and

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(c) The risk management strategy must be clearly documented with a specified time horizon and cannot be defined in a way that is contingent.

Background

4. As discussed at the March 2018 Board Meeting, the role of the target profile within the DRM accounting model is to define the 'objective' management is working towards for a given asset profile. The target profile also allows for the assessment of whether the executed derivative instruments were and continue to be effective in transforming the asset profile. The determination of the target profile should take into account the entity's risk management strategy which, in turn, is influenced by:

   (a) The contractual tenor of financial liabilities where present; and

   (b) Core deposits where present.

5. While the objective of DRM is often described as stabilisation of the net of interest income and expense, the deferral and reclassification mechanisms proposed by the DRM model are designed to also faithfully reflect other risk management strategies.

6. For example, if an entity had CU 1,000 3-year floating rate financial assets yielding LIBOR + 1.00% and CU 1,000 of 3-year fixed rate financial liabilities that bear 6.00% interest and a strategy to stabilise the net of interest income and expense, the tenor of asset profile and target profile before any derivatives are executed would be as follows:

Chart 1

Scenario 1	Float	20X1	20X2	20X3	Total
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Difference	**1,000**			**(1,000)**	

7. Assuming the entity designated a derivative that was equal to the benchmark derivative (ie a 3-year receive fix, pay float interest rate swap), the entity would be perfectly aligned, and the mechanics of the DRM model would ensure the statement of profit or loss reflected the 3-year fixed rate target profile.

8. However, entities can have different strategies and accommodating different risk management strategies is important because, as discussed at the June 2018 Board meeting, the DRM model aims to reflect and not govern risk management. For example, an entity's risk management strategy may be to have the net of interest income and interest expense change in perfect correlation with changes in 1-month LIBOR, a valid risk management strategy. This need becomes more evident in the context of demand deposits as they are insensitive to changes in market factors, such as market interest rates, and therefore, aligning the re-pricing of loans and deposits is difficult and may not be possible, as discussed during the June 2017 Board Meeting and the March 2018 Board Meeting.

9. Irrespective of the need for flexibility within the DRM model, the staff is concerned that in some instances the target profile could be defined in such a way that the proposed mechanics of deferral and reclassification would not provide useful information[1] for users of financial reporting. As a result, in this paper the

[1] Per paragraph 2.4 of the Conceptual Framework 'if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely, and understandable.'

staff discuss whether additional qualifying criteria are needed to preclude an entity from designating certain types of strategies within the target profile.[2]

10. In paragraphs 11 - 25, the staff discuss a couple of examples to illustrate the concern discussed above.

Qualifying criteria to be applied when determining the target profile

11. The role of deferral and reclassification within the DRM model was discussed at the June 2018 Board meeting[3]. In this context, the following paragraphs consider some situations where such mechanics may not provide useful information.

Leverage

12. Consider an entity that has CU 1,000 3-year floating rate financial assets yielding LIBOR + 1.00% and CU 1,000 of 3-year fixed rate financial liabilities that bear 6.00% interest. Given the entity's risk management strategy is to stabilise the net of interest income and expense over a 3-year period, the target profile is a defined as a CU 1,000 3-year fixed rate target profile. The tenor of asset profile and target profile before any derivatives are executed are as follows:

Chart 2

Scenario 1	**Float**	**20X1**	**20X2**	**20X3**	**Total**
Asset Profile	1,000				1,000
Target Profile				1,000	1,000
Difference	**1,000**			**(1,000)**	

13. Chart 2 illustrates a very simplistic risk management strategy and highlights the benchmark derivative required for transformation is a 3-year receive-fix, pay floating interest rate swap. However, the concern regarding leverage becomes

[2] This concern was also noted during the June 2018 Board meeting where the staff noted their intention to discuss qualifying criteria intended to preclude certain 'trading strategies' from being designated as part of the DRM accounting model.

[3] See paragraphs 8 through 20 of the June 2018 Agenda Paper 4C *Financial Performance*.

apparent by altering the scenario. Consider the same scenario where the entity's risk management strategy is to stabilise the net of interest income and expense over a 3-year period, but the target profile is a defined as a CU 2,000 3-year fixed rate target profile. The tenor of asset profile and target profile before any derivatives are executed are as follows:

Chart 3

Scenario 1	**Float**	**20X1**	**20X2**	**20X3**	**Total**
Asset Profile	1,000				1,000
Target Profile				2,000	2,000
Difference	**1,000**			**(2,000)**	**(1,000)**

14. Chart 3 above is constructed using a strategy to stabilise but, as demonstrated by the excess CU 1,000 notional between the asset and target profiles, the derivatives required for transformation must increase the size of the portfolio, rather than just transform the existing one.

15. Absent additional qualifying criteria, given the Board's tentative decisions to date, the entity would define the benchmark derivative as the difference between the asset and target profiles. In this scenario, the benchmark derivative would increase the size of the entity's asset profile, as if those derivatives were a loan or similar type product. Assuming the entity executed and designated derivatives that perfectly aligned, it would apply the DRM model and defer the change in fair value of the designated derivatives in Other Comprehensive Income and then reclassify then to the statement of profit or loss over the life of the target profile.

16. In this particular strategy, the entity's target profile is based on a notional of CU 2,000 whereas the asset profile has a notional of CU1,000. This implies leverage as the entity will need to designate derivative instruments to increase the notional of the asset profile to achieve the target profile. Said differently, rather than using derivatives to transform the financial assets designated within the asset profile, the derivatives would be used to increase the size of the asset profile as if they were financial assets designated within the asset profile, and thus introducing leverage to the DRM model. According to paragraph B4.1.9 of IFRS 9, leverage increases

the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Consequently, if the target profile could be defined in a way that permits leverage, it would not faithfully represent the impact of the entity's risk management activities in financial performance because the model would present as interest contractual cash flows which do not have the economic characteristics of interest. Said differently, the mechanics of the model would transform the derivative cash flows into interest cash flows, even though the derivatives are not transforming financial assets but are being used to create them in the first place.

17. This is why during the March 2018 Board meeting the staff noted that 'the asset profile is the combination of designated financial assets and future transactions and the target profile specifies the re-pricing dates for the asset profile based on an entity's risk management strategy. Therefore, the notional of the asset profile must be equal with the notional of the target profile by definition.'[4] In addition, according to paragraph 28 of the March 2018 Agenda Paper 4B *Target Profile*:

> If the notionals of the target and asset profile are not aligned, then this implies either:
>
> (a) the target profile represents something other than specified re-pricing dates for items designated within the asset profile based on an entity's risk management strategy. For example, this could imply leverage within the target profile; or
>
> (b) financial assets within the asset profile are funded by financial liabilities that are outside the scope of the entity's DRM policies and procedures. This would imply the risk management objective is not to manage the net of interest income and expense but merely interest income.

18. Against this background, the following paragraphs discuss how leverage can be introduced to the target profile in other ways.

[4] Refer to paragraph 27 of the March 2018 Agenda Paper 4B *Target Profile*.

Negative Balances within the target profile

19. The qualifying criterion discussed in paragraph 17 focused on the total notional of the target profile. In this section, the staff consider whether there should be any restriction on the notional within the individual time buckets of the target profile. More specifically, while the criterion discussed in paragraph 17 focuses on the total column of chart 3 above, this discussion considers if there should be any individual restriction on the notionals in each time bucket (ie Float, 20X1, 20X2 and 20X3 columns of chart 3).

20. To begin, the staff considered if the individual time buckets should be equal between the asset and target profiles, however, as the target profile specifies the re-pricing dates for the asset profile based on an entity's risk management strategy, by definition, they are not necessarily equal. In fact, a requirement that the individual time buckets be equal between the asset and target profile would imply there is no need for transformation and thus no need for derivatives to transform the asset profile. As such, the staff think that the notionals in the individual time buckets can be equal, but are not required to, because such a restriction would eliminate the need for the DRM model in the first place.

21. In addition, the staff considered whether the model should restrict the percentage allocated to any particular time bucket (ie should 100% of the total notional be permitted in a specific time bucket). The staff do not think such a restriction would be appropriate for two reasons. Firstly, the intent of the model is to reflect and not govern risk management; and secondly, allocating all re-pricing to a single time bucket is a perfectly valid risk management strategy and can be entirely consistent with the most conservative of strategies. For example, if all financial liabilities re-price in a specific time bucket, then allocating 100% of the target profile's notional to that same time bucket would be consistent with stabilisation as described in paragraph 6 and chart 1 of this paper. As such, the staff think the model should not restrict the percentage allocated to any particular time bucket. For the avoidance of doubt, if the DRM model does not restrict the percentage allocated to individual time buckets, then it is a logical consequence that specific time buckets can have zero balances. If a specific time bucket in the target profile has zero notional allocated, then this means no transformed assets should re-price at that time.

22. However, the staff are concerned about a specific set of circumstances whereby the target profile is defined such that individual time buckets have a negative balance. Colloquially, this would mean the target profile is defined with a "short" position.

23. For example, assume an entity has CU 1,000 3-year floating rate financial assets yielding LIBOR + 1.00% and CU 1,000 of 3-year fixed rate financial liabilities that bear 6.00% interest. The entity believes that the floating rate will be decreasing in the near future and therefore, defines the target profile as CU 1,500 in the 20X3 time buckets and CU (500) in the float time bucket. This target profile is defined in a way that the entity is 'short' financial assets in the 'float' bucket. Said differently, the target profile is defined such that the 'float' re-pricing bucket has a balance less than zero implying the entity will be paying the float rate rather than receiving the float rate. If there is a decrease in interest rates as anticipated by the entity, it will pay less interest and therefore benefit. The tenor of the asset and target profiles before any derivatives are executed would be as follows:

Chart 4

Scenario 2	**Float**	**20X1**	**20X2**	**20X3**	**Total**
Asset Profile	1,000				1,000
Target Profile	(500)			1,500	1,000
Difference	**1,500**			**(1,500)**	

24. The staff believe that such a strategy should not be allowed because this strategy is another attempt to create leverage within the target profile. While the overall notionals are the same, this strategy requires the entity to transform more assets than have been designated in the "float" bucket and in that manner represents leverage for that particular-time bucket. Observed differently, the total re-pricing in the 20X3 bucket of CU 1,500 is greater than the entire notional of the asset profile. Therefore, similar to the situation described in paragraph 16, derivatives are being used to increase the size of the asset profile as if they were financial assets. This raises the same concern as noted in paragraphs 16 that the designated derivatives are not transforming the asset profile.

Preliminary View

25. In view of the above reasons, the staff think negative balances within the target profile should not be permitted within the DRM model. The staff do not believe that deferral and reclassification would provide useful information in this scenario.

Question for the Board

Question for the Board
1) Does the Board agree with the staff preliminary view in paragraph 25?

Changes in risk management strategy

26. As discussed at the September 2018 Board meeting, for the purpose of the DRM model, a change in the risk management strategy occurs when management makes a decision that requires a change in the entity's target profile. Examples of a change in strategy that requires a change in the entity's target profile would be a modification in the time horizon of risk management (ie moving from stabilising over a 3-year to a 5-year period) or say altering the strategy from managing the net of interest income and expense on an undiscounted basis to a present value basis, as discussed during the September 2018 Board meeting.

27. The staff would highlight that entities can change their risk management strategy for a variety of reasons. For example, a change in risk management strategy could occur in response to changes in the economic environment, such as a structural change in the interest rate environment. The staff expect such changes in the risk management strategy to occur infrequently. If these changes occur frequently, this lessens the usefulness of information provided by the DRM accounting model and it becomes less clear if the derivative activity is for alignment rather than to profit from short-term-fluctuations in interest rates. Therefore, if changes are frequent, consideration should be given as to whether management should discontinue the use of the DRM model prospectively.

28. The staff also considered if an entity could define the target profile in such a way that it would not be obvious that a change in the risk management strategy has occurred. For example, consider an entity that defines the target profile as a 5-year fixed rate profile, however, if interest rates were to increase by 200bps before the end of T^1, the entity would then decide to stop actively managing interest rates at the end of T^1 to benefit from such an increase in market rates. The staff think the target profile should not be defined in such a way for two reasons.

29. Firstly, for an entity to manage the net of interest income and expense, it must know what actions are required to accomplish the stated objective. If the objective is not clear, then the entity's actions will be unclear. In the above example, the objective of the entity is potentially unclear. For example, is the objective to stabilise over a 5-year period or is to be in a position to benefit from an anticipated increase in interest rates at T^1? It is worthwhile noting that both both strategies require different actions to be executed at T^0. The former would require entities fixing the net of interest income and expense until the end of T^5. Whereas the later would require entities to transform financial assets such that they re-pricing at the end of T^1. If interest rates will have risen compared with T^0, then the entity will benefit from higher interest income as a result. While both strategies have their merits and drawbacks, both are perfectly acceptable within the DRM accounting model, the entity must be clear regarding which strategy it is following.

30. Secondly, this definition could result in entities avoiding the change in risk management strategy requirements tentatively agreed by the Board during the September 2018 meeting. These requirements clearly permit the change in strategy; however, the entity would be required to reclassify the accumulated amount in Other Comprehensive Income over the life of the target profile as defined prior to the change in risk management strategy. This approach would preclude entities from changing its risk management strategy to achieve a specific accounting outcome that is inconsistent with the purpose of the DRM accounting model. If the entity avoids documenting such a change, the question that arises is what the time horizon should be under these circumstances, is it 5 years, or 1 year? Given the proposed documentation has not clearly defined the period over which the net of interest income and interest expense is managed, reclassification

is not possible because the time horizon is not clear. This is inconsistent with the performance principles of the DRM accounting model and, therefore the risk management strategy must be clearly documented and specifies the target profile's time horizon. The time horizon of the target profile cannot be documented in a way that is contingent.

Preliminary View

31. In view of the above reasons, in addition to the qualifying criteria already tentatively agreed by the Board, the staff are of the preliminary view that the following additional qualifying criteria are required:

    (a) While changes to the risk management strategy and the target profile are permitted, such changes must occur infrequently; and

    (b) The risk management strategy must be clearly documented with a specified time horizon and cannot be defined in a way that is contingent.

Question for the Board

Question for the Board
2) Does the Board agree with the staff preliminary view in paragraph 31?