

# The IASB's proposed Dynamic Risk Management Model

## *Global banking industry survey*

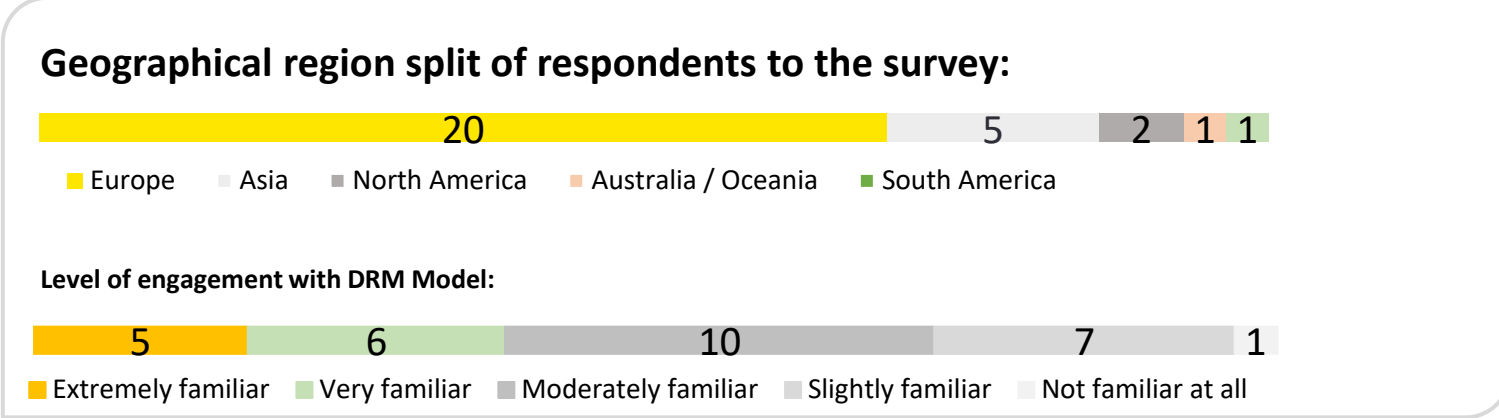
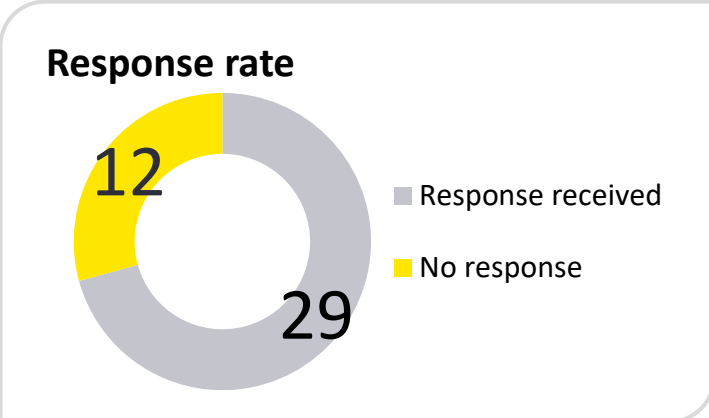
Note: EY conducted a Survey on behalf of ISDA to perform an assessment on the current tentative decisions made by the IASB on the Dynamic Risk Management (DRM) model. The Survey was carried out with the help of 'Qualtrics Core XM' ("The Tool"). All data collected by the "Survey Tool" have been aggregated and anonymised. All information (including personal data) is confidential and will not be retained by "The Tool" after the 'retained period'.

May 2024

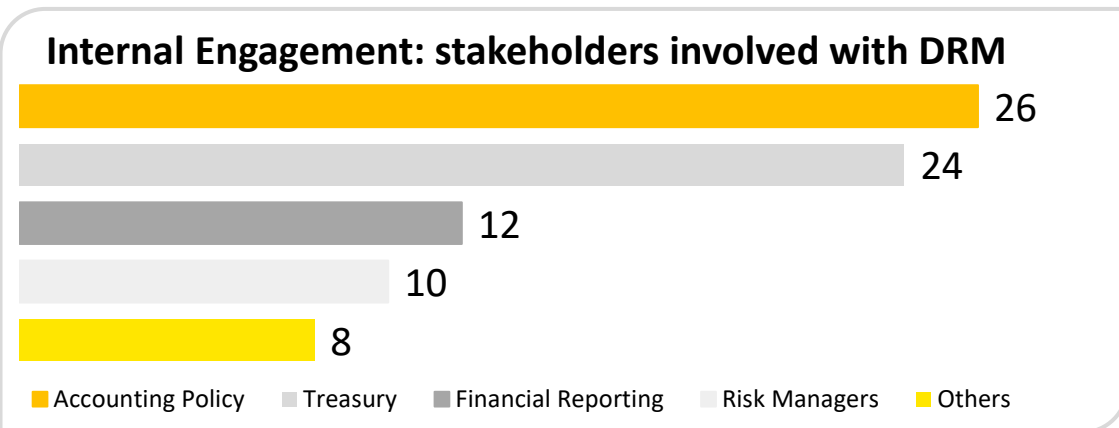


## DRM: Survey Findings:

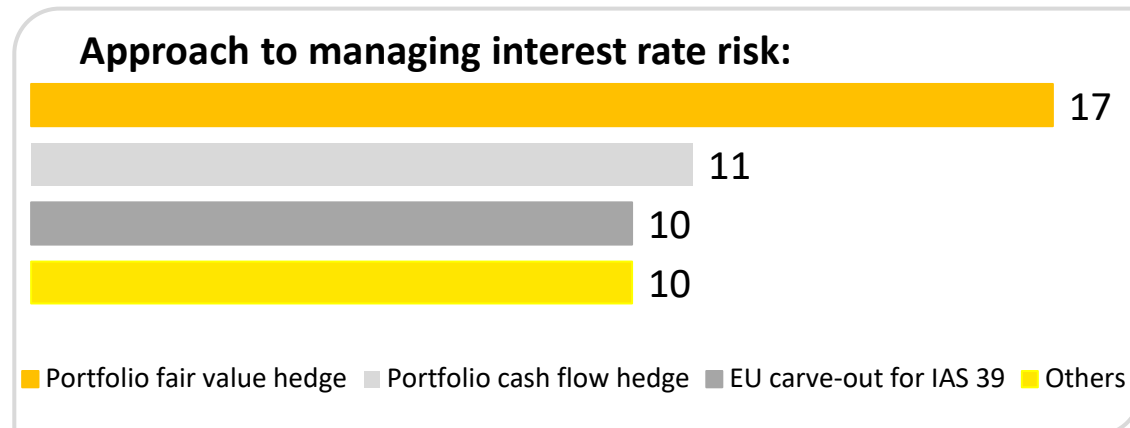
The results show (i) a concentration of respondents in Europe, consistent with the widespread use of current macro hedging approaches across this jurisdiction but also (ii) a material portion of the respondents are still developing their thinking on the consequences of the model and is expected to evolve towards a greater level of familiarity as the development of the model progresses.



Note: Of the 11 banks that responded, 'Extremely familiar or 'Very familiar', all are based in Europe.



Note: For Others, 2 banks have a separate hedge accounting department and 3 noted their ALM department



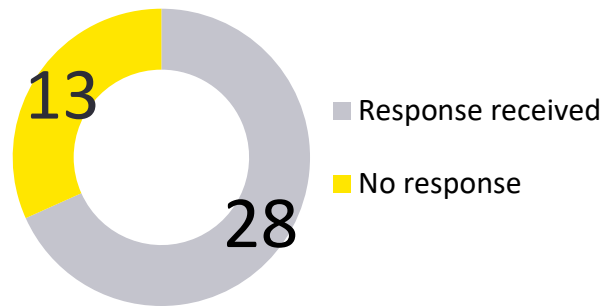
Note: 4 banks stated they use proxy hedging of which 2 banks noted they have shortage of capacity

## Section 1:

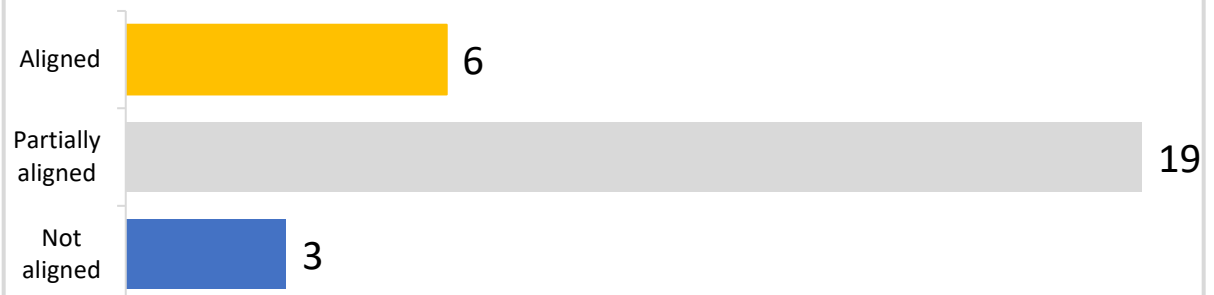
Survey responses considering the *principles* of the DRM model

## Based on your current assessment, how aligned is the definition of the Current Net Open Risk Position (CNOP) and Target Profiles with your risk management?

### Response Summary:



### Response:

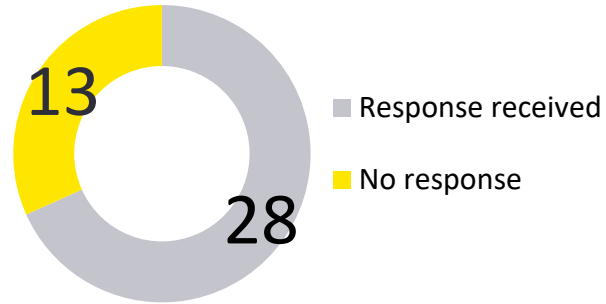


### Further comments:

- Differences to risk management view are a barrier.
- 12 banks commented that equity should be allowed for inclusion in the model.
- 10 banks commented that the DRM model should align more closely with risk management practices.
- Some answered 'partially aligned' as they are still completing their assessment and the model is development is continuing.

# Based on your risk management approach how does your entity / organization manage Interest Rate Risk (Risk Limits) in terms of risk metrics?

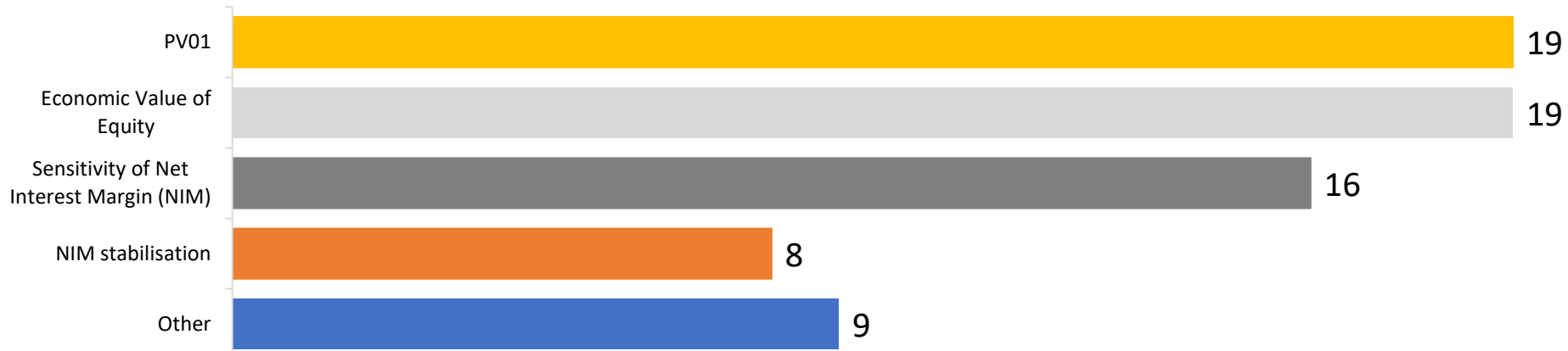
## Response Summary:



Further comments were that other risk metrics include:

- Earnings at risk.
- Sensitivity of net interest income (including to rate shocks and ramps).
- Sensitivity of economic value of equity.
- Interest rate gaps for future periods.

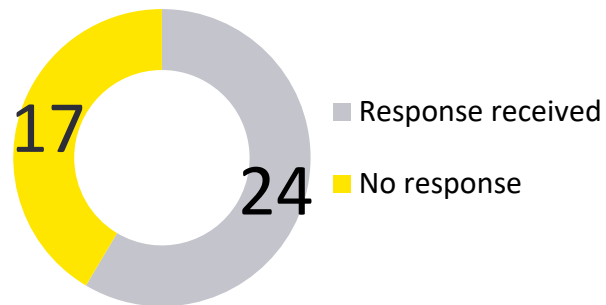
## Response:



Note: Entities often use more than one risk metric, hence the total number of responses is greater than the number of entities that answered.

## Based on your risk management approach how does your entity / organization manage Interest Rate Risk (Risk Limits) in terms of risk management?

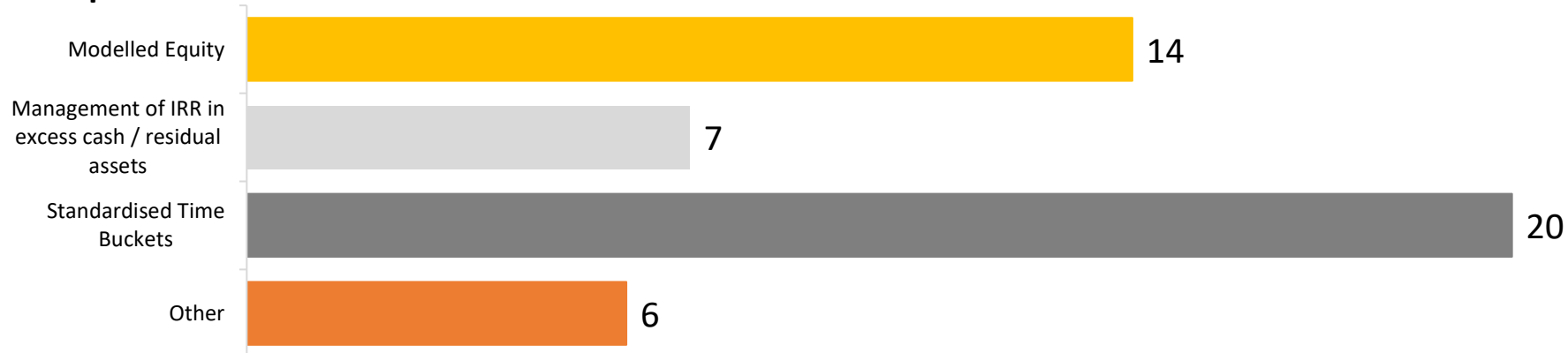
### Response Summary:



Further comments were that other risk management approaches include:

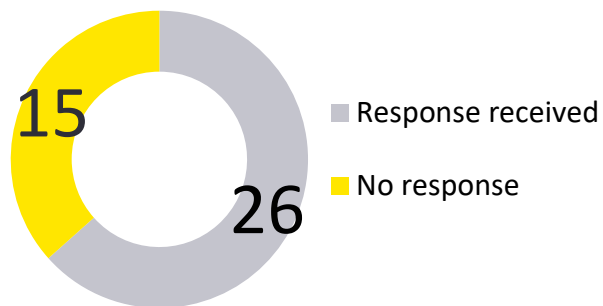
- PV01 of equity.
- Limits not per time buckets but overall that apply across multiple time buckets.
- PV01 NII sensitivity.
- Risk limits on a time bucket and overall basis, with structural balances including equity and core demand deposits modelled for IRRBB purposes.

### Response:



## Based on the current drafting of the DRM tentative decisions do you consider that they provide sufficient room for preparers to exercise judgement in relation to the Target Profile, the CNOP, the definition of the Benchmark Derivative?

### Response Summary:



### Response:

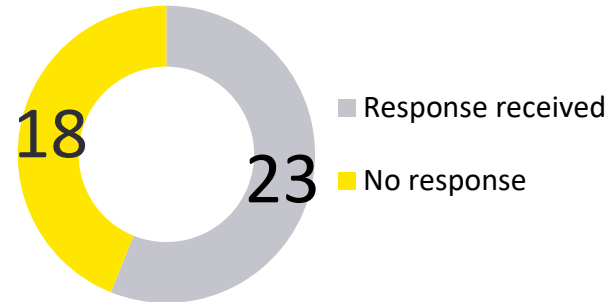


### Further comments :

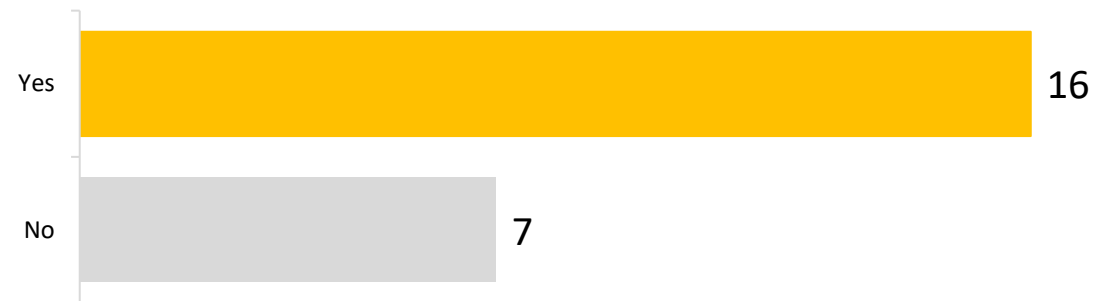
- 1 bank noted that the CNOP may be too restrictive to align with risk management.
- Other banks noted that further clarification and guidance is needed in various areas including, boundaries for direct approach for modelled equity, how changes in deposit volumes and beta convexity is reflected in the model, eligibility criteria in respect of future / forecast transactions, one sided loan commitments such as fixed rate mortgages, scope for dynamic management where additional hedges required in addition to current CNOP for future NII stabilisation.

## Does the mathematical expedient created by the benchmark derivative give a correct representation of the risk (risks being hedged) for risk management purposes?

### Response Summary:



### Response:

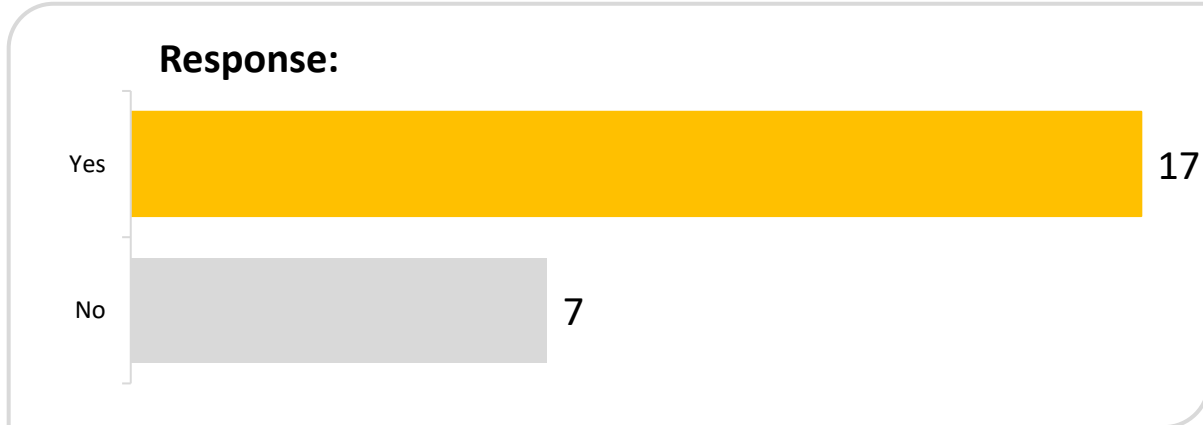
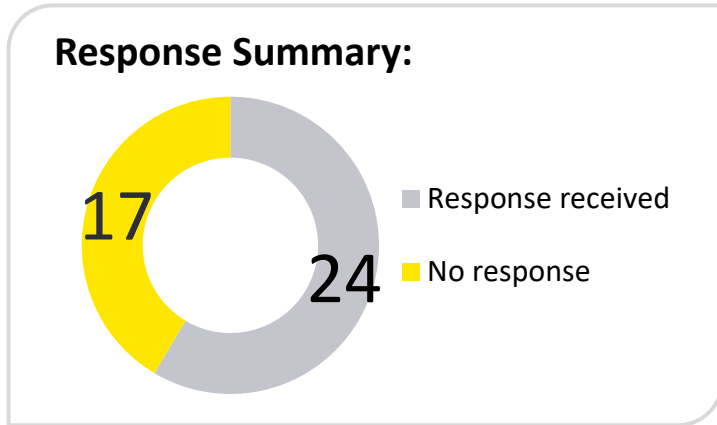


### Further comments :

- A number of banks have open questions on how the BDs will operate, as the BDs may not be reflective of risk management.
- 4 banks noted that the BDs should not be different to the DDs otherwise it adds unnecessary complexity and cost. Coupons should match, both should use the same benchmark rate.
- BDs should not be a pure mathematical expedient.
- It is aligned, other than if DDs need to be less than the CNOP, since when executing hedges it may be practical at times to size a hedge larger than the CNOP to get best execution.



# Do you consider that the scope of the risk mitigation intention in relation to allowable hedging instruments is sufficient to capture the risk management that should be reported under the scope of DRM?

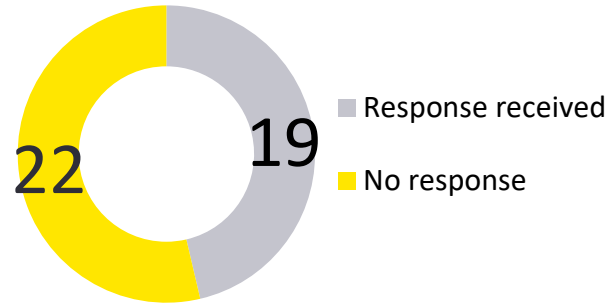


Further comments:

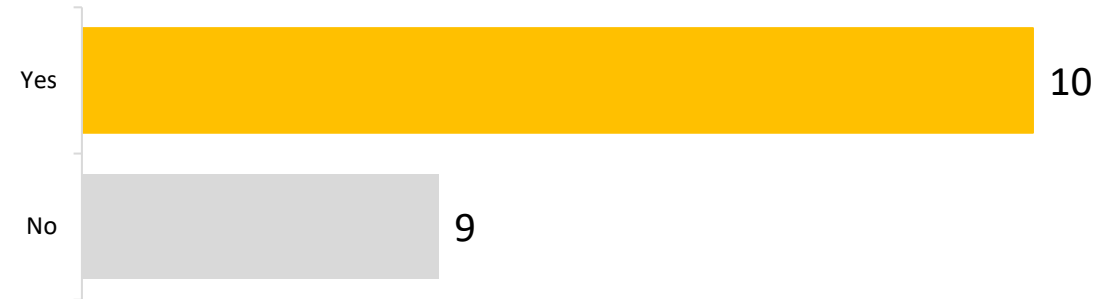
- Actual risk management does not align with DRM so some risk management activity not included.
- Lack of ability to include interest rate risk for equity.
- FX instruments in IRRBB not incorporated.
- Need to understand if non-linear derivatives can be included.

## Do you consider that the principles underlying the prospective and retrospective assessments are sufficiently aligned to risk management to ensure timely adjustments to the Risk Mitigation Intention and Benchmark Derivatives or, if ultimately needed to the CNOP and Target Profile?

### Response Summary:



### Response:

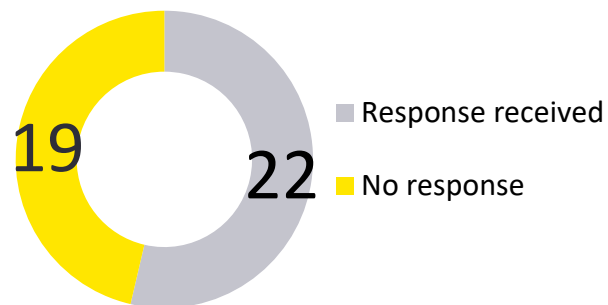


### Further comments:

- Portfolio may change intra-day as risk management is continuous so traditional retrospective concepts like designation and prospective / retrospective do not apply, so a retrospective test needs to consider the 'result' of the hedging strategy. IRRBB can be updated immediately whereas DRM is only revised at measurement dates. May need a daily process to measure and hedge risk.
- If daily monitoring of risk position, a retrospective test should not be required. Unclear how to operationalise the tests, e.g. not sure if report should be run on reporting date or date when derivatives are executed (dates may be different so interest rates will move causing BD to be different to DD,
- Concern that prospective assessment would preclude that NII optimisation strategies in limit could be applied. As long as derivatives reduce residual risk which is within limits, there should be no ineffectiveness
- IASB should eliminate prospective assessment for target profile as this creates implementation challenges for banks that use PV01 on an overall basis (need more guidance on how to construct BDs for relevant time buckets).
- Numerical examples for non-linear derivatives would be helpful.

## Do you consider that the principles underlying the process of the measurement of the mismatch between the Designated Derivatives and the Benchmark Derivatives (adjusted benchmark derivatives) are aligned to risk management and will ultimately reflect the level of misalignment (ineffectiveness) within the DRM designation?

### Response Summary:



### Response:

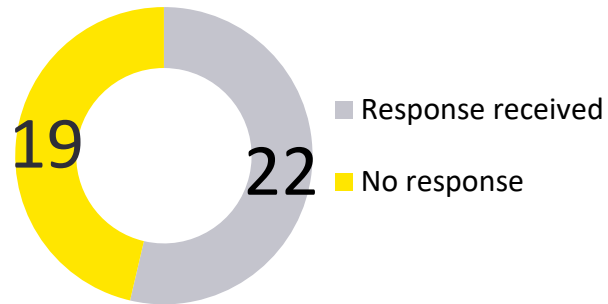


### Further comments:

- The calculation methodology for the FV of BDs should be clarified.
- Performing the lower-of test on DD and BDs and adjusting net income on a life-to-date basis is overly burdensome - lower of test should be based on clean prices and interest accruals on DDS should be booked as NII adjustment.
- Measuring the mismatch will be a mathematical exercise and may not reflect IRRBB reality. Operational method of tracking and measuring BDs needs further consideration and analysis.
- More guidance needed on time buckets, e.g., is it OK to have smaller at short term (e.g., 3 months) and larger at long term (e.g., 1 year)?

## Based on your entity's assessment of the current DRM tentative decisions how should the proposed disclosures be?

### Response Summary:



### Response:

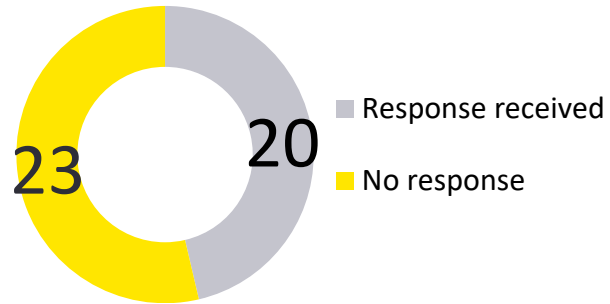


### Further comments

- Align to existing disclosures, e.g. Pillar III, avoid requesting detailed quantitative disclosures as may be commercially sensitive, explanations / judgements will need to be objective based.
- It is important for banks to tell their own story so that financial statement users are able to understand and evaluate the bank's risk management strategy. The objective based disclosures will provide banks with principles to follow, with flexibility in the presentation to provide the most relevant information that are easy to understand to improve the value of disclosures. At the same time, some prescriptive disclosures are needed to ensure critical information provided to users are presented in a similar manner, so banks' financial statements are comparable across jurisdictions.
- Disclosures should align with risk management strategy and objectives.
- Should be in line with regulators' prudential framework.
- Avoid too much detail on risk management information (e.g. Target profile, RMI, CNOP) as already in risk management disclosures.
- Should cross refer to IRRBB disclosures.
- Should not include commercially sensitive information.

Based on your entity's assessment of the current DRM tentative decisions, what do you see as other key areas of improvement, e.g., clarification of existing principles, application guidance or illustrative examples, or something else? Please explain.

### Response Summary:



### Response:

#### *Points of principle*

- Clarification on various areas (capacity test and interest-bearing liabilities, non-linear derivatives, limits on portfolio level if breached, which BD should be adjusted).
- Main area of concern is divergence between DRM model and risk management.
- Include modelled equity.
- Greater alignment to IRRBB model
- Remain principles based to allow for judgement.

#### *Operational considerations*

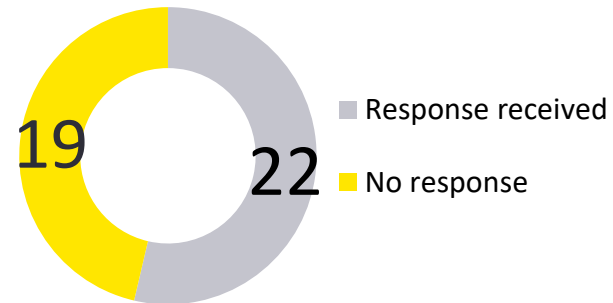
- Lifecycle events.
- Application guidance and illustrative examples (including over multiple periods /through the life).
- To calculate FV of BDs Day 1 P&L should be ignored or accrued.
- Perform lower-of test based unclear prices.
- IASB should set up a transition resource group to address implementation questions.

## Section 2:

Survey responses on the *practical and operational* considerations for applying the DRM model

**Do you have a view for how the capacity test could work? (Note: it has only been discussed at a high level by the IASB and it is not obvious how it works for floating rate exposures in the CNOP). If so, please explain your thinking.**

#### Response Summary:

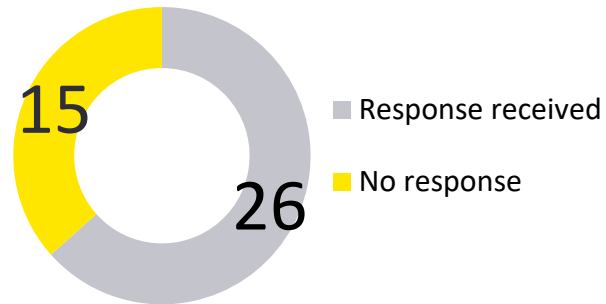


#### Response:

- 9 banks commented that they have no clear view on this yet as they are awaiting further proposals from the IASB.
- Other banks' comments included, that it needs to be practical and aligned to risk management, questions over how it would relate for floating rate exposures. So long as reducing risk with the risk limits there should be no ineffectiveness. Unclear how capacity test differs from the ineffectiveness measurement.
- Questions if failing the capacity test could lead to discontinuation of DRM. Full daily fair value of the CNOP not feasible on a daily basis, PV of aggregated risk management cash flows could be compared to BDs.
- More straightforward for EVE strategies than for NII strategies.
- The further DRM strays from actual risk management, the higher the operational costs due to need to maintain different views of risk.

## Based on your current risk management view, how do you think the DRM adjustment should be recognised in the P&L?

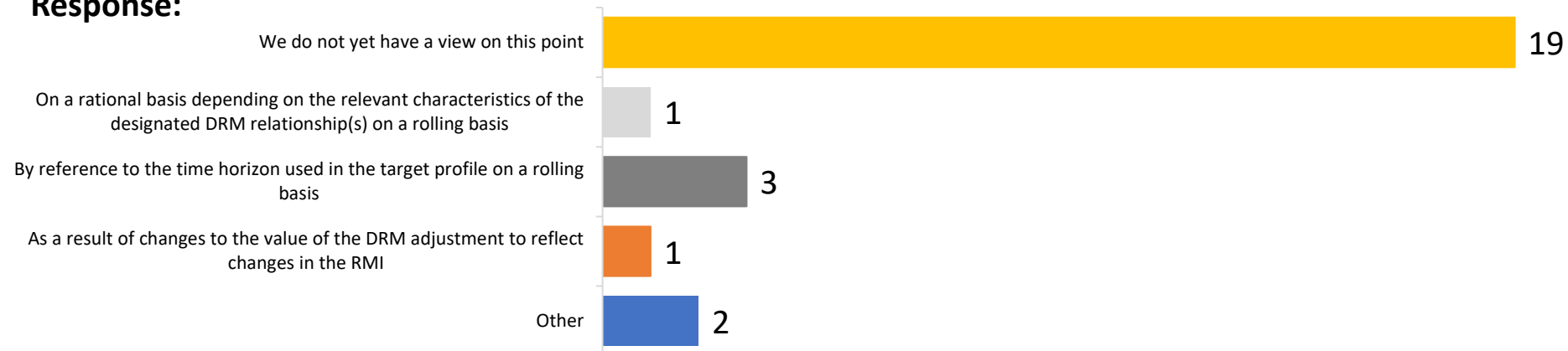
### Response Summary:



Only a few comments, reflecting that banks have not thought about this point yet.

- If we assume that BD and DD are aligned (putting aside lower of test), the DRM adjustment is based on the change in fair value of the BD/DD, which should converge to zero as BD approaches maturity.
- Unclear how DRM adjustment should be presented on balance sheet and how allocated to assets and liabilities, and how allocated across the portfolio.
- Banks should be allowed to define the relevant presentation in the P&L.
- Further work needed on discontinuation and rebalancing aspects.
- P&L presentation should reflect NIM stabilization objectives / limits

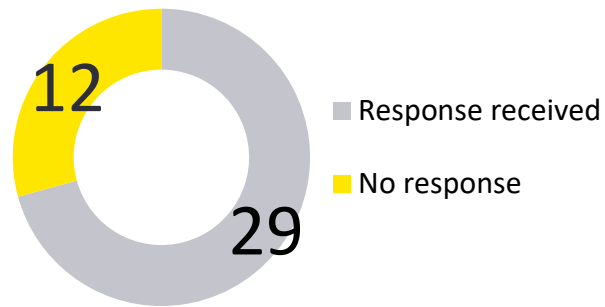
### Response:





## Are derivatives currently utilised for risk management purposes and if not, what are the main constraints to the use of those, for example e.g., the inability to utilise proxy hedging or the lack of market liquidity?

### Response Summary:



### Response:

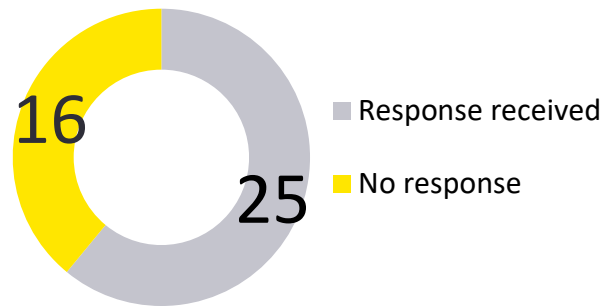


### Further comments:

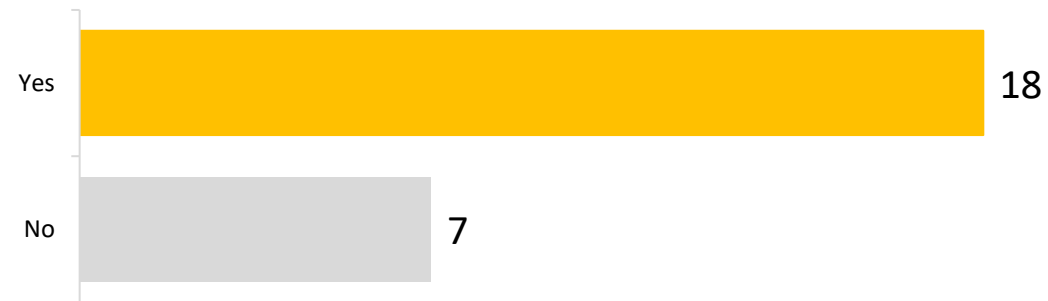
- 4 banks noted that they use proxy hedging of which 2 banks noted that some derivatives used for risk management purposes cannot be designated for hedge accounting, which included some basis swaps and short-term interest rate swaps.
- 2 banks noted the problem with identifying sufficient capacity for proxy hedging.

## Would DRM allow the use of derivatives in the DRM model that cannot presently be used for hedge accounting by your bank?

### Response Summary:



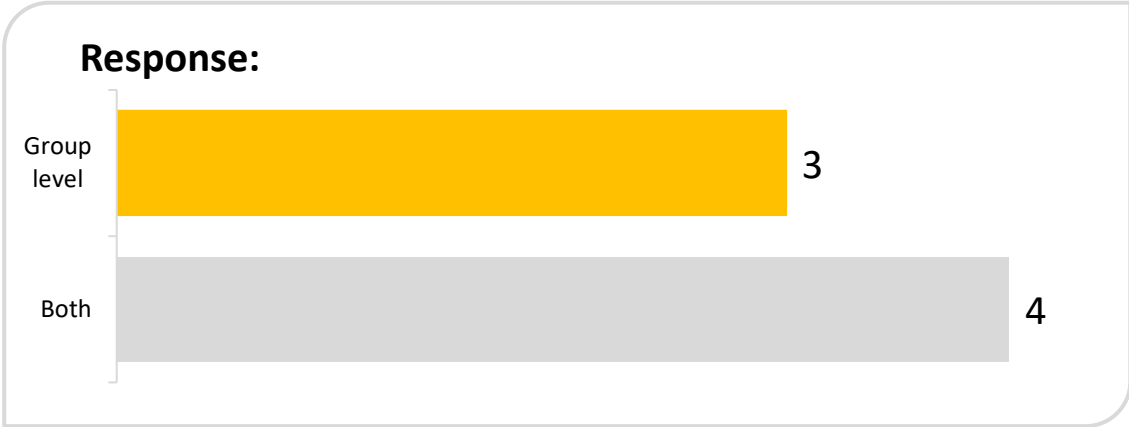
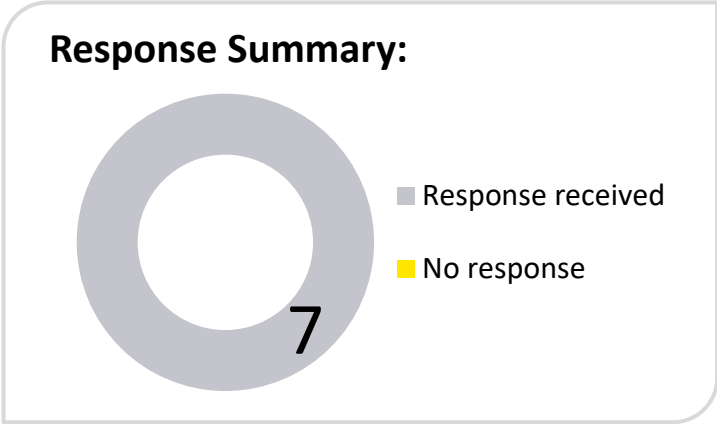
### Response:



### Further comments:

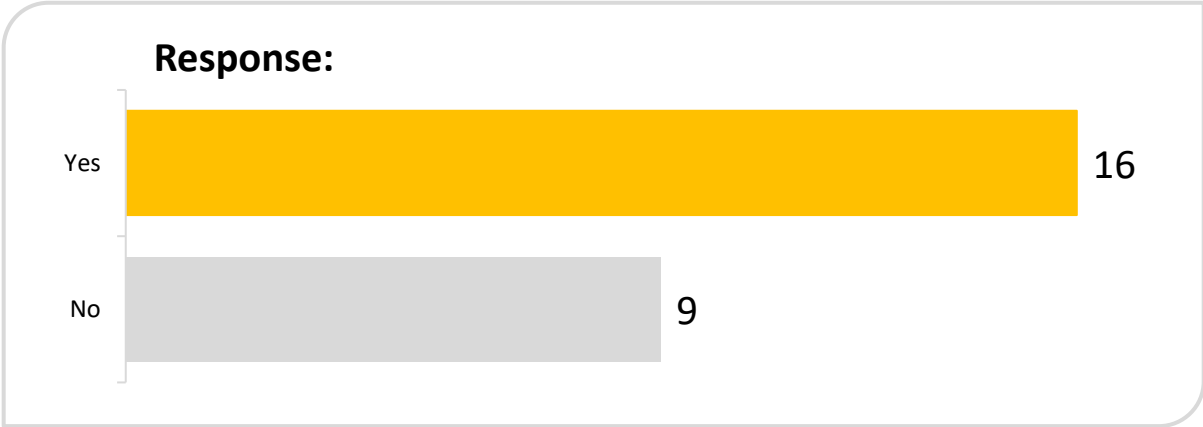
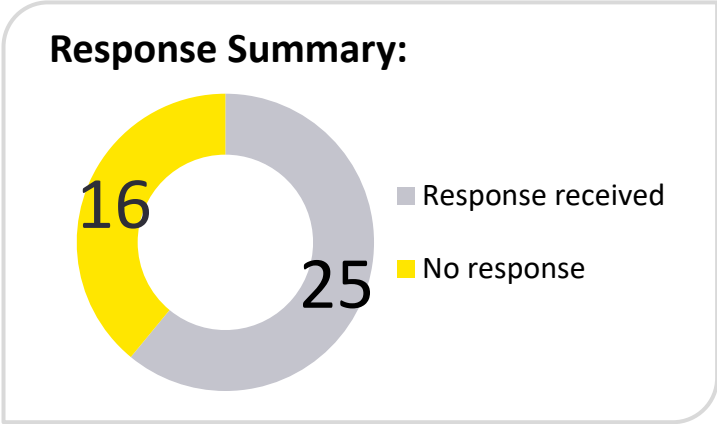
- Benefits include being able to add into the model, core deposit and pipeline risk / forecast transactions.
- Further clarity needed for equity model book and non-linear derivatives.
- Possible inclusion of equity, AT1s and non linear risk would be beneficial.

# If your answer to the previous question was 'no', would the restriction on the use of these derivatives be at the individual entity, group level or both?



No relevant further comments to note

**Do you consider that proxy hedging should exist in the DRM model to deal with its limitations? For example, if the current description of risk management excludes certain practices your organisation undertakes.**

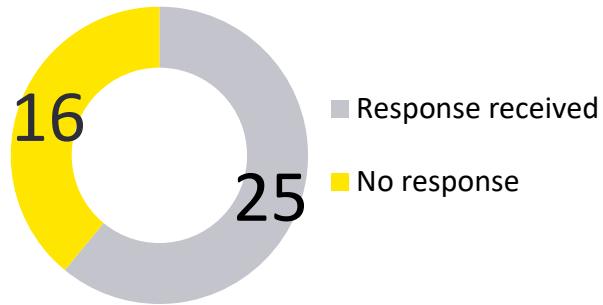


Further comments :

- As the DRM model is not fully aligned to risk management, some proxy hedging will be required, to cover equity, and if using proxy hedging from an IRRBB point of view.
- If DRM requires proxy hedging it reduces the benefit of moving to a new model.

## Do you anticipate that the Benchmark Derivatives will be closely based on the Designated Derivatives (e.g., they will be calibrated to the same market rate and they will have the same floating rate, etc.)? <sup>21</sup>

### Response Summary:



### Response:

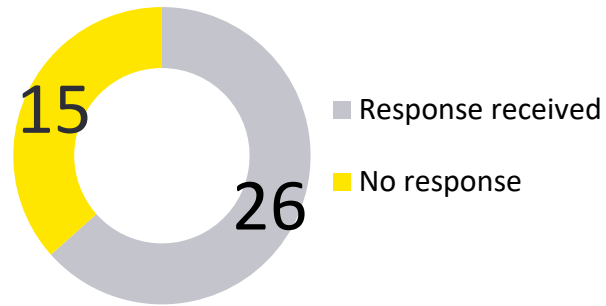


### Further comments:

- Operational complexity of timing given daily DD trades versus periodic updates to BD (e.g., monthly).
- Whether there could be more than one benchmark rate per currency (e.g. it matches the DD).
- Expected managed rate of each CNOP to have same floating rate as DDs.
- Expect fixed leg of BDs to follow market convention for the DDs.

## What should a change in the risk management strategy lead to?

### Response Summary:



Further comments for 'Something else':

- Some form of rebalancing without full discontinuance.
- Not one-off adjustments in the P&L (as not aligned with business model).
- DRM adjustment should only be affected if the change in strategy means the hedging portfolio is no longer a good fit.

### Response:

Discontinuation of the DRM model and recycling of the DRM adjustment

3

Rebalancing of the DRM model and subsequent revision to the DRM adjustment

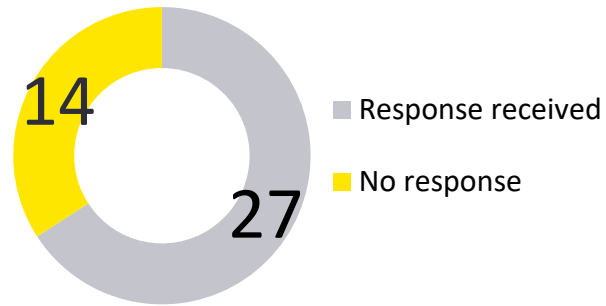
14

Something else

9

## How would you define a change in the risk management strategy?

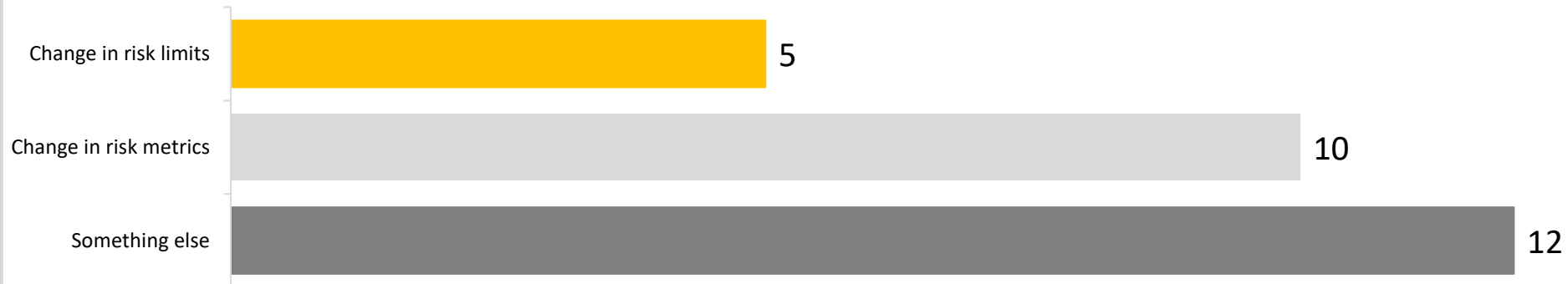
### Response Summary:



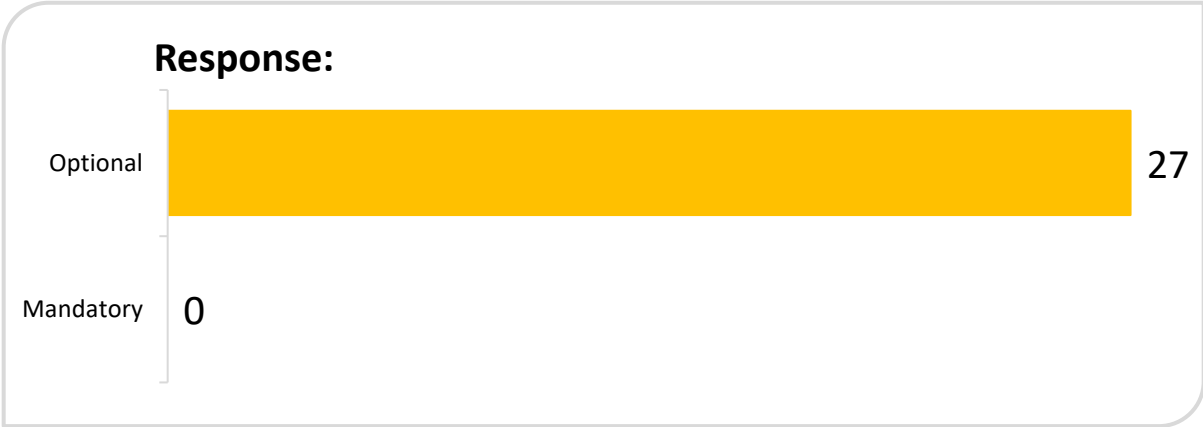
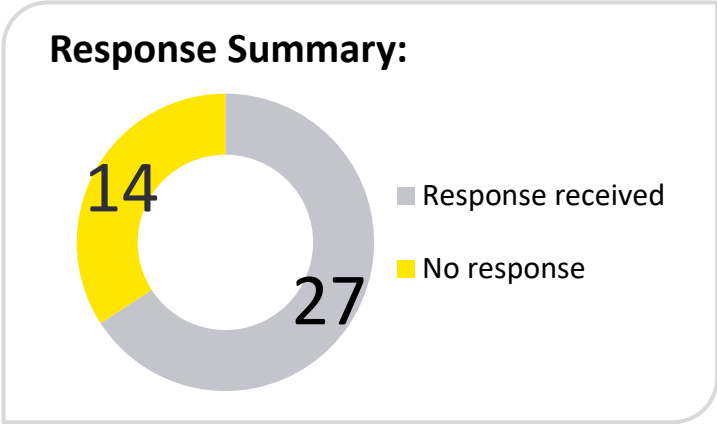
### Further comments for 'Something else':

- A significant /material change in how the entity manages risk as reflected in the risk metrics, or IRRBB.
- Change subject to CDOM governance.
- Change in fundamental assumptions around core deposits and equity. C
- Change in risk limits not necessarily a change in strategy.

### Response:



# Based on your entity's assessment of the current DRM tentative decisions, do you consider that the application of the future DRM should be:

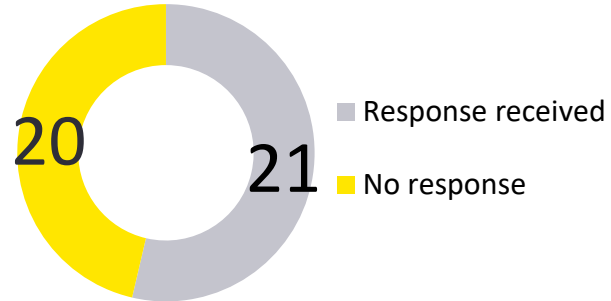




## Based on your entity's assessment of the current DRM tentative decisions where do you see the key operational challenges in the implementation of the model? Please explain.

25

### Response Summary:

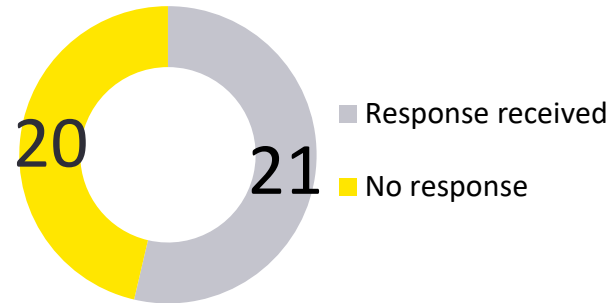


### Response:

- A recurring point is that DRM should be as close to risk management as possible to reduce the need for additional systems and complexity. Potentially large challenges anticipated.
- Lower of test taking into account interest accruals.
- Retrospective test will lead to frequent adjustments to BDs (e.g., due to prepayments) and using clean prices can lower the burden, availability of data / construction of CNOP as exposure of entire balance sheet is required as an input.
- New portfolio of BDs needs to be maintained. Tracking and valuing the BDs.
- Review of current processes and systems (e.g., behaviouralisation, designation process, adjustments to hedge relationships, amortisation of DRM adjustment and ongoing effectiveness assessment and measurement of ineffectiveness).
- Review of risk maps, treasury and performance models.
- Determining the period over which the DRM model is run.
- Establishing the designation and measurement cycle.
- Calculating and booking ineffectiveness etc.
- If inclusion of an equity as a practical expedient is not permitted they are not sure how operationally the model can work.
- Unclear how to use existing risk reports to carry out the tests.
- Implementation will involve many functions (risk management, treasury, IT, front office, accounting policy, and financial reporting)

## When it comes to implementation and ongoing compliance where do you see the areas where significant costs will arise? Please explain.

### Response Summary:

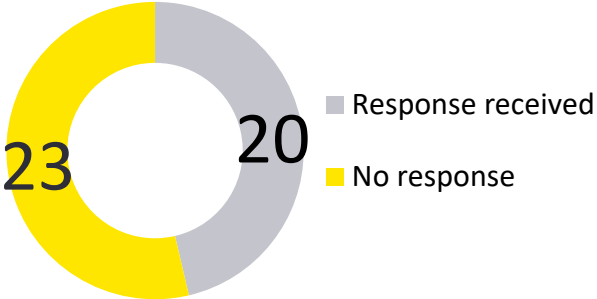


### Response:

- Almost all banks identify the need to invest in new IT systems, including risk management systems. Specific areas identified include
  - need to consider daily portfolio data
  - Risk training of accountants.
  - Portfolio of BDs (most logically in same system as DDs).
  - Having sufficient resources to manage and understand the model once it is running.
  - Valuation method for the capacity test

# What do you see as an appropriate lead time to ensure appropriate implementation of future IFRS on DRM? Please explain. <sup>27</sup>

## Response Summary:



## Response:

- Of the 20 responses, **3 years or more** is the majority view.
- Half think at least 3 years and 2 think at least 4 years
- 6 have no specific view as the detailed requirements are not yet available.
- 2 banks think 2 years.

## Section 3: Summary of key findings from the survey

## Key findings from the survey

As noted on the first slide, only a minority of respondents (11 out of 29) assessed themselves as ‘Extremely familiar’ or ‘Very familiar’ with the DRM model. Their responses may therefore change as they become more familiar with the DRM model

By way of summary, the view of a majority of respondents was that:

### *Considering the **principles** of the DRM model*

- The definition of Current Net Open Risk Position (CNOP) and Target Profiles is partially aligned with risk management (many would like to see greater alignment, mainly with respect to the inclusion of equity, or for workarounds / practical expedients for the inclusion of equity in the CNOP)
- Participants think that the DRM tentative decisions to date do not provide sufficient room for preparers to exercise judgment in relation to the Target Profile, the CNOP and the definition of a Benchmark Derivative (most notably on the differentiation between a mathematical expedient and a market-based approach)
- Despite the previous point, respondents think that the Benchmark Derivatives give a correct representation of the risks being hedged
- The scope of the Risk Mitigation Intention for allowable hedging instruments captures risk management under DRM (but many want equity added)
- Participants think that the principles underlying prospective and retrospective assessment are not sufficiently aligned to risk management
- Respondents think that the principles of the process to measure the mismatch between the Designated Derivatives and Benchmark Derivatives are not aligned with risk management
- Respondents think that the disclosures should be a combination of objective based and prescriptive

## Key findings from the survey

By way of summary the view of a majority of respondents was that:

*Considering the **practical and operational implications** for applying the DRM model*

- Respondents currently have no clear view on:
  - For the capacity test, how it could work, and they await further proposals (it should be practical and aligned to risk management)
  - How the DRM adjustment should be recognised in P&L, and they await further proposals
- DRM should enable inclusion of financial instruments not currently eligible for hedging relationships (adding equity, non-linear derivatives and AT1s would be beneficial)
- Respondents think that to minimise operational challenges, DRM should be as close to risk management as possible to reduce the need for additional systems and processes
- Respondents think that Proxy Hedging should be permitted to deal with the DRM model's limitations (e.g., if equity not included in the model, also IRRBB may use proxy hedging)
- The Benchmark Derivatives will be closely aligned to the Designated Derivatives (complexities include daily rebalancing, multiple benchmark rates or differences in terms dealing with different points of designation)
- The majority of the respondents think that a change in risk management strategy should lead to a rebalancing of the DRM model and subsequent revision to the DRM adjustment (but it is unclear what represents a change in risk management strategy)
- Application of DRM should be optional
- Significant implementation costs are expected by nearly all respondents in IT systems and risk management systems
- 3 or more years will be needed for implementation after publication of the final DRM Standard