Applying IFRS

IASB continues to develop its DRM accounting model

December 2023

Building a better working world

Contents

What you need to know

- The IASB has now completed its initial deliberations on the main components for the future accounting model for portfolios of interest rate risk for many banks. The IASB is starting to assess whether, the model can be extended to a wider range of entities than banks and, potentially, to cover other risks.
- The IASB has sought to align the accounting model with the approach actually used for risk management, so as to limit any inconsistencies between them. In particular, the Dynamic Risk Management (DRM) model would move away from traditional hedge accounting models, that focus on a specific hedged amount, to a risk management strategy that sets out an acceptable range (using risk limits) within which the risk exposure can vary.
- Whereas the IASB had previously intended to apply an accounting approach similar to cash flow hedge accounting, giving rise to volatility in Other Comprehensive Income (OCI), the DRM adjustment is now proposed to be recorded on the balance sheet. Part of the reason for this was that it is unclear whether or not the regulatory filters currently in place for the cash flow hedge reserve would have been replicated for a DRM reserve.
- It is now possible to understand, at a high level, how the model is expected to work. However, the IASB is still developing other areas of the model as it works towards an Exposure Draft, expected to be published in 2025.
- Since the first edition of this publication, the IASB has tentatively decided that own equity may not be included as an exposure in the DRM model but has now clarified that excess floating rate assets can be. This allows a strategy of managing variability in net interest income to be reflected in the DRM model.

1. Introduction

At its meeting in May 2022, the International Accounting Standards Board (the IASB or the Board) completed its deliberations on the outline of the proposed Dynamic Risk Management (DRM) accounting model. In October 2022, the IASB Staff produced a webcast that summarised the model as proposed[1] and in November 2022 the first edition of this publication set out our high-level understanding of how the model would work.

Since then, the IASB has made a number of important additional tentative decisions in their meetings in November 2022 and February, April, May, July and October 2023, which are reflected in this second edition of the publication. These include:

- The reversal of a previous tentative decision that, in effect, required alignment of the notional values of the designated assets and liabilities in the DRM core model (see section 3, step 1 below)
- An entity's equity is not eligible for inclusion in determining an entity's current net open risk position (CNOP) in the DRM model (see section 3, step 1)
- Financial assets may be included in determining the entity's CNOP in the DRM model if they are classified and measured at fair value through other comprehensive income (FVOCI), but not if they are classified and measured at fair value through profit or loss (FVPL), even when they are held in a hold-to-collect business model if they fail the 'solely principal and interest' (SPPI) test (see section 3, step 1)
- The normal requirement that a forecast cash flow should be highly probable to be included in the CNOP will be relaxed for the reinvestment or refinancing of ***existing*** financial assets or financial liabilities at the prevailing market interest rate. These may be included in the CNOP as long as they are ***expected*** to occur (see section 3, step 1)
- A retrospective assessment against an entity's target profile is no longer to be required, only an assessment that the risks were actually mitigated. However, instead, a capacity test will be introduced to capture the effects of unexpected changes in the entity's CNOP, such as significant prepayments that have reduced it. This will ensure the DRM adjustment is not recognised at an amount higher than the expected benefit to be realised in the future (see section 3, steps 7 and 9).

For the May 2023 IASB meeting, the Staff also prepared some detailed examples of how they envisage the DRM model would work.[2]

A number of points of detail have still to be discussed and agreed before the Board can issue an Exposure Draft (ED), which is now expected to be in 2025. The remaining topics which are expected to be brought to the IASB include:

- The IASB has tentatively decided that the DRM model should be discontinued following a change in risk management strategy. The Board will redeliberate the circumstances that may lead to discontinuation of the DRM model.
- Subsequent to the Board's tentative decision in November 2021, that if an entity discontinues the DRM model the DRM adjustment is unwound over time, the DRM model has evolved as a result of the tentative decisions reached by the IASB. The IASB, therefore, plans to redeliberate this area.
- The Board will consider in detail the presentation of the DRM requirements in the statement of financial position, the presentation of

[1] IFRS - Webcast series: Dynamic Risk Management

[2] Agenda Paper 4A: DRM Model, Illustrative Examples, May 2023. LINK

amounts released to the profit and loss and any accompanying disclosure requirements.

- The Board will discuss what transition rules should be applied when entities first apply the DRM model.

It has been the IASB's intention that once this model is completed, entities will no longer be permitted to apply the hedge accounting guidance in IAS 39 *Financial Instruments: Recognition and Measurement*, including the portfolio fair value hedge accounting model.[3]

How we see it

IFRS reporters presently apply various approaches for interest rate portfolio hedge accounting. The development of the transition rules will, therefore, need to be followed closely by users and preparers to ensure they understand the impact of the DRM model on first application.

As the IASB gathers feedback from non-banking entities, the DRM model may evolve to accommodate other risk management practices. Insurers, large corporates and utilities could all potentially benefit from applying the DRM model to better reflect their risk management practices in the financial statements. However, any development to the model should remain consistent with the principles already established. This is necessary to ensure the final DRM model remains principles-based and can be adapted for use by different entities without undue complexity, whilst maintaining consistency and comparability.

Applying the principles that underlie the DRM model is likely to introduce new areas of judgement, which preparers, users and auditors should start to identify and understand as the IASB develops the model.

The components of the DRM model are now substantially complete for interest rate risk management. At its meeting in October 2023, the IASB considered the principles to determine the scope of the DRM model, focussing on the type of risk management and business activities for which the model would be appropriate and provide useful information. It was proposed that the relevant characteristics of the entity's risk management activities would include that the entity engages in maturity transformation[4] and dynamically manages its portfolio(s) of financial assets and financial liabilities to manage its exposure to interest rate repricing risk.[5] Whilst these principles are relevant for banks, the IASB will seek feedback from non-banking entities, such as insurance companies, utilities and large corporates, to understand whether they could apply the DRM model as tentatively agreed. The IASB also intend to consider whether the DRM model can be applied to other risks[6].

2. Background to the project

The IASB began its macro hedging project in September 2010, because of the difficulties associated with applying the normal hedge accounting requirements to a dynamically managed portfolio with continuous or frequent

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[3] IFRS 9 BC6.103-104. LINK

[4] The financial process where entities borrow and lend funds with different maturities simultaneously is commonly referred to as maturity transformation. In addition to interest rate risk, maturity transformation also leads to liquidity risk and credit risk to an entity, although those are not considered in the context of the DRM model. Staff paper AP4, Dynamic Risk Management, Scope of the DRM model, October 2023. LINK

[5] Staff paper AP4, Dynamic Risk Management, Scope of the DRM model, October 2023. LINK

[6] Staff paper AP4B Dynamic Risk Management (DRM) project Direction, May 2022. LINK

changes in the risk positions that are being hedged. These difficulties, as described by the IASB Staff[7], include the following:

i) The normal hedge accounting requirements are designed for 'closed portfolios', in which specific hedging instruments are designated as hedges of specific hedged item for a set period of time, after which there is a discontinuation of the hedge accounting relationship and the designation of new ones. This does not cater well for so called 'open portfolios', which are dynamically managed, with continuous or frequent changes in the risk positions that are being hedged. Among other issues, it gives rise to operational complexities because hedge accounting relationships need to be tracked and hedge adjustments need to be amortised.

ii) It is common for banks to manage interest rate risk arising from a combination of financial assets and financial liabilities on a net basis. However, normal hedge accounting requires portfolio hedges to be designated on a gross basis.

iii) This net interest rate risk position arises from a combination of variable- and fixed-rate exposures. Accordingly, the economic mismatch has both fair value and cash flow variability and banks try to manage both aspects together. However, normal hedge accounting requires the designation of the hedging relationship as either a fair value hedge of the fixed rate items or as a cash flow hedge of the variable rate items, even though neither would faithfully depict the complete economic phenomenon in financial reporting.

iv) Because it is common for customers to maintain demand deposit accounts for an extended period of time, risk managers often identify a part of the demand deposit portfolio that is considered to be stable and treat these 'core demand deposits' as a fixed interest rate liability for risk management purposes. However, because the fair value of demand deposits is deemed to be constant for accounting purposes, fair value hedge accounting is precluded (when not applying EU carved-out version of IAS 39).

An objective of the project is that completion of the DRM model will enable banks to follow a globally consistent accounting approach, using a single DRM model, in contrast to the current situation where banks apply either IFRS 9, IAS 39 or the EU carved-out version of IAS 39 for hedge accounting.

3. Summary of the DRM model

The objective of the DRM model is to provide useful information to enable users of financial statements to understand:

(a) The entity's dynamic risk management strategy and how it is applied to manage interest rate risk (e.g., repricing risk);

(b) How the entity's interest rate risk management activities may affect the amount, timing and uncertainty of future cash flows; and

(c) The effect that applying the DRM model has had on the entity's financial position and financial performance[8].

To achieve this objective, the Board has tentatively agreed to a number of significant conceptual changes in the accounting approach. These are set out in more detail in Section 5.

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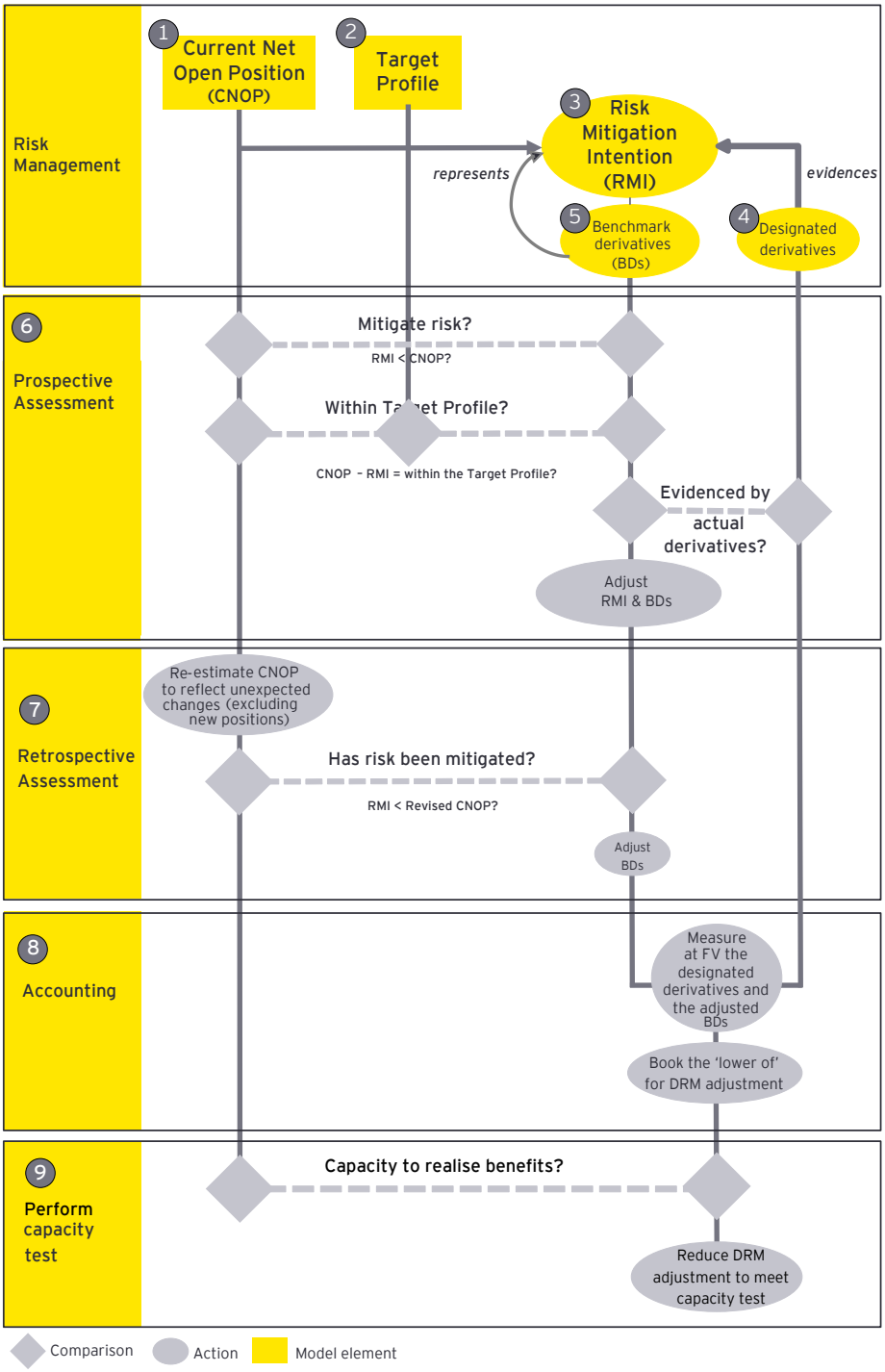
[7] Staff Paper AP4B, Dynamic Risk Management (DRM) Project Direction, May 2022. LINK

[8] As described in Staff Paper AP4A Dynamic Risk Management (DRM) Scope of the DRM model, October 2023. LINK

Overview of the DRM model



The proposed DRM model requires the following nine steps:

1. Determine what assets and liabilities should be included

The entity must first decide what financial assets and liabilities would be managed within the scope of the DRM model. They are represented by what is called the Current Net Open Position (CNOP). This is the interest rate risk position (by time bucket), reflecting both expected (i.e., modelled) cash flows from assets, liabilities (including core demand deposits) and eligible future transactions, over the period in which the entity manages its repricing risk.

The IASB has tentatively decided the qualifying criteria for including financial instruments within the CNOP to be:

(a) Financial assets or financial liabilities must be measured at amortised cost and (as tentatively agreed at the February 2023 meeting) debt instruments measured at fair value through other comprehensive income (OCI) under IFRS 9

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

(c) Future transactions must be highly probable unless they represent the reinvestment or refinancing of ***existing*** financial assets or financial liabilities, in which case they must be at least expected to occur (see further, below)

(d) Future transactions must result in financial assets or financial liabilities that are classified as subsequently measured at amortised cost or debt instruments at FVOCI under IFRS 9

(e) Items already designated in a hedge accounting relationship in accordance with IFRS 9 or IAS 39 are eligible to be included in the CNOP as a hedged exposure (combined with the related hedging instrument) if doing so is consistent with the risk management strategy[9]

(f) Items must be managed on a portfolio basis for interest rate risk management purposes[10]

Derivatives may not be included in the CNOP (unless they are part of a hedge accounting relationship included in the DRM perimeter as a combined exposure) nor an entity's own equity (see below).

It was tentatively decided at the February 2023 meeting that, financial assets classified as FVOCI may qualify for inclusion in the DRM model. However, financial assets classified as FVPL as a result of not having contractual cash flows that are solely payments of principal and interest (SPPI), but nevertheless have contractual payments of interest even if they are considered part of the 'banking book' from a risk management standpoint, would not qualify for inclusion in the DRM model.

How we see it

While entities may find it helpful to be able to include financial assets classified as FVOCI in the DRM model, because of the DRM measurement approach (see step 7), the effects of risk mitigation will be recognised in the balance sheet rather than in OCI. Consequently, this will not reduce the volatility of recorded OCI. Entities may therefore prefer to apply conventional hedge accounting to such assets if they wish to manage their OCI.

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[9] Staff paper AP4B, Designation of hedged exposures in the current net open risk position, July 2023. LINK

[10] As summarised in Staff Paper AP4 Dynamic Risk Management (DRM) Project Plan, July 2022. LINK

Core demand deposits and prepayable assets

'Core' demand deposits, paying a minimal or very low rate of interest and so treated for risk management as, in effect, fixed rate, are in the scope of the model provided they will not reprice immediately with a change in market interest rates and the entity is not contractually obliged to change the interest rate when the market interest rates change. 'Behavioural' models would be used to determine the expected maturity profile of their deemed fixed rate risk.

The notional amount of demand deposits treated as 'core' and their associated tenor must be based on reasonable and supportable information, which means they are derived from the bank's internal models and historical assumptions. However, there has been limited discussion so far on how the effects could be captured in the DRM model when there are changes in model assumptions for core demand deposits[11].

Similarly, the expected maturity profile of prepayable instruments would be modelled using behavioural assumptions.

The entity's equity

It was decided at the November 2022 meeting that the entity's equity is not eligible for inclusion in the DRM model, for two reasons:

1. Equity in itself does not give rise to variability in either economic value or net interest income. This is different from core demand deposits because the fair value of a portfolio of core demand deposits would change when benchmark interest rates change, when customer behaviour is taken into consideration. The impact on the overall interest rate risk exposure of an entity is, instead, determined by the characteristics of the designated net assets that are funded by equity. If the overall net exposure is to variable interest rates (either because it has floating rate assets or because its fixed rate assets will mature and be replaced by new ones at market rates) the entity will be exposed to variability in net interest income (NII).
2. Given the tentative decisions regarding not requiring a notional alignment of assets and liabilities in the DRM model and on future transactions (see below), it is considered unnecessary to designate equity in the DRM model. For instance, if equity is used to finance net floating rate assets, at a high level it makes no difference whether a hedging derivative is labelled as a hedge of 'fixed rate' equity or of floating rate assets. Hence, the decisions would allow entities to include these excess floating rate assets in the DRM model, thus allowing the entity to manage variability in NII. For example, application of the IASB's decision would permit a receive-fixed pay-floating swap with a notional of 10 to offset the risk of 10 of floating rate assets, which is broadly the same as using a similar swap to hedge 'fixed rate' equity. This is illustrated in the example shown in *Notional alignment of designated assets and liabilities* below.

Notional alignment of designated assets and liabilities

In November 2022, the IASB considered whether a previous tentative decision that, in effect, required alignment of the notional values of the designated assets and liabilities in the DRM core model was still necessary, following more recent refinements to the DRM model.[12] The IASB tentatively decided that notional alignment will no longer be required.

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[11] As summarised in Staff Paper AP4 Dynamic Risk Management (DRM) Project Plan, July 2022. LINK

[12] Staff paper AP4B, Notional alignment of designated assets and liabilities, November 2022. LINK

An example given in the Staff Paper[13] is where an entity has fixed rate assets with a notional value of CU100, and CU80 of floating rate liabilities. The entity would have been restricted to including only CU80 of the fixed rate assets in the DRM model. However, participants have said that notional alignment is often not possible, because, for example:

(a) Equity is used as a source of funding for the designated assets and while entities may model the theoretical funding cost of equity as part of their risk management, equity is ineligible for designation in the DRM model (see below)

(b) Other financial instruments are included for interest rate risk management purposes, but are currently ineligible for designation in the DRM model (for example, financial assets that are measured at fair value through profit or loss)

(c) Interest rate risks from financial assets or liabilities are managed and hedged individually using the general hedge accounting requirements in IFRS 9 and are, therefore ,based on the Board's decisions so far, ineligible for inclusion in the DRM model

(d) There is a mismatch in currencies between financial assets and financial liabilities. As such, they cannot be designated in the same DRM model

(e) Funding is raised on an entity-wide basis while designated assets are originated on an individual business unit basis. As a result, the origination of assets cannot be directly matched to the relevant funding liabilities and, therefore, respondents may find it difficult to identify and allocate the funding liabilities needed for each (sub)portfolio to achieve notional alignment.

The Staff Paper explains that continuing to require this alignment:

(a) May limit an entity's ability to designate the risk mitigation intention (see step 3) as evidenced by the derivatives used to externalise the risk. It would therefore not be consistent with the IASB's tentative decisions about the risk mitigation intention and its overall desire to represent actual risk management.

(b) Would take the focus away from an interest risk perspective and a move back towards designating underlying assets and liabilities.

(c) Decisions about which assets or liabilities to exclude (depending on the circumstances at that particular date) would be completely arbitrary.

(d) This approach may lead to an entity having to designate a hedging relationship applying normal hedge accounting for the excess of assets and liabilities that is not eligible for inclusion in the DRM model.

The Staff Paper distinguishes between a risk management strategy that seeks to reduce changes to net interest income (NII) and one that is focused on managing the entity's economic value (EVE). This is best explained with an example of a simple balance sheet:

	Assets	**Liabilities and Equity**	**Net**
	CU	CU	CU
Fixed	20	30	-10
Floating	80	60	+20
Equity		10	-10
Total	100	100	-

[13] Staff paper AP4B, Notional alignment of designated assets and liabilities,, paragraph 20, November 2022. LINK

In this example, the entity may choose either to hedge its net fixed rate exposure of -10 (the EVE approach), by entering into (for instance) a receive-fixed, pay-floating swap with a notional of 10, or its net floating rate exposure of +20 (the NII approach), using (say) a receive-fixed, pay-floating swap with a notional of 20. The difference in the notional values of the two strategies is, of course, the 10 by which the assets in the model exceed the liabilities.

The November 2022 Staff Paper explains that an entity's risk management strategy determines which of these two risk metrics (NII or EVE), takes precedent 'at a particular risk point', implying that a different strategy may be applied to different time buckets. (This is illustrated in the Staff's May 2023 worked examples).

How we see it

The tentative decision not to require an alignment of the notional values of assets and liabilities contributes to avoiding the need to designate equity

in the DRM model. This is because it enables a bank to designate its receive-fixed, pay-floating swaps against floating-rate assets as a proxy for the modelled fixed-rate equity exposure that cannot be directly included in the DRM model.

Nevertheless, if a bank enters into hedging derivatives based on its modelled equity, it is possible that its accounting will be exposed to differences in

the expected repricing dates of the bank's net floating rate assets and the modelled maturity of its equity. Whilst the IASB is still to determine how to apply the tentative decision in detail, a possible consequence is that this difference in the timing of repricing, which may give rise to a level of profit or loss volatility due to the misalignment.

Future transactions

The general requirement is that a future transaction must be ***highly probable*** to be included in the CNOP. However, in April 2023 the IASB tentatively decided that this hurdle should be relaxed for the reinvestment or refinancing of ***existing*** financial assets or financial liabilities at the prevailing market interest rate. These may be included in the CNOP as long as they are ***expected*** to occur.

This decision resolves what would otherwise be an inconsistency between the requirements for forecast rollovers of existing assets and liabilities and the allocation of core demand deposits and prepayable assets based on expected cash flows. It would also allow those banks that currently model their equity as a fixed rate liability to include, instead, in the DRM model the net floating rate assets that are expected to be funded in future by their equity.

The Staff Paper sets out draft guidance of factors to consider when assessing whether such future transactions are expected to occur. An entity should consider all reasonable and supportable information available regarding the occurrence of such transactions, including information that is forward-looking. The assessment should also be consistent with how such expectation is determined for risk management purposes. For example, an entity could consider information including, but not limited to:

(a) The accuracy of past expectations and the length of time until the future transaction is expected to occur

(b) The financial and operational ability of the entity to reinvest or refinance

(c) Future commitments that require financing or future available funding that need to be reinvested

(d) The extent of loss or disruption of operations that could result if the reinvestment or refinancing does not occur (for instance, due to credit or liquidity issues)

(e) The likelihood of using other alternatives to the reinvestment and refinancing

(f) The entity's business plan.

Other questions

The Staff has also received questions on whether an entity could have more than one DRM model for one particular interest rate, for example, when risk management in a single entity is segregated for different business units. At the meeting in October 2023, the IASB staff described how they expect that interest rate risk, that is originated in different business units, will often be centrally aggregated by interest rate benchmark and managed as part of a single systematic process to form the basis of an entity's DRM model. Separate DRM models would be established where a separate risk management strategy is applied to an interest rate benchmark. In the absence of a process to aggregate and manage risks centrally, it may better suit entities to use the general hedge accounting requirements for a group of items within each business unit.[14]

Another issue is whether an entity always needs to have a separate DRM model for each currency. For example, a bank may obtain funding in a currency that is different from the one they use for their main operations, convert this via cross currency swaps, and then manage the interest rate risk together with other assets and liabilities denominated in its functional currency as an aggregated exposure.[15] The IASB tentatively decided in July 2023, that underlying financial assets and financial liabilities denominated in different currencies should be allocated to separate DRM models. However, entities are permitted to convert foreign currency exposures into another currency, for example by transacting cross currency swaps and include them in the DRM model for that currency.[16]

Determination of the CNOP To determine the CNOP, financial assets and financial liabilities are to be aggregated, consistent with how entities monitor and manage the net interest rate risk from their financial assets and financial liabilities. However, financial assets and financial liabilities are included in the CNOP and allocated to time buckets based on expected repricing dates.

The examples prepared for the May 2023 Board Meeting help illustrate the method of allocation that the Staff have in mind. For instance, in scenario 1A, it is assumed that an entity has only a five-year fixed rate asset and a five-year floating rate liability, each with a notional value of 1,000, entered into on 1 January 20X1, each with bullet repayment. These are allocated to time buckets as follows:

	20 X1	**20x2**	**20X3**	**20X4**	**20X5**
	CU	**CU**	**CU**	**CU**	**CU**
Fixed rate assets	1,000	1,000	1,000	1,000	1,000
Floating rate liabilities	1,000	1,000	1,000	1,000	1,000

[14] Staff Paper AP4 Dynamic Risk Management, Scope of the DRM model, October 2023. LINK

[15] Staff Paper AP4 Dynamic Risk Management (DRM) Project Plan, July 2022. LINK

[16] Staff Paper AP4 Dynamic Risk Management (DRM) Designation of hedged exposures in the current net open risk position, July 2023. LINK

How we see it

It will be noted that the example does not just allocate the assets and liabilities to buckets based on their repricing dates, but, instead, forecasts what will be the outstanding exposure at various points in the future and, hence, shows the open risk exposure to interest rate changes for portions of the yield curve. This is different from how banking book interest exposure is often managed for EVE purposes or reported to banking regulators. For instance, according to the recent guidance issued by the Basel Committee, the floating liabilities in the above fact pattern would be allocated only to the 20X1 bucket, while the principal of the fixed rate debt would be allocated to the buckets in which the cash flows are expected to occur[17] (i.e., 20X5 in the example). The Staff's approach is not mandated, since the approach to be used should be consistent with the entity's risk management. However, given that these two approaches have a very different concept of how instruments are allocated to time buckets, whatever approach used has a significant effect on how risks are offset between time buckets, as discussed in step 3.

2 Set the target profile

The entity must establish a **target profile**, defined as the range, using risk limits, within which its CNOP can vary. That is, it is the amount of the risk the entity is willing to tolerate which is clearly documented in its risk management strategy.

In April 2023, the IASB tentatively decided that the managed risk for the purposes of the DRM model is the interest rate risk that the entity manages consistent with its risk management strategy and, therefore, the risk an entity's risk limits are based on. The Staff Paper added that any managed risk identified must be reliably measurable (for example, it must be linked to a benchmark interest rate where there is a sufficiently liquid market to allow construction of a term structure).

The IASB Staff, in their October 2022 webcast[18], set out the following key elements of the risk management strategy that would need to be documented and kept constant throughout the life of the DRM model:

- The process to approve and amend the strategy
- Risk management levels and scope
- Risk metrics used
- Range of acceptable risk limits (i.e., the target profile)
- Risk aggregations method and risk management time horizon
- Methodologies to estimate expected cash flows or core demand deposits

The target profile is set for each time bucket. The target might be that interest rate risk cannot exceed a certain level, plus or minus, set in terms of the notional value, the present value of a movement in interest rates, or some other measure used for risk management purposes.

The target profile must be directly linked to the entity's documented risk management strategy (as with the IFRS 9 hedge accounting model). Furthermore, the target profile should reflect the approach actually used by the entity to manage risk. For instance, if it assesses repricing risks and sets risk limits based on sensitivities to movements in rates, or nominal amounts, across different time buckets, these should be reflected in the target risk profile. It is possible that the target risk profile may differ for different time buckets.

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[17] Basel Committee on Banking Supervision *Interest rate risk in the banking book*, December 2019.

[18] Webcast series: Dynamic Risk Management, October 2022. LINK

There is an expectation in the outlined DRM model that the target profile is sufficiently granular, consistent with what is expected under an effective interest rate risk management framework. Therefore, some preparers have raised the concern whether the model will continue to work if an entity only has one overall risk limit that is not allocated into time buckets, or its risk buckets are very broad. Another concern is that entities may have different risk limits at different levels within the organisation, and these risk limits are likely to have different levels of granularity. The Staff intend to do further research, with the objective of identifying a common principle to be used by all entities for the allocation of risk limits in the context of the target profile.[19]

The Board has tentatively decided that any changes to an entity's risk management strategy that result in a change to the entity's target profile would result in the discontinuation of the hedge relationship.[20] One of the reasons that the risk management strategy must specify the time horizon is to establish the period over which any DRM adjustment (see step 8) would be amortised if the relationship were to be discontinued. Changes in an entity's risk management strategy and, therefore, its target profile (risk limits) are expected to be rare in practice. However, some preparers are concerned that entities may occasionally need to respond to the changes in their balance sheet structure and general market conditions, or might slightly change risk limits as a fine tuning of their risk appetite. These preparers have suggested to the IASB to consider whether it is possible to relax the requirements around changes of target profile or risk management strategy and this is likely to be discussed further by the Board.[21]

3 Set the risk mitigation intention

In each period, the entity must establish a risk mitigation intention (RMI). This is the extent to which an entity intends to mitigate the CNOP so as to be within the target profile, through the use of derivatives. Even when the CNOP is already within the target profile, an entity may still choose to mitigate risks further.

In practice, the risk mitigation intention needs to be evidenced by actual derivatives traded in the market (see step 4). The actual externalisation of the risk mitigation intention is a useful indicator of the extent of risk the entity wants to mitigate. The RMI would be calculated in a manner consistent with the entity's actual risk management practices. The RMI may be adjusted, prospectively, over time.

The RMI is constrained by the following:

- It cannot exceed the CNOP determined for each time bucket
- It transforms the CNOP so that the target risk profile is achieved (this requirement establishes the minimum amount that the entity must designate as its RMI to be consistent with its risk management strategy)
- It is evidenced by real actions taken to mitigate risk, e.g., the designated derivatives traded in the market – see step 4.

The April 2023 Staff Paper provided additional discussion on the determination of the RMI. Since it is based on the amount of risk actually traded externally, it is not necessary to separately document the RMI before entering into the risk mitigation activities. Hence, in the view of the Staff, since the RMI is based on the designated derivatives, evidencing the RMI

[19] Staff Paper AP4 Dynamic Risk Management (DRM) Project Plan, July 2022. LINK

[20] Staff Paper AP4A Managing Equity, November 2021. LINK

[21] Staff Paper AP4 Dynamic Risk Management (DRM) Project Plan, July 2022. LINK

should only require minimal incremental effort or processes and should not have an impact on the risk management actions of the entity.[22]

Also in April 2023, the IASB tentatively confirmed that the RMI cannot be based on internal derivatives traded with an internal risk transfer trading desk without being explicitly traced to external derivatives, otherwise the entity would not faithfully reflect the effects of its dynamic interest rate risk management. This has some similarity to the conclusion reached by global regulators, that requires the risks of the banking and trading books to be kept separate for the purpose of determining regulatory capital.[23]

For the purpose of the standalone financial statements prepared by legal entities within a group, derivative transactions entered into between subsidiaries can be recognised on application of the DRM model if the derivatives are transacted externally to the individual legal entity. This is similar to the existing hedge accounting requirements in IAS 39 and IFRS 9.

At its April 2023 meeting, the IASB also discussed an issue raised by stakeholders where, for example, an entity may have a CNOP in the nine-years repricing period while there may be a very limited market for a nine-years interest rate swap[24]. As a result, the entity may choose to mitigate the nine-year risk using a ten-year swap, which is more commonly available in the market. The IASB tentatively concluded that the RMI would be limited up to the nine-year point and would be zero at the ten-year repricing time period. Consequently, any changes in the fair value of the designated derivative that result from the interest rate risk in the nine-to-ten-year repricing time period would remain in profit or loss (in combination with the mismatching in fixed rates between RMI and designated derivative).

How we see it

The Staff's economic analysis of the risk offset that a ten-year swap would provide for a nine-year bond is clearly correct. This analysis is also consistent with the approach used to allocate instruments by time buckets in the examples provided for the May 2023 IASB meeting, as described in step 1. However, if entities do not follow this approach for interest rate risk management, but instead allocate assets and liabilities into buckets according to their repricing dates (as described in step 1), it may prove difficult for them to determine the risk offset between time buckets, as envisaged above. This is an area that would seem to require further consideration, following consultation with the banking industry.

4. Enter into designated derivatives

The entity enters into **designated derivatives** with external counterparties in order to manage its risks, in accordance with its risk mitigation intention and its target profile.

Such derivatives would include swaps, basis swaps and forward rate agreements. In July 2023, the IASB tentatively decided to permit non-linear derivatives such as interest rate options, but not net written options, to be included in the model where their use is consistent with the risk management strategy.[25]

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[22] Staff Paper, AP4B Risk mitigation intention and the construction of the benchmark derivatives, April 2023. LINK

[23] For the Fundamental Review of the Trading Book (FRTB) as prescribed by Basel 3, the Basel Committee require that a clear boundary is maintained between the trading book and the banking book for the purpose of assessing an entity's regulatory capital requirements. See Basel Committee on Banking Supervision, Explanatory note on the minimum capital requirements for market risk, January 2019. LINK

[24] Staff paper AP4C Further considerations on the current net open risk position, April 2023. LINK

[25] Staff paper AP4C, Designated derivatives, July 2023. LINK

It is likely that the 'credit risk must not dominate' restriction will be applied to all the designated derivatives as for the assets and liabilities (see step 1).

How we see it

- The starting point to determine the designated derivatives will be those derivatives actually used to manage interest risk, but some derivatives will need to be excluded, for instance, if they hedge exposures that are excluded from the DRM model, e.g., FVPL items (see step 1).
- For some banks, possibly the biggest challenge in aligning the DRM model with their actual risk management would be the requirement that all designated derivatives have been entered into with third parties. Given that banking risk is often managed by entering into 'internal' derivatives with the trading desk (either at a legal entity or group level), the application of the DRM model will be most straightforward if the trading desk enters into specific external derivatives to offset these internal trades. However, in contrast, the trading desk may choose to trade the position, within its own limits and observing regulatory requirements to separately manage risks between the trading and banking book[26], such that there may be no direct relationship between the internal and external derivatives and it is more challenging to substantiate the externalisation of hedging instruments. Hence, the designated derivatives selected would need to be those that most closely reflect the risk management intention (see step 3). Although banks may be able to leverage existing methods used to demonstrate that derivatives have been externalised, any differences may lead to the effects of misalignment being recorded in profit or loss (see step 8).
- The DRM model as currently envisaged would seem to allow new business and new derivatives to be added only at the beginning of each period. This means that, unless the DRM model permits the mirroring of intra-month designated and benchmark derivatives to minimise misalignments, it may be necessary to run the model daily if that is how often the derivative portfolio is updated.

5. Set the benchmark derivatives

In order to be able to measure the effects of the DRM model, the risk mitigation intention is represented by benchmark derivatives (i.e., mathematical expedients to enable measurement of the risk mitigation intention). These are not reset for every period, but at the beginning of any period new benchmark derivatives are added to those brought forward from the previous period, so as to increase or reduce the risk mitigation, in line with the current RMI. In addition, as discussed in steps 6 and 7, the benchmark derivatives may need to be revised to satisfy certain assessment criteria.

The benchmark derivatives may be based on the designated derivatives (i.e., the derivatives actually entered into to mitigate the risk - see step 4) in risk terms, but will not necessarily be the same, since the benchmark rate, tenor, maturity and volume must be consistent with the RMI which, in turn, is constrained by the CNOP and target profile (see step 6).

[26] For the Fundamental Review of the Trading Book (FRTB) as prescribed by Basel 3, the Basel Committee require that a clear boundary is maintained between the trading book and the banking book for the purpose of assessing an entity's regulatory capital requirements. See Basel Committee on Banking Supervision, Explanatory note on the minimum capital requirements for market risk, January 2019. LINK

In April 2023 the IASB confirmed that the concept of a benchmark derivative is based on the same principles as those described in IFRS 9 regarding a hypothetical derivative. Hence the benchmark derivatives must be calibrated to current market rates of the managed risk, when first included within the DRM model, to achieve an initial fair value of zero. The Staff Paper expanded upon this by proposing that the creation of a benchmark derivative must be based on the following principles:

(a) The benchmark derivative is constructed to be on-market at initial designation using the managed risk for rate calibration. This means that the floating leg of this derivative must be based on the managed risk and the fixed leg is calibrated using the risk yield curve managed by the entity as risk target

(b) A benchmark derivative cannot be used to include features in the value of the RMI that only exist in the designated derivatives, but not in the RMI. An example is the valuation adjustments made to reflect the credit risk of the designated derivatives, as these are not relevant for the RMI

(c) The amount of risk and the tenor of the benchmark derivative is prescribed by the RMI and expressed in the risk metric the entity manages at that repricing time period (for example, ΔNII or PV01)

(d) An entity's preferred risk metric is mandated by its risk management strategy. This means that the creation of the benchmark derivative cannot change from one metric to another period-on-period

Any managed risk identified must be reliably measurable (for example the managed risk must be linked to a benchmark interest rate where there is a liquid market to allow construction of the term structure of interest rates).

Because the benchmark derivative must be based on the managed risk, it will not necessarily be the same as the interest rate basis present in the CNOP.

The expectation is that an entity may benefit from the use of the same front office system for the designated and the benchmark derivatives, therefore benefiting from the same valuation framework. This is intended to allow limited changes to existing system set ups (for further discussion see section 7, Preliminary views on implementation below).

6. Prospective assessment

The RMI is subject to a **prospective assessment** at the beginning of the period to ensure it meets the criteria set out at step 3 above, i.e.,

- It cannot exceed the CNOP determined for each time bucket
- It transforms the CNOP so that the target risk profile is achieved
- It is evidenced by the designated derivatives

This assessment must be documented. The first two of these criteria are described as the DRM boundaries. If the RMI does not satisfy these criteria, it must be adjusted and the benchmark derivatives must also be adjusted accordingly.

7. Retrospective assessment

In the model as articulated in May 2022, two **retrospective assessments** were required to be performed at the end of the period under assessment, as to whether:

- The entity has mitigated interest rate risk (i.e., an entity may not over-hedge its CNOP)
- Whether the 'target profile' based on the entity's RMI had been achieved

Both retrospective assessments were to be made based on the portfolio as at the beginning of the period, i.e., excluding new business, but adjusted by updating, at the end of the observation period, the expectations and assumptions used previously in projecting the expected cash flows. For example, the opening CNOP would be adjusted if prepayments during the period (and/or related expectations) were greater or less than expected. In

case that either of the retrospective assessments failed, the benchmark derivatives set at the beginning of the period were to be adjusted retrospectively, so as to satisfy these tests. If different prepayments were either expected or had occurred for a specific time bucket resulting in the net of the CNOP and the RMI being outside the risk limits, the benchmark derivatives would have needed to be adjusted so as to bring the mitigated position (i.e., the net of the CNOP and the RMI) back within the risk limits.

At its meeting in February 2023, the IASB tentatively decided to remove the requirement to test whether the target profile has been achieved, but to retain the requirement that risk has to have been mitigated (this is discussed further in step 8). At the same meeting the IASB tentatively decided to require a capacity test instead (see step 9).

8. Accounting

The **accounting mechanics** of the DRM model require:

(a) The designated derivatives to be measured at fair value through profit or loss.

(b) A DRM adjustment to be recognised in the statement of financial position (with an offset to profit or loss), measured as the lower of (in absolute amounts):

  (i) The cumulative gain or loss on the designated derivatives from the inception of the DRM model

  (ii) The cumulative change in the fair value of the benchmark derivatives (i.e., reflecting the risk mitigation intention as well as the effects of any unexpected changes, attributable to repricing risk) from inception of the DRM model

(c) The difference between the net gain or loss from the designated derivatives calculated in accordance with (a) and the DRM adjustment calculated in accordance with (b) is therefore recognised in profit or loss.

(d) As set out in the examples provided by the Staff for the May 2023 IASB meeting[27], the adjustment to net interest income for each period (with an offset to the DRM adjustment), representing the realisation of the DRM benefit, is based on the lower of the cumulative gains and losses realised for the designated derivatives (DDs) and those of the benchmark derivatives (BDs). This is also referred to as the "coupon accrual profile".

As described in step 7, the Board has tentatively decided to retain the requirement to make a retrospective effectiveness assessment only for whether the risks have been mitigated. However, any unexpected changes in the CNOP may still result in the effects of misalignment being reported in profit or loss. This involves two steps:

1. The CNOP must be revised (consistent with step 7), based on the portfolio as at the beginning of the period, i.e., excluding new business, with the expectations and assumptions used in projecting the expected cash flows updated to reflect any differences. For example, the opening CNOP will be adjusted if prepayments have been or are now expected to be greater or less than previously expected

2. The risk metric of the benchmark derivatives, e.g., the notional value or PV01, used for the 'lower of' measurement would be limited so as not to exceed that of the revised CNOP

   For example, if the CNOP had originally been estimated at a notional value of 100 and the entity decided to mitigate this risk by entering into derivatives with a notional value of 80, but the opening CNOP is subsequently re-estimated at period end to be only 60, the benchmark derivatives as at the beginning of the period would need to be adjusted so as to have a notional value of 60 as well. This would be achieved by

[27] Staff paper4A DRM Model, Illustrative Examples, May 2023. LINK

adding additional benchmark derivatives with a notional value of -20, based on prevailing market rates as at the beginning of the period with a zero fair value. Meanwhile, the actual designated derivatives traded in the market are not adjusted retrospectively.

As the DRM adjustment would be based on the lower of the change in fair value of the designated derivatives with a notional value of 80 and that of the revised benchmark derivatives with a net notional value of only 60, it is likely that part of the revaluation of the designated derivatives would be recorded in profit or loss. This is the case even if, from a risk management perspective, the 'overhedge' of 20 in this time bucket is viewed as an offset of risk in another time bucket. However, although the requirement that the RMI is less than the CNOP applies separately to each time bucket, the 'lower of' calculation is made in aggregate for all time buckets.

The DRM adjustment, therefore, represents the extent to which the designated derivatives mitigate (i.e., reduce) the variability in both the fair value of, and the net interest income from the risk mitigation intention. The latter is achieved as the DRM adjustment unwinds over time and is recognised in net interest income through the periodical cash flows of the derivatives.

The worked examples provided by the Staff for the May 2023 IASB meeting provide more insight as to how they envisage the DRM model should work:

1. The DRM adjustment is based on the lower of (in absolute amounts) the cumulative fair value changes from the inception of the DRM model of the DDs on the one hand and the BDs on the other, combining in each case both those gains or losses that have been realised as well as the 'clean' fair value change that is as yet unrealised.
2. The DRM benefit is based on the lower of the cumulative realised gains and losses for the DDs compared to those for the BDs. 'Realised' for this purpose includes the notional payments on the BDs and embraces both amounts paid in cash and accrued for the period (this is also referred to as the "coupon accrual profile").

In the Staff's example 1C, the cash payments on the derivatives are assumed to occur on 31 December, so there are no accrued but unpaid interest payments. By the end of X2, the entity's expectation regarding the repayment profile of the financial asset changes, with half the fixed rate financial asset now forecast to be repaid a year earlier than when the RMI was determined at the start of X2. The resulting change to the RMI during X2 must be captured to ensure the DDs are not mitigating risk that does not exist, so the BDs for X2 are revised (based on market rates at 1 January X2) to reflect the unexpected changes. This contributes to the changes in fair value and cash payments made from inception of the DRM model, which are as follows:

	31/12/X1	31/12/X2
DDs		
Clean fair value	31.93	(45.08)
Life to date cash settlements	(3.82)	2.92
Total life to date fair value change	28.11	(42.16)
BDs		
Clean fair value	(31.93)	36.43
Life to date cash settlements	3.82	(3.20)
Total life to date fair value change	(28.11)	33.23

The DRM adjustment is based on the lower of the life to date fair value changes for X2 of (42.16) and 33.23, i.e., the latter, arising from the BDs, while the realisation of the DRM benefit is based on the lower of the life to date cash flows realisation (and accrual, if any) profiles, 2.92 and (3.20), i.e., the former, arising from the DDs. The accounting entries for the year X2 are, therefore:

	DR	CR
DR net trading income	77.01	
CR designated derivatives		77.01

To record the change in the clean fair value of the designated derivatives ((45.08) - 31.93) for the year X2. (This is not affected by the 'lower of calculation').

DR cash	6.74	
CR net trading income		6.74

To record the cash paid on the designated derivatives (2.92 - (3.82)) for the year X2. (Again, this is not subject to the 'lower of calculation')

DR DRM adjustment	61.34	
CR net trading income		61.34

To record the change in the DRM adjustment (33.23 - (28.11)) for the year X2, being the lower of the life to date change in fair value of the designated derivatives and the benchmark derivatives (in this case, that of the benchmark derivatives) less the amount booked at the previous period end.

DR DRM adjustment	6.74	
CR net interest income		6.74

To record the DRM benefit (2.92- (3.82)) for the year X2, being the lower of the life to date realised cash flows on the designated derivatives and the life to date notional realised cash flows on the benchmark derivatives (in this case based on the designated derivatives), less the amount booked at the previous period end.

How we see it

In case any DDs are closed out before their maturity, to be able to make the 'lower of' calculations of the cumulative realised gains and losses from the inception of the DRM model, it will be necessary for entities to be able to track the realised cash flows separately for each DD.

Consideration of clean fair value changes of DDs and BDs would probably achieve similar results to the ones exposed in the Staff's examples but with a lower degree of operational burden, this would reduce the need for tracking all historical cash flows.

9. Perform capacity test

In February 2023, the IASB tentatively decided that a retrospective test based on the entity's risk limits would no longer be required. However, it added a new retrospective assessment as to whether the entity has the

'capacity to realise the expected benefits' of the DRM adjustment.[28] The purpose of this test is to deal with unexpected changes in the CNOP due, for instance, to unexpected prepayments or rollovers, impairment, or sales of assets or liabilities, so as not to leave DRM adjustments stranded on the balance sheet after the assets or liabilities that gave rise to them have been derecognised. This is required since the DRM model has been designed to avoid the need for tracking the DRM adjustment in relation to specific assets or liabilities that form part of the CNOP.

While the retrospective assessment of whether risk has been mitigated in the current period addresses situations where an unexpected change in the CNOP affects the current period DRM calculations, the capacity test is needed to address where unexpected changes in the CNOP affect DRM adjustments recorded in previous periods.

As described in the Staff Papers, the capacity test would be made by comparing the DRM adjustment to the difference between the fair value and amortised cost of the CNOP at the assessment date, assuming no further increases or decreases in the CNOP until the end of the time horizon. This is best illustrated by a very simple example with only one repricing period, where an entity has floating rate assets of CU100, equity of CU50 and fixed rate liabilities of CU50.

	Assets	Equity and liabilities
Equity		50
Fixed rate liabilities		50
Floating rate assets	100	

Assuming an EVE strategy (see step 2), the entity is exposed to fair value movements in its liabilities and so has a CNOP of +50, where the plus sign is used to show that there would be a fair value profit if interest rates were to rise. The entity, assuming it is averse to fair value risk, might seek to establish an RMI of -50, and enter into a receive fixed-pay floating swap with a notional value of CU50.

One period later, interest rates have gone up, and the swap has fair value losses of CU2.5. Accordingly, as the designated derivatives are aligned to the benchmark derivatives, the DRM adjustment is to record an asset of CU2.5.

The capacity test would compare the DRM adjustment against the change in the fair value of the CNOP. In this simple example, the DRM adjustment and the fair value of the CNOP would be equal at CU2.5 and so there would be no capacity issue.

In the next period, assume that interest rates do not change but CU10 of the liabilities are prepaid at their fair value of CU9.5, realising a gain of CU0.5. They are replaced with new fixed liabilities at the current market rate. The gain of CU0.5 will be recorded, but the DRM adjustment of CU2.5 will now exceed the fair value compared to the amortised cost of the CNOP of only CU2.0. Because the capacity test will have failed, the DRM adjustment will need to be reduced by CU0.5, with a debit to profit or loss. In this simple fact pattern this adjustment will exactly offset the recorded gain.

[28] Staff paper AP4B Dynamic Risk management (DRM) Performance assessment and unexpected changes, February 2023. LINK

How we see it

The capacity test is in principle an appropriate way to reflect the effect of unexpected changes in the CNOP on DRM adjustments made in past periods without introducing a significant tracking burden.

For EVE strategies, the approach as suggested by the Staff Paper and illustrated above should work, where the DRM adjustment is compared to the difference between the fair value and amortised cost of the CNOP at the assessment date.

However, for NII strategies, the capacity test may need to be further developed because the CNOP comprises floating rate instruments that will remain at par when fair valued for interest rate risk and so will equal their amortised cost.

4. Examples

A. Simple example, assuming with only one time bucket

Step 1 At the start of a period, a bank's Current Net Open Risk Position (CNOP) is modelled to be +12. The figures in these examples could represent currency units or a sensitivity measure such as PV01, while the + or – signs indicate whether the fair value of the financial instruments involved goes up or down if the interest rate increases or falls.

Step 2 The bank has set a target profile for the time bucket of within +5 to -5.

Step 3 The bank chooses to mitigate this risk by entering into derivatives that have a risk of -9. The Risk Mitigation Intention (RMI) is, therefore, to reduce the risk by 9, so that the CNOP less the RMI is +3.

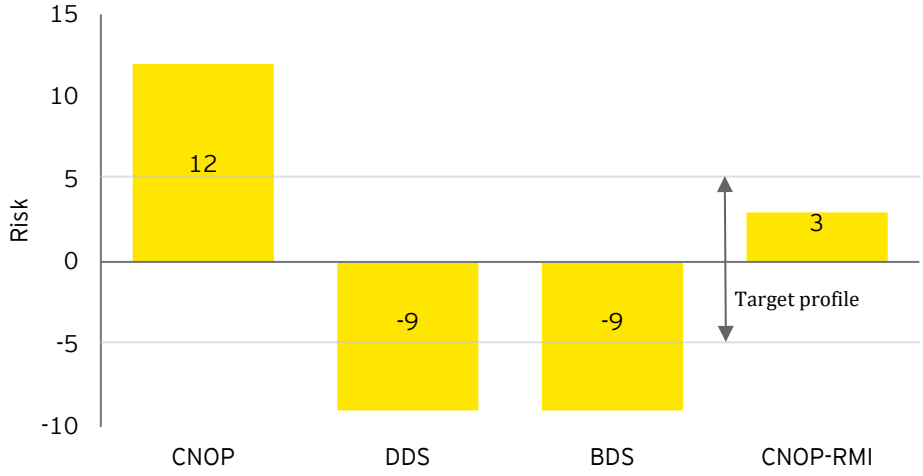
Step 4 The benchmark derivatives (BDs) would have a risk of -9 as well.

Step 5 The bank enters into designated derivatives (DDs) in accordance with the RMI with a risk of -9.

Step 6 This fact pattern satisfies the prospective assessment criteria:

- The RMI of -9 is less (in absolute terms) than the CNOP of +12
- The CNOP less the RMI (i.e., +3) is within the target profile of +5 to -5
- The bank has entered into DDs consistent with the RMI

At the start



Steps 7 and 8 At the period end the CNOP is re-estimated. We set out two scenarios, as follows:

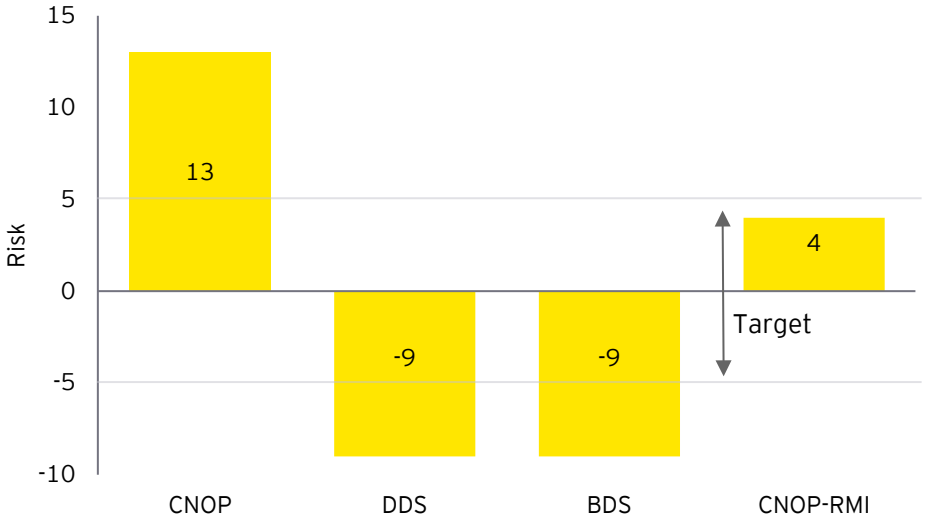
- **Scenario 1**

  The CNOP is re-estimated to be +13.This means the RMI of -9 is still less than the revised CNOP of +13. The DRM adjustment will be the lower of:

  - The cumulative change in fair value of the DDs with a sensitivity of -9

    And

  - The cumulative change in fair value of the BDs with a sensitivity of -9
  - Given the similar sensitivities of the DDs and the BDs, the consequence is that hedge ineffectiveness, if any, will be restricted to differences in the terms of the DDs and the BDs.



- **Scenario 2**

  The CNOP is re-estimated to be +3. The RMI of -9 is now greater (in absolute terms) than the revised CNOP of +3. Therefore, the BDs will need to be adjusted to have a sensitivity of -3.

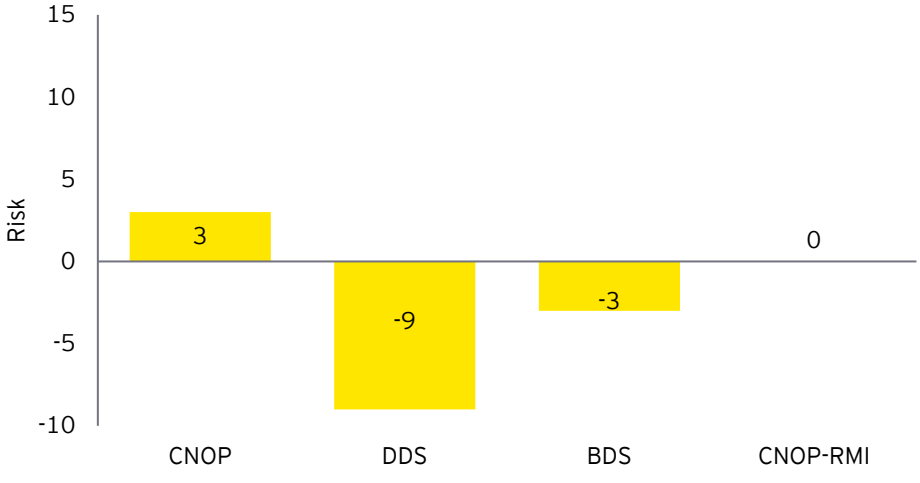
  In step 7, the DRM adjustment will be the lower of:

  - The cumulative change in fair value of the DDs with a sensitivity of -9

    And

  - The cumulative change in fair value of the revised BDs with a sensitivity of -3

  As the DDs will show a greater change in fair value, there is likely to be significant hedge ineffectiveness to record.



Step 9 For simplification, the new capacity test is not considered here.

B. More complicated example, with two time buckets

Initially the CNOP is estimated as +3 for bucket 1 and +8 for bucket 2. The target profile is within +5 to -5 for each time bucket. The risk managers enter into derivatives with external parties with a sensitivity of -9 for bucket 2, giving an RMI of -9 for bucket 2, but do not seek to mitigate the risk in bucket 1.

The prospective assessment criteria must be applied separately for each time bucket:

Bucket 1

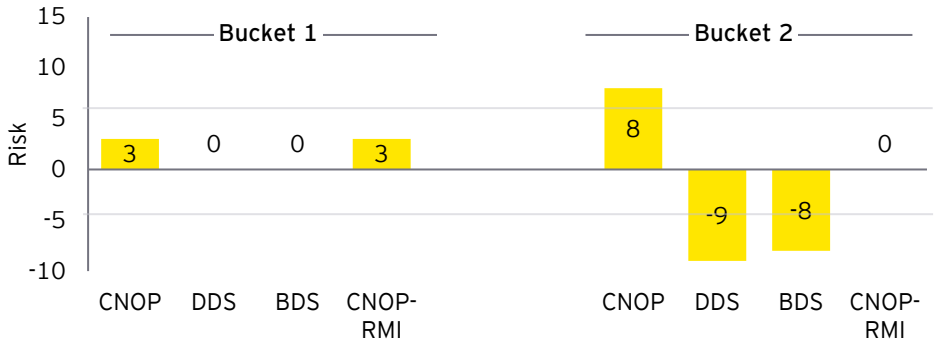
- The RMI of nil is less than the CNOP of +3
- The CNOP less the RMI of +3 is within the target profile of +5 to -5
- Hence, even though no derivatives have been entered into that affect this time bucket, as the risk is within the target profile, the criteria are satisfied

Bucket 2

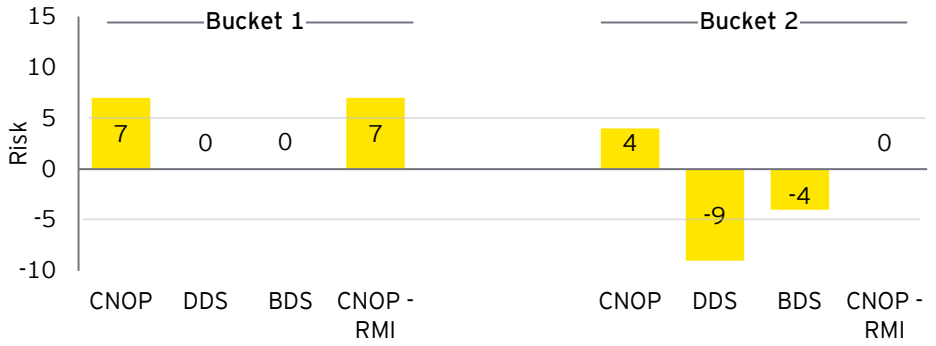
- The RMI of -9 is greater than the CNOP of +8
- The CNOP less RMI of -1 is within the target profile of +5 to -5
- Hence, the first criterion is not satisfied, and the BDs will need to be adjusted to have a sensitivity of -8, so as not to exceed the CNOP, which would bring the CNOP less the RMI to nil

At the period end, the CNOPs are re-estimated to be unchanged in aggregate, but amended by time bucket, so that the exposures for time buckets 1 and 2 are revised to be +7 and +4.

At the start



At period end



The bucket 1 RMI of nil is still less than the revised CNOP of +7, so the BDs will not be adjusted. In contrast, in the July 2022 version of the DRM model, the effect of the retrospective assessment based on the target profile of +5 to -5 would have been to increase the BDs so as to ensure the RMI is met. Hence, they would have been adjusted to have a sensitivity of -2.

The bucket 2 RMI of -9 is higher than the revised CNOP of +4. Hence the BDs will need to be adjusted to have a sensitivity of only -4.

The DRM adjustment will be the lower of:

- The cumulative change in fair value of the DDs with a sensitivity of 0 in bucket 1 and -9 in bucket 2

  And

- The cumulative change in fair value of the revised BDs with a sensitivity of 0 in bucket 1 and -4 in bucket 2

Because the DDs are likely to show a greater change in fair value than the revised BDs, the consequence is that there is likely to be significant hedge ineffectiveness to record. It is important to note that the proposed removal of the retrospective assessments based on the target profile from the DRM model results, in this fact pattern, in the potential for higher ineffectiveness, since the accounting effect of the over-hedge in bucket 2 is not offset against the under-hedge in bucket 1.

As with examples in A, for simplification, the capacity test is not considered here.

5. Significant conceptual steps in the development of the model

Target profile

One of the biggest changes in the evolution of the DRM model has been to move away from the idea that the target profile should be a defined single outcome to a range of possible outcomes, within risk limits (see step 2). Compared to the current IFRS 9 hedge accounting concepts, the target profile now represents the risk management strategy (the range of acceptable risk limits within which the current risk exposure can vary) rather than the risk management objective. In any period, this is represented by the risk mitigation intention; the extent of risk the entity intends to mitigate using derivatives.

Inclusion of core demand deposits

A major conceptual innovation has been to allow entities to include core demand deposits that pay no, or little, interest, to be included in the DRM model as if they are fixed rate liabilities, provided that those deposits will not reprice with a change in market interest rates and the entity is not contractually obliged to change the interest rate when the market interest rates change (see step 1). This helps align the model with actual risk management by many banks.

Elimination of tracking

Because the DRM model is based on the RMI as represented by the benchmark derivatives, there is no need to track the underlying assets and liabilities that make up the CNOP over multiple periods. This simplifies the application of the DRM model, but a consequence has been the need for the capacity test to address scenarios where there are unexpected changes in the CNOP, such as additional prepayments or sales of assets (see step 9).

Adjustment to the statement of financial position rather than to OCI

By requiring the DRM adjustment to be reflected as an asset or liability, DRM activity would have no effect on equity (except through any ineffectiveness recorded in profit or loss). This avoids the concern that there might be a consequential impact on regulatory capital, given that it is unclear whether or not the regulatory filters currently in place for the cash flow hedge reserve would have been replicated for a DRM reserve. (Regulators may, of course, wish to consider the regulatory capital treatment of the DRM adjustment).

The Staff Paper describing this approach[29] accepts that recognition of the DRM adjustment as an asset or a liability would not necessarily be consistent with the definition of an asset or a liability in the Conceptual Framework. However, the Staff rejected the OCI approach because an adjustment to OCI would have "an impact on equity that is not a faithful representation of the economic phenomenon of dynamic risk management" and the balance sheet approach provides more useful information. The Paper goes on to stress that this argument does not apply to traditional cash flow hedges, where recognising gains and losses in OCI does faithfully represent the effect of the hedge on the entity's financial performance "consistent with the sole purpose of a cash flow hedge to manage cash flow variability."

Although the DRM adjustment will be reflected in the statement of financial position, the DRM model is based on a 'lower of test', similar to cash flow hedges. The Staff Paper explains that, if the entire change in fair value of the benchmark derivatives were required to be reflected in the DRM adjustment, this would "faithfully represent only a part of the purpose for which entities do dynamic risk management — that is, to achieve offset, i.e., reduce variability, in the fair value of entity's underlying items. It fails to faithfully represent the dual purpose because it does not fully represent the reduced variability of net interest income." The 'lower of test' approach is considered to provide more useful information. The consequence is that ineffectiveness will only be reported in profit or loss to the extent that the change in fair value of the designated derivatives is greater than that of the retrospectively adjusted benchmark derivatives.

Allowing a net interest income (NII) risk management strategy

The rationale for recording the DRM adjustment in the statement of financial position rather than in OCI was initially based, as described in the previous paragraph, on the fact that, there had to be alignment of the notional values of assets and liabilities making up the CNOP. Because net fixed rate assets/liabilities would be balanced by net floating rate assets/liabilities, the model represented simultaneously the management of economic value and net interest income. (In effect, the model would be equivalent to both a fair value hedge and a cash flow hedge at the same time).

Probably the most significant further development has been to permit the notional values of assets and liabilities in the CNOP to differ. This means that it is possible to include assets funded by equity. It also means that net fixed rate assets/liabilities may now be higher or lower than net floating rate assets/liabilities and so entities have to decide whether (by time bucket) they are pursuing an economic value (EVE) risk management strategy or an NII risk management strategy (see step 1, above). The consequence is that the DRM adjustment will be recorded in the statement of financial position even where the CNOP consists of a net floating rate exposure. This differs from a cash flow hedge where the hedge adjustment would be recorded in OCI.

Application of the DRM model to other risks

At its meeting in October 2023, the IASB agreed to seek feedback from non-banking entities, such as insurance companies, utilities and large corporates, to understand whether they could apply the DRM model as tentatively agreed. The IASB also intend to consider whether the DRM model can be applied to other risks.[30]

[29] Staff Paper AP4A Mechanics of the DRM model, May 2022. LINK

[30] Staff paper AP4B Dynamic Risk Management (DRM) project Direction, May 2022. LINK

How we see it

The DRM project has to date focused on how banks manage their aggregated portfolio of interest rate risk with respect to a chosen benchmark. This benchmark is inherently a risk component of banks' centrally managed interest rate exposure. The IASB has not discussed whether a risk component managed within the DRM model must meet the requirement to be separately identifiable and reliably measurable (SIRM). This represents a potential difference to IAS 39 and IFRS 9, which require that a risk component is SIRM to be eligible for hedge accounting. As the IASB assesses how the DRM model can be applied to non-banking entities and to other risks, we encourage the IASB to consider how the SIRM requirement can be best incorporated to help broaden the model's usefulness and applicability.

6. Disclosures

In its meeting in July 2019[31], the IASB tentatively agreed areas of focus for disclosures that should assist users to:

- Understand and evaluate an entity's risk management strategy. This would be a combination of qualitative and quantitative disclosures, including the target profile, explaining why the target profile is as defined and what that implies for the future earnings and cash flows
- Evaluate management's ability to achieve that strategy
- Understand the impact on current and future economic resources. This might include quantitative disclosures that compare the designated derivatives with the benchmark derivatives throughout the period
- Understand the impact on an entity's financial statements from the application of the model

In light of developments to the model since the previous tentative decisions were reached, the IASB will develop the detailed presentation and disclosure requirements for inclusion in the ED. In developing these requirements, the IASB will continue its outreach with preparers and obtain further input from users of the financial statements to better understand their expectations for the presentation and disclosures.

How we see it

Ensuring that the financial statements tell the story of an entity's approach to dynamic risk management is a crucial element of the DRM model. Given the inherent complexity of the topic, the presentation and disclosure requirements have the potential to be extensive. We, therefore, encourage preparers and users to carefully consider what should be included in the requirments and to provide their suggestions to the IASB as it develops its proposals in advance of publishing the ED.

7. Preliminary views on implementation

From an implementation point of view, the DRM model can be seen as a modified risk management process that is used for accounting purposes. Acknowledging the IASB's intent to limit the burden of implementation by using already existing procedures[32], implementing the DRM model could

[31] Staff paper AP4D Cover note, July 2019. LINK

[32] Staff paper AP4B Risk mitigation intention and the construction of the benchmark

require some significant effort by preparers depending on their business model, the scope and sophistication of their risk management activities and their existing information technology landscape.

Subject to the final scope of and the remaining decisions on the DRM model, we anticipate the most challenging implementation issues to be:

- Designing a suitable DRM information technology architecture by using existing functionalities as far as possible e.g., roll-out of behavioural cash flows, fair value measurement and use of hypothetical derivatives.
- Constructing and processing the benchmark derivatives over time. In our view it is not obvious where to locate the benchmark derivatives, for example:
  (a) In the operational systems, but they would have to be excluded from all other processing and reporting that is unrelated to DRM
  (b) In the risk management systems even if used for accounting purposes only
  (c) In a financial instruments subledger used to process derivatives but not to generate instruments and to prevent them from being recognised in processes unrelated to DRM
- Handling any residual differences between the risk management portfolio and the DRM portfolio due to eligibility limitations
- Enlarging the existing data model to provide the different valuations needed for financial instruments and related historic data whilst monitoring and controlling the increase in the volume of data due to the life-to-date calculations since the inception of the DRM model
- Developing harmonised internal and external reporting on portfolio risk management
- Assigning the different DRM functionalities, data and related governance responsibilities between risk management and accounting as the DRM functionalities itself are risk management related but used for accounting purposes

It should not be overlooked that implementing and applying the DRM model offers preparers a number of significant opportunities beyond the improved accounting, which could include:

- A more predictable and stable net interest income than current hedge accounting models can achieve
- A traceable, detailed reconciliation between actual risk management and DRM model results
- Enhanced data to provide the basis for a meaningful communication with investors and regulators on interest rate risk management and the accounting which results from it
- Increased automation of accounting processes, with benefits that include more frequent reporting capability, an improved control environment and long-term cost-savings

These potential benefits should be clearly identified and targeted by preparers for any project to implement the DRM model, to help secure and maintain sponsorship from internal stakeholders. They provide a further reason for preparers to closely follow the ongoing development of the DRM model and provide feedback to the IASB.

derivatives, April 2023; Staff Paper AP4A Refinements to the DRM model—Risk Limits, November 2021; and Staff Paper AP4C Operational Simplifications, July 2019.

How we see it

- The IASB is to be commended for having worked hard to arrive at a conceptually novel accounting model which should go a long way to align the accounting with actual risk management.
- The main components of the DRM model as it would be applied by banks have now been tentatively agreed by the IASB. It is, therefore, important for banks to understand what is proposed and to assess whether the model is workable. This may require field testing or a similar exercise.
- It will also be necessary for those entities that currently apply IAS 39 portfolio fair value hedge accounting, which is expected to be withdrawn once the DRM model is finalised, to understand the differences compared to the DRM model and including the effects of implementation and the resulting outcomes.
- Insurers and other entities, such as utilities and large corporates, need to consider whether the principles of the DRM model as tentatively agreed, could be used to reflect in the financial statements their approach to dynamically managing interest rate risk and potentially other risks too.

A key element of any project to implement the DRM model will, of course, also be the disclosures that entities are required to give. The IASB will be guided by the information needs of users of the financial statements, as it develops the proposed disclosures. Preparers also need to assess how they would meet the disclosure requirements as they are developed. In addition, preparers need to consider what disclosures may be most helpful to users, as they assess how they would apply the DRM model.

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