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<b>Project</b>	Dynamic Risk Management (DRM)	
<b>Paper topic</b>	Refinements to the DRM model—Risk Limits	
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## Introduction

1. At its September 2021 meeting, the International Accounting Standards Board (Board) discussed potential refinements to the DRM model which aim to closer align the DRM model to entities' risk management practices by incorporating the concept of risk limits into the target profile.<sup>1</sup>
2. In this paper, the staff set out further refinements to the DRM model for incorporating risk limits, based on Board members' comments and questions at that meeting.
3. One of the questions asked at that meeting, related to the terminology used to describe the refinements discussed in this paper. These descriptions do not necessarily reflect how they will eventually be drafted in IFRS Standards. The staff will further explore how best to describe the refinements (for example, whether to continue with the description of 'risk mitigation intention' or use another term). Accordingly, we may further refine these descriptions to be consistent with the

<sup>1</sup> See Agenda Papers [4A](#) and [4B](#) of the September 2021 Board meeting.

terminology used in other IFRS Standards where relevant, or to avoid risking unintended consequences of using the same term to refer to different concepts.

### Summary of staff recommendations

4. The question in paragraph 59 of this paper, asks whether Board members agree with the staff recommendation to make the following refinements to the DRM model for the purpose of incorporating risk limits:
- (a) revising the definition of the target profile as the range (risk limits) within which the current net open risk position can vary while still being consistent with the entity's risk management strategy;
  - (b) introducing the risk mitigation intention as a new single-outcome element to the DRM model, representing the extent of risk to be mitigated through the use of derivatives, ie the portion of the current net open risk position the entity intends to mitigate through the use of derivatives;
  - (c) revising the construction of benchmark derivatives so that they represent the risk mitigation intention; and
  - (d) introducing prospective assessments to ensure the DRM model is used to mitigate interest rate risk and achieves the target profile, supplemented by similar retrospective assessments designed to capture the potential misalignment arising from unexpected changes.

### Structure of this paper

5. This paper is structured as follows:
- (a) A reminder of the issue (paragraph 6–7);
  - (b) Refinements to the DRM model to incorporate risk limits (paragraph 8–48);
  - (c) Benefits of these refinements (paragraph 49–57);
  - (d) Staff recommendations (paragraph 58); and
  - (e) Question for the Board (paragraph 59);

## A reminder of the issue

6. The challenges identified during outreach relating to the description of the target profile can be summarised as follows:
  - (a) it represents the objective for a given asset profile, thereby considering the assets and liabilities of the entity as two separate elements. Outreach participants told us that, from a risk management perspective, they consider assets and liabilities in combination to determine the net open risk position;
  - (b) the target profile is assumed to be a single outcome and represents a key element in the measurement of misalignment in the statement of profit or loss. Outreach participants told us that their risk management strategies do not constitute a single targeted outcome, but rather a range of acceptable outcomes through the use of risk limits; and
  - (c) although an entity's risk management strategy is not expected to change frequently (ie the risk limits are not expected to change from one period to the next), the extent to which the entity decides to carry out further risk mitigation activities (ie through the use of derivatives) is dynamic and may change very frequently based on numerous factors.
7. In the staff's view, the refinements described in paragraphs 8–44 of this paper directly respond to these challenges and would therefore enable the DRM model to achieve the objectives of the DRM project as tentatively agreed at the [November 2017 Board meeting](#).

## Refinements to the DRM model to incorporate risk limits

8. The objective of the refinements discussed in this paper are to incorporate risk limits into the DRM model whilst ensuring discipline and robustness in the application of the DRM model.
9. A key aspect of the suggested refinements is the separation of the risk management strategy and risk management objective elements of the model. While the risk management strategy element is relevant to the definition of the target profile as one of the qualifying criteria to apply the DRM model, the risk management

objective element is an important part of the continuous application of the DRM model.

### **Definition and objective of the target profile**

10. As discussed in [Agenda Paper 4A](#) for the September 2021 Board meeting, currently the target profile fulfils the role of both the risk management strategy (ie *what* risk the entity wants to mitigate) and the risk management ‘objective’ (ie *how* much of the risk exposure the entity wants to mitigate).
11. In our view, it would be clearer and more aligned to how entities’ risk management strategies are set, if the target profile only represent the risk management strategy element, while a new element is included in the DRM model to represent the risk management ‘objective’ (see paragraphs 17–26 of this paper).
12. The target profile would therefore be defined as ***the range (risk limits) within which the current net open risk position can vary while still being consistent with the entity’s risk management strategy.***<sup>2</sup>
13. The target profile is required to be directly linked to the entity’s documented risk management strategy. In other words, it is not merely an accounting concept; the determination of the target profile is significantly tied to the entity’s risk management. When entities assess repricing risks across different time buckets when applying the DRM model, these time buckets need to be consistent with the entity’s risk management strategy and the characteristics of the underlying risk positions (ie consistent with how the entity aggregates and manages risk).
14. Consistent with the Board’s previous tentative decisions on the target profile, the specification and documentation of the target profile, as one of the qualifying criteria to apply the DRM model, should be done at the initial designation of the hedge. This means any changes to an entity’s risk management strategy that results in a change to the entity’s target profile would result in the discontinuation of the hedge.<sup>3</sup>

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<sup>2</sup> The current net open interest rate risk position is derived from the combination of the assets and liabilities (including core demand deposits) over the period which the entity is managing the risk.

<sup>3</sup> This consequence is consistent with the Board’s previous discussions (see Agenda Paper [4C](#) of September 2018 Board meeting).

15. We continue to consider this requirement an important element of the DRM model and a way to ensure that users of financial statements are provided with useful information. This is because the target profile represents an actual economic phenomenon ie a change in target profile means the entity is no longer pursuing achievement of a specified risk management strategy. Therefore, the continuation of the DRM model would no longer provide useful information about whether the entity has achieved its risk management strategy.
16. The staff is of the view that the refinement to the definition and role of the target profile will have the following benefits:
- (a) the revised definition is more intuitive and more closely aligned with how entities' risk management strategies are defined and managed in practice, ie risk managers focus on the current net open interest rate risk position from assets and liabilities and execute their hedging instruments accordingly;
  - (b) the DRM model performance and potential disclosures will provide useful information to the users of the financial statements about whether and to what extent an entity achieved their risk management strategy; and
  - (c) although not one of the Board's main objectives with the project, we think the suggested refinements would also achieve greater alignment with the general hedge accounting model in IFRS 9, which will improve the understandability and operability of the DRM model.

### ***The risk mitigation intention***

17. As discussed in the earlier sections, entities' risk management strategies specify risk limits within which the risk should be managed, rather than a single targeted outcome. However, outreach participants told us that even when the current net open risk position is within the target profile, they may still decide to further mitigate the risk by making use of derivatives. Furthermore, as the underlying portfolios are dynamic, the extent to which the current net open risk position is mitigated, varies frequently. Therefore, measuring the performance of the DRM model (ie the extent of alignment achieved) against a range of acceptable risk exposures, would pose significant conceptual and practical challenges. In addition,

measuring performance against a range would also not result in useful information to the users of the financial statements as it will not provide any information about the extent to which the entity wanted to mitigate the risk.

18. As discussed at the September Board meeting, we are of the view that the *risk mitigation intention* could fulfil a similar role in the DRM model as the risk management objective in the general hedge accounting model of IFRS 9. In other words, it relates to how the particular derivatives are used to mitigate the portion of risk exposure the entity wants to mitigate.
19. The risk mitigation intention can therefore be described as ***the extent to which an entity intends to mitigate the current net open risk position through the use of derivatives***. In other words, the risk mitigation intention is a single-outcome element and could be determined based on an entity's preferred risk metrics (for example in PV01 or nominal terms).
20. However, to ensure the robustness of the DRM model and to maintain the normal discipline accompanying the application of hedge accounting, we are of the view that the risk mitigation intention should be accompanied by some boundaries/limitations (ie prospective assessments). These prospective assessments should include the following:
  - (a) the risk mitigation intention cannot create new risks. That is, the cumulative amount of risk to be mitigated through derivatives must reduce the interest rate risk of the current net open risk position by time bucket and cannot exceed the total amount of risk by time bucket (ie an entity cannot over hedge its current net open risk position); and
  - (b) the risk mitigation intention has to transform the current net open risk position to a residual risk position that is within the target profile.
21. The prospective assessments would ensure that the DRM model is not inappropriately applied by synthetically creating a risk position through derivatives, which an entity otherwise would not have been exposed to based on its assets and liabilities.
22. The restriction described in paragraph 20(a) is not new. It is consistent with the Board's original intention when it reached the tentative decision in April 2019, that the DRM model should not permit negative balances to be defined within the target

profile.<sup>4</sup> Following the refinement to the definition of target profile as per paragraphs 10–16, the restriction is now applied on the risk mitigation intention to avoid introducing leverage (ie new risks) through the use of the DRM model.

23. Unlike the general hedge accounting model in IFRS 9, where the hedging relationship has to be discontinued when the risk management objective has changed, changes in the risk mitigation intention can occur without affecting the continuation of the DRM model. This is because of the dynamic nature of the underlying portfolios which result in changes to the entity's risk mitigation intention and requires additional DRM actions.
24. Changes to the risk mitigation intention can only be made prospectively, ie changes only affect future periods. In other words, an entity cannot retrospectively adjust the risk mitigation intention to reflect unexpected changes in the current net open risk position for the period under review. The effect of any such unexpected changes for that period will be captured through the retrospective assessments and may impact the measurement of misalignment in the financial statements (see paragraphs 30–38 of this paper).
25. In practice, the risk mitigation intention might be evidenced by the designated derivatives available relating to a specific interest rate risk point. The actual externalisation of the risk mitigation intention is a useful indicator of the extent of risk the entity wants to mitigate the risk (for example, an entity may decide to only mitigate the current net open risk exposure partially). Therefore, this is directly linked to an entity's target profile which will mandate how much risk the entity is willing to accept or to leave open – see paragraph 46(c) for a further explanation.
26. While the target profile is set as a range of acceptable outcomes within which the entity wants to manage the risk, the risk mitigation intention is naturally a fixed amount of risk to be mitigated through derivatives and is set for a period of time. How long that period is, depends on the frequency of the changes to the underlying portfolio with which the entity is making decisions about risk mitigation (ie designating a larger or smaller portion of the current net open risk position or

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<sup>4</sup> See [Agenda Paper 4B](#) of the April 2019 Board meeting.

trading new derivatives). This ensures as much alignment as possible between the risk management activities and the application of the DRM model.

### **Construction of the benchmark derivatives**

27. In the context of the revision to the description of the target profile and the inclusion of the risk mitigation intention, we are of the view that the construction of the benchmark derivative must be based on the risk mitigation intention rather than the target profile. This is because the target profile represents the acceptable open risk positions given the entity's risk management strategy, but it does not specify the extent to which the entity decides to mitigate the risk, which is now determined through the risk mitigation intention. Once constructed, the benchmark derivative is used as the theoretical derivative which can be used as the anchor point for performance and measurement purposes.
28. The benchmark derivative represents the risk mitigation intention, which might be evidenced by the designated derivatives as discussed in paragraph 25 of this paper. The economic details and other relevant information of these designated derivatives (ie the actual derivatives traded with the market) are usually readily available in an entity's trading systems. Therefore, the benchmark derivative would also serve as the documentation of the risk mitigation intention for the designation period.
29. However, the designated derivatives only serve as *evidence* of the extent to which the entity intends to mitigate the risk inherent in the current net open risk position; the benchmark derivatives are not simply the inverse of the designated derivatives. As discussed in paragraph 62 of [Agenda Paper 4A](#) for the September meeting, there are several reasons why the benchmark derivatives might be different from the designated derivatives. Therefore, the benchmark derivative cannot simply impute the terms of the designated derivatives which are not reflective of the risk mitigation intention.

### **Retrospective assessments**

30. In this section, we describe in more detail the retrospective assessments contemplated in the refinements to the DRM model. These are performed at the end of the period under assessment in order to assess whether:

- (a) the entity has mitigated interest rate risk; and
- (b) the target profile has been achieved.

*Has the entity mitigated interest rate risk?*

31. The refinements to the DRM model retain the restriction from synthetically creating a risk position through derivatives. In other words, in applying the DRM model, an entity cannot introduce risk positions by using derivatives and yet take advantage of the measurement requirements to recognise the changes in fair value of such derivatives in OCI, instead of the statement of profit or loss. This view stands even if an entity's residual risk position falls within entity's target profile.
32. Consistent with this view, the potential refinements to the DRM model require a retrospective assessment—that is, assessing whether the effect of unexpected changes to the current net open risk position during the period, resulted in the entity creating risk, ie the entity was over-hedged. This would be evidenced by comparing the current net open risk position at the end of the period under assessment with the risk mitigation intention for the period. This comparison is done separately for each time bucket.
33. If the effect of unexpected changes to the current net open risk position is such that the risk mitigation intention is lower than the current net open risk position at the end of the period, the entity have mitigated the interest rate risk, and this *would not give* rise to misalignment (ie the outcome would be under-hedging). Conversely, if the effect of unexpected changes on current net open risk position at the end of the period is such that the risk mitigation intention is greater than the updated net open risk position, that would mean that risk is created rather than mitigated (ie the outcome would be over-hedging). Such a new risk created *would give* rise to misalignment.

*Has the target profile been achieved?*

34. The potential refinements to the DRM model include an additional retrospective assessment against the entity's target profile<sup>5</sup>, designed to determine whether the residual net open risk position (ie the difference between the current net open risk

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<sup>5</sup> For the avoidance of doubt, this assessment is separate from that against risk mitigation intention described in paragraphs 31–33 of this paper.

position at the end of the period and the risk mitigation intention) falls within the target profile. This comparison is done separately for each time bucket.

35. To the extent that the residual net open risk position falls within the entity's target profile there would be no misalignment. Conversely, if the net open residual risk position falls outside the target profile that might give rise to misalignment.

### ***Determining misalignment***

36. We note that the retrospective assessments are designed to capture the misalignment driven by the effect of unexpected changes on the current net open risk position during the period under assessment, to the extent that such unexpected changes caused the entity to breach any of the two assessments.
37. In addition, as described in paragraph 29 of this paper, there could be other sources of misalignment driven by the differences between benchmark derivatives and designated derivatives. It follows that, misalignment for a particular period could arise as a result of the comparison of:
- (a) changes in the fair value of the designated derivatives for the period; and
  - (b) the combination of:
    - (i) changes in the value of the benchmark derivatives for the period; and
    - (ii) the effect of the unexpected changes in the current net open risk position during the period;
38. However, because of the interaction with the DRM measurement mechanics, not all misalignment would necessarily be recognised in profit or loss. The recognition of misalignment in the statement of profit or loss will be determined based on the 'lower of' test, as described in paragraphs 39–44.

### ***Communicating the impact of misalignment***

39. When developing the DRM model, the Board tentatively decided to base the measurement of misalignment in profit or loss on the 'lower of' test within the

DRM model to communicate the impact of misalignment.<sup>6</sup> The refinements discussed in this paper do not recommend any change to that tentative decision.

40. As a reminder, the ‘lower of’ test is applied in cash flow hedges and is set out in paragraph 6.5.11(a) of IFRS 9 and further discussed in paragraphs BC6.371–BC6.374 of the Basis for Conclusions of IFRS 9. For example, paragraph BC6.373 of IFRS 9 states:

‘IAS 39 required a ‘lower of’ test for determining the amounts that were recognised for cash flow hedges in Other Comprehensive Income (the effective part) and profit or loss (the ineffective part). The ‘lower of’ test ensured that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not recognised. [...]

41. In paragraphs 30–38 of this paper we describe the retrospective assessments included in the refinements and the situations when such assessments result in misalignment. As illustrated in [Agenda Paper 4B](#) of the September 2021 Board meeting, an entity would then apply the ‘lower of’ test to determine the extent of misalignment that is recognised in the statement of profit or loss.
42. Retaining the ‘lower of’ test means that there could be outcomes whereby the misalignment resulting from the retrospective assessments described in paragraphs 36–38 of this paper, does not necessarily lead to the recognition of a gain or loss in the statement of profit or loss for that period. For example, misalignment arising from an unexpected increase in the current net open risk position that results in breaching the target profile assessment may not be recognised in the statement of profit or loss in that period. This is because, applying the ‘lower of’ test, the cumulative changes in the value of the benchmark derivatives and the effect of unexpected changes that exceed the cumulative fair value changes of the designated derivatives are not recognised.
43. Nonetheless, we highlight that the ‘lower of’ test is a cumulative (ie inception-to-date, not a period-to-date) test. As a result, the effect of any misalignment for a

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<sup>6</sup> Refer to [Agenda Paper 4B](#) of the September 2018 Board meeting.

particular period will continue to impact the ‘lower of’ tests done in future periods and will be reported in the statement of profit or loss over time.<sup>7</sup>

44. The staff will continue to explore an approach to ensure misalignment is faithfully represented in the financial statements, including potential disclosures to aid communication of such misalignment and facilitate understanding by the users of financial statements about how successful entities are in achieving their risk management strategies.

### ***Ensuring robustness of the risk mitigation intention***

45. Some Board members asked about ways in which robustness of the risk mitigation intention could be achieved in order to ensure that the DRM model achieves the objectives and provides useful information to users of the financial statements.
46. In our view, the prospective assessments an entity needs to satisfy when determining the risk mitigation intention, supplemented by the two retrospective assessments (refer to paragraphs 30–35), provides the necessary robustness to the DRM model and ensures that an appropriate level of discipline in the application of the DRM model is maintained. Entities are also restricted by the following considerations when determining their risk mitigation intentions:
- (a) the maximum amount of risk mitigation intention is capped to the current net open risk position, and not affected by the entity’s target profile (ie risk limits) determined at the inception of the hedge. In addition, for entities that monitor and manage their current net open risk position by maturity time buckets, there would be further discipline that the maximum amount of risk mitigation intention in each maturity time bucket is capped at the current net open risk position within that bucket.
  - (b) the risk mitigation intention needs to transform the current net open risk position to a residual risk position that is within the target profile—this

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<sup>7</sup> When misalignment is not recognised in the statement of profit or loss for the period, the entity would have been in an under-hedge position for that period, so that the fair value changes of the designated derivatives is lower than the changes in the value of the benchmark derivatives and the effect of unexpected changes. In such case, the entity did not fully hedge the repricing risks from its net open risk position, and thus for the under-hedged portion, changes in benchmark interest rates will impact the future net interest income over time.

requirement establishes the minimum amount that an entity needs to designate as risk mitigation intention to be consistent with its risk management strategy.

- (c) the risk mitigation intention needs to be evidenced by real actions taken to mitigate risk (eg the actual derivatives traded in the market). Once it is determined, it would be documented via the construction of the benchmark derivatives, and entities will not be able to amend the risk mitigation intention retrospectively. For example, when an entity mitigates its current net open risk position by entering into a pay fixed derivative with a PV01 of CU100, the risk mitigation intention (and hence the benchmark derivatives) cannot be artificially set as PV01 of CU80. However, the risk mitigation intention can be adjusted if it is required to meet the prospective assessments as discussed in paragraph 20.

47. In determining the current net open risk position, an entity allocates risk exposures to time buckets based on the expected repricing dates. This is consistent with the Board's tentative decisions about using 'behavioural' models to determine the expected repricing of items such as core demand deposits and prepayable loans. As the current net open risk position is required to be consistent with the net exposure used for risk management activities, in the staff's view, this helps to minimise the potential opportunities for deliberately overestimating or underestimating the current net open risk position, and therefore provides a robust basis to determine the risk mitigation intention and benchmark derivatives for the period.
48. Having the focus of the DRM model on the current net open risk position, rather than the gross risk exposure also provides additional discipline which helps to avoid introducing leverage to the DRM model. This is because, unlike the current hedge accounting requirements, when applying the DRM model, entities can no longer designate derivatives against a gross position. For example, when an entity has PV01 of CU1,000 from fixed assets and CU600 from fixed liabilities, the maximum amount of risk mitigation intention would be CU400 as that would mitigate the net exposure to zero. This is in line with the entity's economic position (ie mitigate the PV01 of CU400 from the net fixed assets using pay fixed derivatives). However, applying the portfolio fair value hedge accounting requirements in IAS 39, the

entity could designate any amount up to CU1,000 pay fixed derivatives against the gross fixed assets.

## Benefits of the refinements

### *Alignment to risk management strategy*

*The risk mitigation intention is driven by real actions taken to mitigate risk*

49. The introduction of the risk mitigation intention provides a clear link between the application of the DRM model and the entity's risk management strategy, which do not exist to the same extent under the current hedge accounting requirements. The requirement to evidence the risk mitigation intention with actual actions taken to mitigate the risk prevents outcomes where previously entities might have been able to achieve hedge accounting for derivatives not used for risk management purposes.
50. As a result, preparers would find it easier to explain the DRM results in their financial statements as the DRM model would more closely represent the risk management activities of an entity. This also means that users of the financial statements would be able to better understand the extent to which the actual results achieved alignment with the entity's target profile and/or its risk mitigation intentions.

*Reduction of 'proxy hedging'*

51. Stakeholders have continuously told the Board that because current hedge accounting requirements have limitations when applied to dynamically managed interest rate risk exposures, banks have developed accounting approaches to accommodate their dynamic risk management activities. Under current hedge accounting requirements entities often revert to the use of designations that do not necessarily represent the risk management activities using so-called 'proxy hedge accounting', which has led to a disconnect with the risk management strategy.
52. In our view, incorporation of risk limits into the DRM model would enable entities to better reflect their risk management activities in the financial statements without the need to revert to proxy hedging.

53. As mentioned in [Agenda Paper 4A](#) of the April 2021 Board meeting, other components of the DRM model that contribute to reduction of proxy hedging include:

- (a) the requirement to designate net open risk positions;
- (b) the inclusion of core demand deposits as eligible financial liabilities; and
- (c) the ability to reflect the dynamic nature of open portfolios through continuous designation.

***Operational simplification—one ‘look-back’ period’***

54. Another issue identified from the outreach feedback related to the perceived operational complexity linked to the implementation of the DRM model. Many of the issues raised stemmed from the anticipated issues associated with the construction of benchmark derivatives and/or the reflection of unexpected change in the underlying portfolio.

55. The refinements contemplate entities systematically doing period-to-period retrospective assessments, and ‘look-back’ only one period each time to assess the effect of unexpected changes. Those effects would be captured as a source of misalignment for the period under assessment, which in turn could affect the ‘lower of test’ in subsequent periods until maturity.

56. In practice, entities only need to compare the updated net open risk position at the end of the period with the net open risk position at the beginning of the period and determine changes in the value due to the movements in interest rate benchmarks for that period only (if the entity breaches one of the retrospective assessments). There are a number of potential ways in which an entity could measure the misalignment arising from unexpected changes occurring during the period. For example, as set out in [Agenda Paper 4B](#) of September 2021 Board meeting, a possible way to facilitate capturing the effect of these unexpected changes, as well as the related subsequent unwinding, could be by constructing additional hypothetical derivatives at the end of the period representing the unexpected changes.

57. In our view, this represents an operationally simpler approach whereby entities are not required to track the changes in expected cash flows across several periods, which could be inherently complex, costly and prone to error.

### **Staff recommendations**

58. The staff recommend the Board make the refinements to the DRM model for incorporating risk limits as described in paragraphs 4 of this paper.

### **Question for the Board**

59. The staff would like to ask the Board the following question.

**Question for the Board**

Does the Board agree with the staff recommendation to make the refinements to the DRM model as set out in paragraph 4 of this paper?