

## STAFF PAPER

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## IASB® meeting

<b>Project</b>	Dynamic Risk Management (DRM)	
<b>Paper topic</b>	Mechanics of the DRM model—Feedback and staff analysis	
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## Introduction

1. When developing the core model for Dynamic Risk Management (DRM core model), the IASB tentatively decided that when derivatives align the asset profile with the target profile, the changes in fair value of such derivatives are recognised in other comprehensive income (OCI).
2. At its April 2021 meeting, the IASB discussed feedback from outreach on the DRM core model (2020 Outreach). Volatility in equity arising from the recognition of fair value changes in OCI was one of the three main challenges identified as key to the viability and operability of the DRM model.
3. As part of our research and analysis of feedback from 2020 Outreach, we considered the hedge accounting mechanics applied for cash flow and fair value hedge accounting in IAS 39 and IFRS 9. Our analysis and summary of the feedback (both from the 2020 Outreach as well as on the IASB's other consultations) about using these mechanics for dynamic risk management are set out in this paper. This paper also analyses the unique nature of hedging the repricing risk due to change in interest rates and discusses why alternative accounting *mechanics* might be justified for the DRM model. The accounting

mechanics specify which amounts, and where they are recognised in the financial statements.

4. In Agenda Paper 4B, we explore two potential alternatives for the mechanics the IASB could consider for the DRM model. Both approaches aim to better reflect the risk management activities in the financial statements and address the concerns raised during the 2020 Outreach.
5. At this meeting, we seek the IASB's view on the direction of our future work, without asking the IASB to make any decisions. Based on the IASB's feedback provided at this meeting, we will develop proposals and bring back further analyses at a future meeting.
6. This paper provides:
  - (a) [background](#);
  - (b) [summary of feedback](#);
  - (c) [staff analysis](#); and
  - (d) a [question for the IASB](#).

## Background

7. At its November 2017 meeting, the IASB discussed the accounting mechanics to be used in the DRM core model.<sup>1</sup> The IASB noted that applying IFRS Accounting Standards, there are two types of hedging relationships for hedging interest rate risk, ie a fair value hedge and a cash flow hedge.
8. Paragraph 6.5.2 of IFRS 9 sets out the difference between a fair value and a cash flow hedge. Paragraphs 6.5.8–6.5.10 of IFRS 9 and 6.5.11–6.5.12 of IFRS 9 set out the mechanics used to account for each type of hedge. We summarise these requirements in the following table:

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<sup>1</sup> See [Agenda Paper 4](#) of the November 2017 IASB meeting.

	Fair value hedge	Cash flow hedge
<b>Risk exposure</b>	a hedge of the exposure to <b>changes in fair value</b> of the hedged item, that is attributable to particular risk and could affect profit or loss	a hedge of the exposure to <b>variability in cash flows</b> that is attributable to a particular risk associated with the hedged item and could affect profit or loss
<b>Hedged item</b>	a <b>recognised</b> asset, liability or an unrecognised firm commitment, or a group or component of any such item	all, or a component of a recognised asset or liability or a <b>highly probable forecast transaction</b>
<b>Hedge accounting mechanics (key elements)</b>	the gain or loss on the hedging instrument is recognised in <b>profit or loss</b> adjustment driven by the hedged item—the hedging gain or loss adjusts the carrying amount of the hedged item, and is recognised in <b>profit or loss</b>	the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge <sup>2</sup> is recognised in <b>OCI</b> adjustment driven by hedging instrument—capped by the cumulative change in fair value of the hedged item

9. In essence, the difference in hedge accounting mechanics between these types of hedging relationships is that a fair value hedge partially alters the measurement basis of a hedged item, otherwise measured at amortised cost (or fair value through OCI). Conversely, in a cash flow hedge the changes in fair value of the hedging instrument (subject of the ‘lower of’ test) are recognised in OCI, instead of profit or loss.
10. In deciding on the mechanics to use in the DRM model, the IASB considered the advantages and disadvantages of the mechanics of both types of hedging relationships, in the context of DRM model.<sup>3</sup> It was noted that the main advantages of the cash flow hedge mechanics relative to fair value hedge mechanics are:

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<sup>2</sup> That is the portion of the gain or loss on the hedging instrument that is offset by the change in the cash flow hedge reserve which is calculated as the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value (present value) of the hedged item.

<sup>3</sup> See paragraphs 33–44 of [Agenda Paper 4](#) of the November 2017 IASB meeting.

(a) **conceptual alignment**—in a cash flow hedging relationship, the hedged exposure is the variability in future cash flows attributable to a particular risk. At the time, the IASB considered that dynamic risk management essentially is a process that involves managing how and when a change in market factors will affect cash inflows (interest revenue) and cash outflows (interest expense). Therefore, a model leveraging cash flow hedge mechanics arguably seemed to have a stronger conceptual alignment considering how entities manage interest rate risk. This was also consistent with feedback on the IASB’s [Discussion Paper \*Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging\*](#) (2014 DP).<sup>4</sup> In contrast, in a fair value hedge, the hedged exposure is the variability in fair value of the hedged item attributable to the hedged risk. Therefore, it was assumed to be less amenable to dynamic risk management given its objective is to *transform cash flows* rather than *mitigate fair value risk*; and

(b) **highly probable forecast transactions**—entities dynamically manage interest rate exposures arising from highly probable forecast transactions. Using cash flow hedge mechanics prevents the recognition of the revaluation of forecast transactions for the hedged risk being recognised on the statement of financial position (see paragraphs BC6.372 of the Basis for Conclusions of IFRS 9). In contrast, using fair value hedge mechanics would require the recognition of changes in the fair value arising from a highly probable forecast transaction as an asset or liability on the statement of financial position. The IASB has previously raised concerns with such an outcome, including paragraph BC148 of the Basis for Conclusions of IAS 39 which states:

The IASB also noted that treating a hedge of a forecast transaction as a fair value hedge is not appropriate for the following reasons: (a) it would result in the recognition of an asset or liability before the entity has become a party to the contract; (b) amounts would be recognised in the balance

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<sup>4</sup> See paragraph 10(b)(ii) of [Agenda Paper 4A](#) of February 2015 IASB meeting.

sheet that do not meet the definitions of assets and liabilities in the Framework; and (c) transactions in which there is no fair value exposure would be treated as if there were a fair value exposure.

11. In November 2017, the IASB tentatively decided to use the cash flow hedge mechanics for the DRM model. It was noted that while using cash flow hedge mechanics gives rise to the challenge of providing a complete picture of performance, given the requirements of the ‘lower of’ test, recognition of changes in fair value attributable to the hedged risk in the statement of financial position is a greater challenge.
12. The ‘lower of’ test was considered as applicable in the DRM core model since the designated profiles in the DRM core model contain not only existing financial asset but also highly probable forecast transactions. This is the same reason as the ‘lower of’ test in cash flow hedges under IFRS 9. Furthermore, 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.

### **Summary of feedback**

13. As part of its project on developing an accounting model for dynamic risk management, the IASB has discussed approaches based on the fair value hedge mechanics (see [2014 DP](#)) and the current approach in DRM model based on cash flow hedge mechanics. As noted in paragraph 14–20, stakeholders have raised significant challenges with both types of mechanics.

### ***Feedback on Portfolio Revaluation Approach—2014 DP***

14. As a reminder, in the Portfolio Revaluation Approach (PRA) set out in the 2014 DP, the net open risk position (ie the net position arising from long and short managed exposures within a managed portfolio) is identified and revalued for changes in the interest rate risk, with any gains or losses recognised in profit or loss. This approach used fair value hedge accounting mechanics, focusing on dynamic risk management; ie revaluing all dynamically managed risk exposures. Most respondents expressed concerns with the idea of ‘revaluing’ all managed exposures, noting this approach did not necessarily reflect a risk management view.

15. The IASB had also discussed an alternative that would limit the items to be revalued for the hedged risk. This alternative focused on risk mitigation, ie hedged items are revalued only when an entity has undertaken risk mitigation through hedging. Respondents that preferred this alternative with a scope focused on only the mitigated risk, said it provides useful information about the revaluation of risk exposures to the extent that they offset fair value changes of derivatives used for risk management. The resulting information would be consistent with their risk management view.
16. However, even for respondents who supported a scope focused on mitigated risk, it was broadly recognised that the approach is operationally challenging because of onerous tracking and amortisation requirements that will unavoidably arise due to the fact that risk mitigated exposures can change frequently over time under a dynamic environment and limited linkage between information generated for risk management purposes and financial reporting.<sup>5</sup>
17. In the 2014 DP, the IASB also considered the alternative of recognising PRA through OCI. Under this alternative, the net effect of the revaluation of the managed portfolios and the changes in the fair value of the hedging instruments would be recognised in OCI, rather than in profit or loss. Respondents' views were mixed. Many disagreed with this alternative approach because of the conceptual and practical difficulties, including volatility in equity. Other respondents said this approach would be worth exploring if the prudential regulators provided a filter which allowed them to eliminate any volatility in OCI that might arise from the application of the DRM model.

### ***Feedback on DRM core model from 2020 Outreach***

18. In principle, almost all participants supported the objective of the DRM model to better reflect interest rate risk management strategy and activities in the financial statements.
19. Similar to the feedback on the 2014 DP discussed in paragraph 17, the use of cash flow hedge mechanics, specifically, recognising a portion of the changes in the fair

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<sup>5</sup> See [Agenda Paper 4B](#) of February 2015 IASB meeting.

values of derivatives in OCI was identified as a concern because it would give rise to significant volatility in equity and therefore would not resolve the accounting mismatch between assets and liabilities and the designated derivatives.

20. All outreach participants said that they are concerned about the potential impact this may have on their regulatory capital, ie common equity tier 1 (CET1) and the resulting volatility of capital. In addition, some participants were also concerned with the resulting volatility of IFRS equity, ie equity reported in the IFRS financial statements.

### **Staff analysis**

21. The objective of DRM model is to better reflect entities' interest rate risk management strategies and activities in the financial statements. In other words, the application of the DRM model should provide useful information to enable users of financial statements to understand:
- (a) the entity's interest rate risk management strategy and how it is applied to manage interest rate risk;
  - (b) how the entity's application of the DRM model may affect the nature, timing and uncertainty of future cash flows; and
  - (c) the effect that the DRM model has had on the entity's financial position and financial performance.
22. To provide users of financial statements with the information set out in paragraph 21, the staff is of the view that any accounting mechanics adopted for the DRM model must enable users of financial statements to understand the extent to which the entity was successful in achieving its interest rate risk management strategy. As a result, it is necessary to consider the unique nature of the DRM model (being the hedging of repricing risk), before analysing the challenges in existing mechanics and exploring any potential alternative mechanics.

### ***Business view—managing repricing risk***

23. For entities applying dynamic risk management for interest rate changes, the economic hedging activities typically look at the funding liabilities together with the originated assets, as this combination is the source of any repricing risk due to

changes in interest rates (hereafter referred as ‘repricing risk’).<sup>6</sup> Therefore, the focus of risk management is on the net open risk position. An entity manages this net open risk position ie the repricing risk from all assets and liabilities (including eligible future transactions) – the underlying portfolio – using a holistic approach with no reference to the individual assets or liabilities that generate the risk. This holistic view of interest rate management is somewhat more common in some types of business, for example, is predominantly used in the banking industry.

24. In banks, this holistic view of interest rate risk management is typically achieved by transferring and aggregating the (benchmark) interest rate risk exposure into a centralised unit such as, for example, treasury functions. This risk transfer from the business units to treasury can be done in a number of different ways and at different rates but is governed by a bank’s internal transfer pricing framework.<sup>7</sup> Treasury takes on the interest rate risk exposures and manages it through economic hedging.
25. The objective of this economic hedging is to mitigate the repricing risk using derivatives, so that the interest rate risk exposures are transferred to external counterparties of the entity or group, in order to protect the economic value and/or net interest income from the underlying portfolio over its maturity. Economic value refers to the net present value of an entity’s assets, liabilities and future transactions due to changes in interest rates.<sup>8</sup> It is a long-term economic measure that is used to assess the degree of interest rate risk exposure of a bank.
26. Any typical derivative executed to mitigate the repricing risk of the underlying portfolio will start with a fair value of zero on the trade date (ie the derivative is on-market where both parties are indifferent on trading day). During the life of the hedge, the derivative fair value will move in the opposite direction and to the extent of the risk mitigation intention provides an offset to the changes in value of the underlying portfolio, while eventually reverting back to zero at maturity.
27. Therefore, in present value terms, an entity does not realise an economic gain or loss from using a derivative in this way to achieve its interest risk management strategy as the purpose of the derivative is to ‘protect’ (ie hedge) the original

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<sup>6</sup> Repricing risk is sometimes also referred by stakeholders as the maturity gap between assets and liabilities.

<sup>7</sup> For example, during 2020 Outreach banks mentioned transferring via internal derivatives or internal loans.

<sup>8</sup> In this context economic value is not the same as fair value as defined in IFRS 13.

(present) value or net interest income of the underlying portfolio. Similarly, when considered from an earnings perspective, the entity would also not recognise any additional contribution to net interest income when changes in the interest rate benchmark occur, as the derivative would, to an extent, mitigate the variability in cash flows that were used to determine the current net open risk position.

### ***The objective of hedge accounting***

28. The objective of hedge accounting in IFRS 9 is to represent, in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss.<sup>9</sup>
29. Without the use of hedge accounting an *accounting mismatch* arises when an entity engages in economic hedging—that is, the difference between assets and liabilities measured at amortised cost (the items being hedged) and derivatives measured at fair value through profit or loss (the financial instruments used to achieve the economic hedging objective). Entities often describe this as 'artificial' volatility or variability in the financial statement given that they consider themselves fully hedged, ie economically the entity's exposure to risk is to some extent offset by the derivatives.
30. Hedge accounting is used to mitigate this variability and is an exception to the normal recognition and measurement requirements in IFRS. For example, the current hedge accounting requirements permit:
  - (a) recognition of items that would otherwise have not been recognised (for example, a firm commitment);
  - (b) measurement of an item on a basis that is different from the measurement basis that is normally required (for example, adjusting the measurement of a hedged item in a fair value hedge); and
  - (c) deferral of the changes in the fair value of a hedging instrument in OCI, for a cash flow hedge. Such changes in fair value would otherwise have

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<sup>9</sup> See paragraph 6.1.1 of IFRS 9.

been recognised in profit or loss (for example, in hedging a highly probable forecast transaction).<sup>10</sup>

31. Paragraph BC6.77 of the Basis for Conclusions on IFRS 9 further states that although hedge accounting is an exception from normal accounting requirements, in many situations, the information that would have resulted from applying those normal requirements, without using hedge accounting, would not provide useful information either or would have omitted important information.
32. For interest rate risk, the objective of hedge accounting is currently achieved using either a cash flow hedge or a fair value hedge applying the hedge accounting requirements in IFRS 9 or IAS 39. These two types of hedging relationships have different perspectives as summarised in paragraph 8 of this paper.
33. The DRM model intends to achieve the same objective. As discussed in paragraph 27, in a *fully hedged* portfolio, changes in interest rates would affect neither the economic value nor the net interest income. However, without hedge accounting the same portfolio would, in accounting terms, show volatility in profit or loss. When the underlying movements in the market interest rates are significant and volatile, these accounting mismatches can be significant, which may not deliver useful information and would not provide faithful information about the actual economic performance to the users of financial statements.

### ***An accounting model for repricing risk***

#### *A different type of hedging relationship*

34. The DRM model is developed as an accounting model for hedging interest rate repricing risk, which focuses on eliminating or reducing the repricing risk due to changes in interest rates. It is the combination of floating and fixed-rate exposures from both the interest generating assets and funding liabilities, that gives rise to such repricing risk (ie the *current net open risk position*).<sup>11</sup> Therefore, the DRM

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<sup>10</sup> See paragraph BC6.76 of the Basis for Conclusions on IFRS 9.

<sup>11</sup> See paragraph BC6.98 of Basis for Conclusions on IFRS 9 which refers to the dual character of such a (net) risk position.

model aims to hedge exposure to both fair value and cash flow variability due to changes in interest rates, in the same accounting model.

35. Typically, an entity operates within specified risk limits which means the entity accepts an amount of open risk that is acceptable to management, thereby also accepting some variability in net interest income. Therefore, to align with this principle of risk management, the DRM model enables the entity to determine, period-on-period, the extent of risk it intends to mitigate through the use of derivatives by determining the *risk mitigation intention*.<sup>12</sup>
36. Some entities monitor and manage the changes in net interest income (earnings) (ie using  $\Delta$ NII method) for risk management purposes while others monitor and manage the changes in economic values (ie using  $\Delta$ EVE method) and some use both methods (ie  $\Delta$ NII in the short term and  $\Delta$ EVE in the longer term). However, regardless of the method(s) used, entities are using derivatives to eliminate or reduce the variability of the net interest income in both cash flow and present value terms. Therefore, an entity is hedging its cash flow exposure (in other words, the variability in the statement of profit or loss of its net interest income), while at the same time managing the change of the fair (present) value of the of the risk mitigation intention by aiming for a particular transformation objective.<sup>13</sup>
37. Consequently, in our view, neither the cash flow nor the fair value hedge mechanics on their own, are a ‘perfect’ fit for the DRM model, as the hedging of repricing risk includes features of both types of hedging relationships.

#### *Cash flow hedge mechanics in the context of DRM model*

38. The DRM model currently applies mechanics that are similar to a cash flow hedge. It requires an entity to recognise the aligned portion of gains and losses from changes in fair value of designated derivatives into OCI. Such gains and losses will subsequently be reclassified into the statement of profit or loss over time.

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<sup>12</sup> As long as an entity meets the requirement of the prospective assessments such that the risk mitigation intention would mitigate repricing risk due to changes in interest rates, and achieve its target profile. Refer to [Agenda Paper 4A](#) of the IASB’s November 2021 meeting.

<sup>13</sup> Given a bank typically only hedges the benchmark component of the interest rate risk, the fair value of the hedged exposure is not its entire fair value, hence the exposure is not measured at fair value as required by IFRS 13.

39. As highlighted in paragraph 20, all 2020 Outreach participants raised concerns about potential impacts on regulatory capital, and many were also concerned with the resulting volatility of IFRS equity.
40. In addition, in our view, recognising gains and losses of the aligned portion in OCI may not necessarily provide useful information about the application of the DRM model. This is due to the unique features of the DRM model, as discussed in paragraphs 23–27.
41. As described in paragraph 27, from an economic perspective, when the DRM model is fully aligned, the aligned portion of designated derivatives will be gradually offset over time by the realisation of value in the risk mitigation intention. This means, the DRM model has reduced both fair value and cash flow variability when interest rates change.
42. As such, recognising gains and losses in OCI may not faithfully reflect the economic nature and the complete effect of all risk positions including the designated derivatives. This is because, when interest rates change, the fluctuating balance in the DRM reserve does not reflect actual increases or decreases in economic value of all risk positions including designated derivatives. In other words, there are no changes to the net interest income to be recognised in the statement of profit or loss in future periods, when taking into account the effect of all risk positions including designated derivatives.
43. This is different to a cash flow hedge, where the hedged items give rise only to variability in cash flows, but have no exposure to changes in fair value. In a cash flow hedge, the effective portion recognised in the cash flow hedge reserve represents gains and losses on the hedging instruments that are recognised in OCI, but are yet to be reclassified (recycled) to profit or loss. These gains and losses are ‘deferred’ through OCI and will be reclassified to profit and loss in the same periods during which the hedged expected future cash flows affect profit and loss. Therefore, in the case of a cash flow hedge, the cumulative gains and losses recognised in OCI faithfully reflect the actual increases or decreases in the economic value of all risk positions, including the designated derivatives.

*Fair value hedge mechanics in the context of DRM model*

44. In our view, using fair value hedge-like mechanics may also have significant challenges, especially when entities focus on risk mitigation and manage the repricing risk dynamically to achieve the target profile that is defined as risk limits.
45. In the accounting for a fair value hedge, entities adjust the carrying amount of the hedged item and recognise the gains or losses in the statement of profit or loss. The hedge adjustment is thus changing the measurement basis of these items in the statement of financial position to reflect the changes in fair value of the hedged item attributable to the hedged risk. Although entities are allowed to designate a component of an item as a hedged item, that component should be a specified part of the amount of an item, so that the entity may remeasure that particular component for changes in fair value attributable to the hedged risk.<sup>14</sup>
46. In comparison, in the DRM model, entities take a holistic view for all eligible assets and liabilities (based on expected cash flows) and use that to calculate their current net open risk position. However, the current net open risk position itself is not the ‘hedged item’, but just defines the total net open risk exposure from which to determine the risk mitigation intention in the DRM model. The risk mitigation intention, which reflects the extent or portion of risk entities intend to mitigate, may also change from period to period at the entities’ discretion (as long as it’s mitigating risk and helps to achieve the target profile).
47. Using fair value hedge mechanics, the subsequent measurement in the DRM model focuses on the changes in fair value of the risk mitigation intention. However, it would not be possible to attribute such fair value changes to the individual underlying items that were aggregated into the current net open risk position. In addition, in case the DRM hedge is discontinued, it would also be difficult to measure the amortisation based on a recalculated effective interest rate since the underlying items consist of both assets and liabilities and it is not possible to determine the extent to which an individual item is represented in the risk mitigation intention.

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<sup>14</sup> See paragraph 6.3.7(c) of IFRS 9 and paragraphs B6.3.16–B6.3.20 of the Application Guidance on IFRS 9.

*Conclusion*

48. Based on the analysis in paragraph 21–47, the staff is of the view that neither cash flow nor fair value hedge accounting mechanics in isolation provides the optimal mechanics to use in the DRM model. Exploring potential alternative accounting mechanics may lead to a better reflection of the economic features of the DRM model. See Agenda Paper 4B of this meeting for analysis on potential alternative mechanics.

**Question for the IASB**

49. The staff would like to ask the IASB the following question.

**Question for the IASB**

Does the IASB have any questions or views on the staff analysis on this paper, as set out in paragraph 21–48?