IFRS Accounting

Staff paper

Agenda reference: 4A

IASB® meeting

Date	**April 2023**
Project	**Dynamic risk management (DRM)**
Topic	**Summary of tentative decisions and glossary of defined terms**
Contacts	Alev Halit Ongen (alev.halitongen@ifrs.org) Matthias Schueler (mschueler@ifrs.org) Zhiqi Ni (zni@ifrs.org) Riana Wiesner (rwiesner@ifrs.org)

Purpose of this paper

1. This paper provides an update on the DRM project based on the proposed project plan the IASB discussed in July 2022 as outlined in Agenda Paper 4 of that meeting. It also:
   (a) summarises the tentative decisions taken by the IASB to date that are relevant to the refined DRM model;
   (b) identifies the areas that are still subject to the IASB's deliberation based on the proposed project plan; and
   (c) provides a glossary of defined terms.

2. This paper does not ask for a decision from the IASB and is structured as follows:
   (a) IASB's tentative decisions to date and areas identified for further deliberation relating to:
      (i) Objective and scope of the DRM model;
      (ii) Current net open risk position;
      (iii) Designated derivatives;

(iv) Qualifying criteria for the DRM model;

(v) Accounting for the DRM model;

(vi) Disclosure and presentation;

(vii) Transition and effective date; and

(b) Appendix A: Glossary of defined terms

Objective and scope of the DRM Model

3. Agenda Paper 4A for the May 2022 IASB meeting, describes the objective of the DRM model as 'to better reflect an entity's dynamic risk management strategies and activities in the financial statements'. The application of the DRM model should provide useful information to enable users of financial statements to understand:

(a) the entity's dynamic risk management strategy and how that strategy is applied to manage repricing risk due to changes in interest rates;

(b) how the entity's application of dynamic risk management may affect the nature, timing and uncertainty of future cash flows; and

(c) the effect that dynamic risk management has had on the entity's financial position and financial performance.

4. This is consistent with the objective of general purpose financial reporting as stated in paragraph 1.2 of the IASB's Conceptual Framework for Financial Reporting (Conceptual Framework), which is to provide financial information about the reporting entity that is useful to existing and potential investors and creditors (primary users of the financial statements) in making decisions.

5. For the purpose of developing the DRM model, the IASB initially decided to limit the scope to the dynamic interest rate risk management of banks.

6. However, the IFRS Accounting Standards are not developed for specific types of entities or industries, but rather for specific types of transactions, rights and

obligations or income and expenses. At a future date, the IASB will consider the type of risk management activities that will determine the scope of the DRM model.

7. In its July 2019 meeting, the IASB tentatively decided that the application of the DRM model should be optional.

Current net open risk position

8. In November 2021, the IASB revised the core DRM model and tentatively agreed to introduce the concept of a current net open risk position (CNOP) being the net open interest rate risk position (by time bucket) derived from the combination of an entity's financial assets and financial liabilities (including core demand deposits) over the period the entity is managing such risk.

9. To determine the CNOP, financial assets and financial liabilities are aggregated, consistent with how entities monitor and manage the net interest rate risk from their financial assets and financial liabilities holistically. In other words, this is the 'organic' interest rate risk position of the entity before considering any instruments that are being used for mitigation of interest rate risks (ie designated derivatives).

10. When an entity aggregates the risk from its underlying financial assets and financial liabilities as part of the dynamic risk management process, it is common to manage all positions against changes in a particular benchmark interest rate, for example the entity's internal interest transfer pricing or funding rate.

11. Financial assets and financial liabilities are included in the CNOP and allocated to time buckets based on expected repricing dates, rather than on a contractual basis. Therefore, entities need to consider the effect of prepayments and/or cash flow modelling of core demand deposits (ie 'behavioural' models would be used to determine the deemed fixed interest rate risk of items such as core demand deposits and prepayable loans).

Qualifying items for determining the current net open risk position

12. When developing the core DRM model, the IASB had tentatively decided on the qualifying criteria for the designation of financial assets and financial liabilities in the DRM model (see Agenda Paper 4A for the April 2019 meeting). When the DRM model was refined, the IASB tentatively decided that the same qualifying criteria should apply when determining the CNOP:

    (a) financial assets or financial liabilities are measured at amortised cost in accordance with IFRS 9 *Financial Instruments*;

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

    (c) future transactions (eg forecast transactions and firm commitments) are highly probable [1];

    (d) future transactions result in financial assets or financial liabilities that are subsequently measured at amortised cost in accordance with IFRS 9;

    (e) items already designated in a hedge accounting relationship do not qualify for designation in the DRM model [2]; and

    (f) qualifying items are managed on a portfolio basis for interest rate risk management purposes.

13. In its February 2023 meeting, the IASB tentatively decided that, when an entity determines its CNOP under the DRM model, financial assets measured at fair value through other comprehensive income (FVOCI) qualify to be included in the CNOP, but financial assets measured at fair value through profit or loss (FVPL) do not. The IASB's rationale for its tentative decision is that financial assets measured at FVOCI

[1] Regarding growth, the IASB tentatively agreed an entity may choose to designate growth as a future transaction. Please also see Agenda Paper 4C for the April 2023 meeting for further considerations.

[2] In accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial instruments: Recognition and Measurement*.

have the same exposure to variability in future net interest income and fair value changes due to interest rate risk, as financial assets measured at amortised cost.

14. In its November 2022 meeting, the IASB tentatively decided that when determining an entity's CNOP, an entity's own equity instruments do not qualify for inclusion in the CNOP.

15. As summarised in Agenda Paper 4A for the April 2019 IASB meeting, the IASB also tentatively decided that financial liabilities designated at FVPL do not qualify to be designated in the DRM model (ie cannot be included in CNOP).

16. Regarding core demand deposits, the IASB tentatively decided that the DRM model will allow for inclusion of core demand deposits in the CNOP, based on an entity's risk management strategy, provided those deposits:

    (a) have a demand feature; and

    (b) 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.

17. The notional amount of a demand deposit being treated as core and its associated tenor must be based on reasonable and supportable information.

18. In its April 2023 meeting, the IASB will redeliberate the requirement for highly probable assessment in regard to the reinvestment and refinancing of existing financial asset and financial liabilities.

19. At a future date, the IASB will:

    (a) redeliberate whether items already designated in a hedge accounting relationship in accordance with IFRS 9 or IAS 39 may qualify for inclusion in the CNOP; and

    (b) consider whether the DRM model may be applied to the management of cross currency basis risk and tenor basis risk.

Designation of qualifying items in the DRM model

Designation on a portfolio basis

20. As summarised in Agenda Paper 4A for the April 2019 meeting, the IASB tentatively agreed that financial assets, financial liabilities and future transactions dynamically managed for interest rate risk and meeting the qualifying criteria should be designated on a portfolio basis in the DRM model. Therefore, qualifying items should be included in the CNOP on a portfolio basis.

21. The IASB also tentatively agreed that portfolios should be defined consistently with the entity's risk management policies and procedures, and should share similar risk characteristics such as being denominated in the same currency.

22. The IASB also tentatively agreed that the application of the DRM model should take effect from the date an entity has completed the necessary documentation to designate a specific portfolio. See tentative decisions relating to documentation in paragraphs 48 and 49 of this paper.

Designation and the dynamic nature of portfolios

23. As summarised in Agenda Paper 4A for the April 2019 meeting, the IASB tentatively agreed that an entity should have a choice to designate future transactions to be part of the DRM model, provided such designation is consistent with the entity's risk management strategy. The IASB will redeliberate the qualifying criteria for future transactions in its April 2023 meeting, see Agenda Paper 4C.

24. In addition, the IASB also tentatively agreed that changes to the designated portfolios (ie CNOP) resulting in updates to the DRM model should not result in discontinuation of the existing relationship.

Notional alignment between designated financial assets and financial liabilities

25. In its November 2022 meeting, the IASB tentatively decided that in determining an entity's current net open risk position, notional alignment is not required between the qualifying financial assets and financial liabilities that are designated in the DRM model.

De-designation of qualifying items

26. As summarised in the Agenda Paper 4A for the April 2019 meeting, the IASB expressed preliminary views not to allow voluntary de-designation of financial asset portfolios or financial liability portfolios within the DRM model when the risk management objective remains the same and the financial assets or financial liabilities in their respective portfolios continue to meet the qualifying criteria.

27. In addition, the IASB also tentatively agreed that financial assets, financial liabilities and future transactions should be de-designated when they no longer meet the qualifying criteria or when they are derecognised from the statement of financial position in accordance with the requirements of IFRS 9.

Designated derivatives

Qualifying derivatives

28. As summarised in the Agenda Paper 4A for the April 2019 meeting, the IASB tentatively decided to address interest rate swaps, including basis swaps and forward start swaps, and forward rate agreements first, as these will capture a significant portion of the DRM hedging instruments.

29. With respect to internal derivatives, the IASB tentatively decided that only contracts with a party external to the reporting entity (ie external to the group or the individual entity that is being reported on) can be designated within the DRM model.

30. At a future date, the IASB will consider the inclusion of non-linear derivatives (eg interest rate options) and off-market derivatives in the DRM model.

Designation and de-designation of derivatives

31. As summarised in the Agenda Paper 4A for the April 2019 meeting, regarding designation and de-designation of derivatives, the IASB tentatively decided that formal designation is required and should occur when the entity completes the necessary documentation requirements, as detailed in paragraphs 48 and 49 of this paper. While designation can occur on an individual or group basis, an entity must demonstrate sufficient specificity to enable performance assessment (see paragraphs 53 and 58 of this paper for the performance assessment).

32. In addition, the IASB tentatively decided that the DRM model should not allow voluntary de-designation of a derivative when the risk management objective for that particular derivative remains the same.

33. The IASB tentatively decided that the DRM model should allow the designation of a proportion of the notional amount of a derivative, such as a percentage of its notional amount, however, a designated derivative may not be designated for a part of its change in fair value that results from only a portion of the time period during which the designated derivative remains outstanding.

Qualifying criteria for the DRM model

Risk management strategy

34. Although the IASB has not defined the risk management strategy, it should be noted that paragraph B6.5.24 of IFRS 9 states that:

> …The risk management strategy is established at the highest level at which an entity determines how it manages its risk. Risk management strategies

typically identify the risks to which the entity is exposed and set out how the entity responds to them. A risk management strategy is typically in place for a longer period and may include some flexibility to react to changes in circumstances that occur while that strategy is in place (for example, different interest rate or commodity price levels that result in a different extent of hedging). This is normally set out in a general document that is cascaded down through an entity through policies containing more specific guidelines…a risk management strategy can involve many different hedging relationships whose risk management objectives relate to executing that overall risk management strategy…

Target profile

35. As detailed in Agenda Paper 4A for the November 2021 IASB meeting, the IASB tentatively decided that the target profile (ie risk limits) is required to be directly linked to the entity's documented risk management strategy. In other words, it is not merely an accounting concept. 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).

36. The specification and documentation of the target profile, as one of the qualifying criteria to apply the DRM model, should be done at inception of the model. This means 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 relationship in the DRM model as set out in paragraph 59 of this paper. The IASB will further deliberate when the discontinuation of the DRM model occurs and whether such changes lead to discontinuation of the model at a future date.

Risk mitigation intention

37. In November 2021, the IASB introduced the risk mitigation intention as a 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. It is measured and represented by the benchmark derivatives and evidenced by the designated derivatives.

38. As detailed in Agenda Paper 4B for the February 2022 meeting, the risk mitigation intention in the DRM model is calculated as follows:

Step 1—qualifying portfolios of (expected) cash flows from financial assets, financial liabilities, and future transactions are designated in the DRM model;[3]

Step 2—the CNOP is determined as the net interest rate risk position of the designated portfolios, for example, by allocating expected cash flows across repricing time period and determining the risk by repricing time period arising from the aggregated position; and

Step 3—the entity determines the extent to which it wants to mitigate the interest rate risk in the CNOP, consistent with its risk management strategy, being the RMI. The RMI is evidenced by the designated derivatives traded with external counterparties and can change from one DRM assessment period to the next.[4]

39. In November 2021, the IASB also tentatively decided *not* to make additional refinements in the DRM model to allow an entity to designate a portion of a portfolio of prepayable financial assets. This is because the risk mitigation intention would enable an entity to decide the extent of the CNOP to mitigate by using derivatives within the target profile. Such a decision—ie how much of the risk exposure to

[3] Consistent with the IASB's tentative decisions in February and April 2018, future transactions such as forecast transactions and firm commitments that are highly probable to occur and meet certain qualifying criteria can be designated in the DRM model.

[4] The DRM assessment period may be different to the reporting period.

mitigate—could be driven by many factors, including an entity's current expectations of prepayment levels or other risk management factors, but it must be consistent with the entity's risk management strategy and activities.

40. In its July 2019 meeting, the IASB tentatively decided that aggregation of the benchmark derivatives would be permitted if the maturity dates, payment dates and interest rate basis are the same.

41. In its April 2023, the IASB will consider the requirement to evidence risk management intention and how an entity identifies managed risks; and how the benchmark derivatives are constructed, particularly with respect to the relevant input factors such as the notional, tenor, reset terms, benchmark interest rate etc. to ensure consistent application of the DRM model.

42. As detailed in Agenda Paper 4A for the November 2021 IASB meeting, the IASB tentatively decided that the determination of the risk mitigation intention is subject to specified restrictions. An entity applying the DRM model needs to apply both prospective and retrospective assessments to be able to apply the DRM model. The prospective assessments need to be satisfied at the time the risk mitigation intention is determined (ie the beginning of the DRM assessment period), supplemented by the retrospective assessment at the end of each assessment period.

43. The risk mitigation intention needs to be evidenced by an entity's 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.

Prospective assessments

44. The prospective assessments are performed at the start of each DRM assessment period, and thus are based on all reasonable and supportable information available at that time. The aim of the prospective assessments is to ensure that the entity only

applies the DRM model to activities that achieve its risk management strategy. In its November 2021 meeting, the IASB decided that:

(a) 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 mitigate 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.

45. As a result of the prospective assessment requirements, when an entity is determining its risk mitigation intention, it is restricted by the following considerations:

(a) the maximum amount of risk mitigation intention is capped at the current net open risk position, and this maximum amount is not affected by the entity's target profile (ie risk limits) determined at the inception of the entity's DRM model. Consistent with how entities monitor and manage their current net open risk position, the maximum amount of risk mitigation intention in each maturity time bucket is capped at the current net open risk position within that bucket; and

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

Retrospective assessment

46. In addition to the prospective assessments, in the same meeting in November 2021, the IASB also tentatively decided to introduce a retrospective assessment to reflect misalignment arising from unexpected changes in the DRM model; the test being whether the entity has mitigated interest rate risk (ie did unexpected changes during the period result in over-hedging?).

47. As an entity is only able to determine a risk mitigation intention that satisfies the prospective assessments at the start of the assessment period, any breaches against the retrospective assessment are likely to be caused by unexpected changes in the underlying cash flows during the DRM assessment period. As a result, the retrospective assessment is designed to capture potential misalignment arising from unexpected changes in the CNOP.

Documentation

48. As summarised in the Agenda Paper 4A for the April 2019 IASB meeting, the IASB discussed and tentatively agreed that an entity should formally document:

    (a) the portfolio(s) of financial assets and portfolio(s) of financial liabilities designated in the DRM model;

    (b) a description of the methodology and key assumptions used by the entity to estimate the core and non-core portions of its demand deposit portfolio;

    (c) the methodology used by the entity to determine the amount of future transactions to be designated in the DRM model and how such designation is consistent with its risk management policies and procedures; and

    (d) evidence supporting the high probability of future transactions occurring[5].

49. In addition, the documentation provided should be supported by an entity's risk management strategy, procedures and objectives. The following key elements of the risk management strategy would need to be documented and kept constant throughout the life of the DRM model:

    (a) the processes to approve and amend the strategy;

    (b) risk management levels and scope;

    (c) the managed risks and the risk metrics used;

[5] Please refer to Agenda Paper 4C of the April 2023 meeting for further considerations on the highly probable assessment.

(d) range of acceptable risk limits (ie the target profile); and

(e) risk aggregation methods and risk management time horizon

50. Changes in an entity's risk management strategy and therefore its target profile (risk limits) are expected to be rare in practice, however the IASB will deliberate whether such changes result in the discontinuation of the DRM model at a future date, as mentioned in paragraph 36 of this paper.

Accounting for the DRM model

Accounting for qualifying items and derivatives designated in the DRM model

51. In May 2022, the IASB tentatively decided to retain the classification and measurement of the designated derivatives as at fair value through profit or loss. Given that derivatives themselves expose an entity to risk and are sensitive to changes in market factors or other risks, information about changes in their fair value is important to users of financial statements, even if these derivatives are used for risk management purposes.

52. In Agenda Paper 4A for the May 2022 meeting, the staff explained that retaining the original classification and measurement of the financial assets and financial liabilities included in CNOP, would provide useful information to the users of financial statements about the nature and extent of risks the entity is exposed to and is arising from the items, and thus would provide predictive value, confirmatory value or both.

Performance assessment

Calculation of the DRM adjustment

53. In its meeting of May 2022, the IASB tentatively decided that the DRM adjustment would be recognised in the statement of financial position, in absolute amounts, as the lower of (thereon, 'the lower of test')):

(a) the cumulative gain or loss on the designated derivatives from the inception of the DRM model; and

(b) the cumulative change in the fair value of the risk mitigation intention attributable to repricing risk from inception of the DRM model. This would be calculated using the benchmark derivatives as a proxy.

54. The DRM adjustment is recognised in the statement of financial position instead of other comprehensive income. This is consistent with the fact that the purpose of the DRM model is to reduce both variability in net interest income and in fair value of the risk mitigation intention.

Forward-looking capacity assessment

55. In Agenda Paper 4B for the February 2023 meeting, the IASB tentatively decided to require a capacity assessment based on the fair value of the current net open risk position at the assessment date, assuming no further increases or decreases in the current net open risk position until the end of the time horizon. This fair value represents an entity's capacity to realise the expected benefits (of reduced earnings or economic value variability) represented by the DRM adjustment.

56. In other words, this assessment will ensure that the DRM adjustment is not recognised at an amount higher than the expected benefit of reduced variability to be realised in future. Any excess of the DRM adjustment over the fair value of an entity's current net open risk position is recognised in the statement of profit or loss in the period of the assessment.

57. The IASB will deliberate the principles of determining the fair value of the CNOP for the capacity assessment at a future date.

Recognition of the DRM adjustment

58. The DRM adjustment would be recognised in the statement of financial position as discussed in paragraph 53 of this paper. The amount deferred in the DRM adjustment will then be recognised in the profit or loss, based on the lower of the accrual profile of the designated derivatives and the benchmark derivatives. The IASB will clarify the presentation requirements in profit or loss for these subsequent adjustments at a future date.

Discontinuation of the DRM model

59. As discussed in Agenda Paper 4A for the November 2021 meeting, the IASB tentatively decided that any changes to an entity's risk management strategy, for example any changes that result in a change to the entity's target profile, would result in the discontinuation of the DRM model. The IASB will redeliberate at a future date, circumstances that may lead to discontinuation of the DRM model.

60. The IASB tentatively decided that if an entity chooses to discontinue the DRM model, and the cash flows from the underlying financial assets and financial liabilities still exist and/or future transactions are still expected to occur, then the amount recognised as the DRM adjustment would be recognised over time. The IASB will redeliberate this tentative decision at a future date, taking into account the refinements made to the DRM model.

Disclosure and presentation

61. In its July 2019 meeting, the IASB tentatively decided that the areas of focus for disclosures should be those that assist users of financial statements to:

    (a) understand and evaluate an entity's risk management strategy;

(b) evaluate management's ability to achieve that strategy;

(c) understand the impact on current and future economic resources; and

(d) understand the impact on an entity's financial statements from the application of the model.

62. The IASB will further deliberate specific presentation requirements such as the presentation of the DRM adjustment in the statement of financial position, and the presentation of amounts subsequently released to the profit or loss at a future date, along with any accompanying disclosure requirements.

Transition and effective date

Transition

63. The IASB will consider the transition requirements at a future date.

Appendix A: Glossary of Defined Terms

Definitions	
Benchmark derivative	a theoretical derivative representing the entity's risk mitigation intention for measurement purposes.
Core demand deposits	financial liabilities, as defined in IAS 32 *Financial Instruments: Presentation*, that are payable on demand and will not reprice with a change in market interest rates over time. The extent of financial liabilities with demand features to be treated as core demand deposits is ultimately based on the entity's risk management policies and procedures.
Current net open risk position	the interest rate risk position (by time bucket) which is derived from the combination of expected (ie modelled) cash flows from financial assets, financial liabilities (including core demand deposits) and eligible future transactions over the period which the entity is managing repricing risk.
Designated derivatives	derivatives (as defined in Appendix A of IFRS 9 *Financial Instruments*) that are traded with external counterparties which are being used for executing an entity's risk management strategy.
Risk limit	the extent of an entity's defined tolerance level for risk.
Risk mitigation intention	the extent to which an entity intends to mitigate the current net open risk position through the use of derivatives.

Definitions	
Target profile	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.