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## IASB<sup>®</sup> meeting

Date	<b>April 2023</b>
Project	<b>Dynamic risk management (DRM)</b>
Topic	<b>Further considerations on the current net open risk position</b>
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (IASB). This paper does not represent the views of the IASB or any individual IASB member. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS<sup>®</sup> Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB<sup>®</sup> *Update*.

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## Introduction

1. To better reflect the effect of an entity's risk management activities in the financial statements using the DRM model, the IASB tentatively decided in [November 2021](#) to introduce the current net open risk position (CNOP). This represents 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) and eligible future transactions over the period the entity is managing such risk.
2. The qualifying criteria for inclusion of financial assets and financial liabilities in the CNOP were tentatively agreed by the IASB in [February 2018](#) and [April 2018](#). The IASB also made some further tentative decisions in [November 2022](#) and [February 2023](#) about an entity's own equity and financial assets measured at fair value through other comprehensive income (FVOCI) and financial assets measured at fair value through profit or loss (FVPL).
3. In summary, the current qualifying criteria for inclusion in the CNOP are:

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- (a) financial assets are measured at amortised cost or FVOCI in accordance with IFRS 9 *Financial Instruments*;
  - (b) financial liabilities are measured at amortised cost in accordance with IFRS 9;
  - (c) the effect of credit risk must not dominate the changes in expected future cash flows;
  - (d) future transactions are highly probable;
  - (e) future transactions must result in financial assets or financial liabilities that are classified as subsequently measured at amortised cost or financial assets measured at FVOCI in accordance with IFRS 9;
  - (f) items already designated in a hedge accounting relationship do not qualify for designation in the DRM model; and
  - (g) qualifying items are managed on a portfolio basis for interest rate risk management purposes.
4. We focus on the qualifying criteria listed in paragraph 3(d) in this paper, ie future transactions are highly probable, and consider whether further refinement is necessary with respect to this requirement.
5. This paper is structured as follows:
- (a) [summary of staff recommendations](#);
  - (b) [summary of previous discussions and feedback](#);
  - (c) [staff analysis](#); and
  - (d) [question for the IASB](#).
6. This paper also includes [Appendix A—Implementation Guidance F.3.7 of IAS 39 \*Financial Instruments: Recognition and Measurement\*](#).

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## Summary of staff recommendations

7. For the reasons explained in paragraph 15–34 of this paper, we recommend the IASB:
  - a) require future transactions that are the reinvestment or refinancing of existing financial assets or financial liabilities at the prevailing market interest rate to be included in the CNOP when they are expected to occur; and
  - b) retain the requirement for all other future transactions to be highly probable to occur.

## Summary of previous discussions and feedback

8. This section summarises why the relevant qualifying criteria were deemed necessary during the development of the core DRM model. It also summarises the feedback on the challenges that could arise when applying the DRM model and how this might be seen as inconsistent with the objective to better reflect the effects of risk management activities in financial statements.
9. While we acknowledge that the concept of CNOP did not exist when the IASB tentatively decided the qualifying criteria for the asset profile and target profile during the development of the core DRM model, we believe that those continue to be consistent with and relevant for the DRM model when determining the CNOP.<sup>1</sup>
10. When an entity manages its interest rate risk exposures holistically and dynamically, in addition to the interest rate risk exposures already recognised in the statement of financial position, it is common to also consider interest rate risk exposures associated with future transactions that are expected to affect future interest income and expense.
11. As discussed in [agenda paper 4B](#) for February 2018 IASB meeting, only future transactions (such as forecast transactions and firm commitments) that are highly

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<sup>1</sup> Despite the new name, the CNOP is simply the net risk position derived from qualifying financial assets that were previously in the asset profile, and financial liabilities that were previously part of the target profile and any qualifying future transactions.

probable to occur are eligible to be included when determining an entity's CNOP.<sup>2</sup> These highly probable future transactions can result in both fixed rate and variable rate financial assets or financial liabilities, and should be included in CNOP accordingly.

12. To assess whether a future transaction is highly probable, the core DRM model refers to existing IFRS Accounting Standards (ie IFRS 9 and IAS 39) rather than creating new requirements in the context of the DRM model and also provides an example of possible required documentation in this regard.<sup>3</sup> Further guidance on how the term highly probable should be interpreted can also be found in F.3.7 in the Implementation Guidance that accompanied IAS 39, which can be found in [Appendix A](#) of this paper. Although the IASB decided not to carry forward this Implementation Guidance, paragraph BC6.95 of Basis for Conclusions on IFRS 9 explains that not carrying forward the Implementation Guidance did not mean that the IASB had rejected that guidance.
13. During the outreach on the core model, the issue of future transactions, and in particular what constitutes a future transaction and how to determine whether an exposure is highly probable, have not been raised as a particular area of concern. Participants generally accepted that the term highly probable is well understood and applied in the context of the hedge accounting requirements in IFRS 9 and/or IAS 39.
14. However, as the DRM model has been developed further and stakeholders have been providing informal feedback on the IASB's tentative decisions, more questions about the meaning of highly probable in the context of repricing risk are being raised. Stakeholders observed that there seems to be an inconsistency between the requirements for future transactions and the allocation of core demand deposits and prepayable assets based on expected cash flows. This is because future transactions

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<sup>2</sup> In addition, such highly probable future transactions must also result in financial assets that are classified as subsequently measured at amortised cost or FVOCI or financial liabilities that are classified as subsequently measured at amortised cost under IFRS 9.

<sup>3</sup> See agenda paper [4B](#) para 33 and 76 (c) for the February 2018 IASB meeting.

have to be highly probable to occur at a specified timing and amount, while prepayable assets and core demand deposits are allocated based on the expected timing and amount of future cash flows. Stakeholders said that highly probable is a much higher threshold than ‘expected to occur’.

## Staff analysis

15. The staff think it is therefore necessary to provide some further clarification on how to assess whether future transactions are highly probable, and how these transactions would be considered in the context of the DRM model. In particular, we think it is necessary to distinguish between future transactions relating to growth and future transactions relating to the expected refinancing of *existing* financial liabilities or reinvestment of *existing* financial assets after their maturity date.
16. Entities generally manage the interest rate risk of future transactions, if such risk can be accurately identified, monitored and measured, ie when the entity has an interest rate risk exposure from future transactions. To that extent, the qualifying criteria for future transactions provide a useful basis to assess whether future transactions are eligible to be included in CNOP. It also ensures the DRM model can faithfully reflect the interest rate risk exposures considered holistically under the DRM process.
17. The highly probable assessment is not a new concept developed for the DRM model. It has existed in the hedge accounting requirements in IAS 39 and IFRS 9 for many years in relation to the designation of a forecast transaction. The term highly probable indicates a much greater likelihood of happening than the term ‘more likely than not’.<sup>4</sup> An assessment of the likelihood that a forecast transaction will take place is not based solely on management’s intentions because intentions are not verifiable. A transaction’s probability should be supported by reasonable and supportable information.

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<sup>4</sup> See F.3.7 of Implementation Guidance of IAS 39.

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18. Some future transactions, such as firm commitments, are by definition highly probable to occur based on their contractual terms, and therefore, a separate highly probable assessment is not necessary when an entity includes such future transactions when determining the CNOP.<sup>5</sup> In comparison, a highly probable assessment is necessary for other future transactions, such as forecasted transactions or some one-sided loan commitments, as there is a reasonable possibility that such future transactions may not happen.<sup>6</sup> Therefore, a highly probable assessment ensures an entity does not mitigate an interest rate risk that does not exist.
19. From an interest rate risk management perspective, future transactions considered for the DRM model could be a result of:
- (a) expected growth in financial assets or financial liabilities; or
  - (b) planned reinvestment of proceeds from the existing financial assets or refinancing of existing financial liabilities after their maturity date.

### ***Expected growth***

20. We focus on the future transactions due to expected growth first. Although an entity might have budgeted for growth in financial assets and financial liabilities, if such future transactions have not been priced or originated, future pricing will take place at the prevailing market interest rates for both. Therefore, no mitigating actions are required because there is no exposure to interest rate risk until such time. In other words, it is not necessary for an entity to include such future growth in their interest rate risk management process.<sup>7</sup>

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<sup>5</sup> Firm commitment is defined as ‘a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates’ in Appendix A of IFRS 9.

<sup>6</sup> Some loan commitments are only one-sided firm commitments, ie a bank commits to provide credit (ie make a loan) at a specified rate of interest for a specified maturity during a fixed period of time, but the customer has an option on whether to commit to such a loan during that fixed period of time. This is different to a typical pipeline transaction where neither the bank nor the customer yet has a contractual commitment.

<sup>7</sup> The entity could still include the financial assets and financial liabilities, that are expected to be originated in future, into the CNOP if they meet the highly probable requirement, but this will not affect the CNOP directly.

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21. In contrast, if a future transaction has already been priced, an entity would have reasonable and supportable information that the future transaction is highly probable to occur. A typical example of such a scenario could be when an entity assesses that it is highly probable that there will be growth in its core demand deposit balance in one year's time. Since the entity knows the core demand deposit typically pays zero or near zero interest and is modelled like a fixed rate liability, it can include the interest rate risk exposure from such highly probable transactions in its current net open risk position and start to manage the interest rate risk from that point onward.
  22. In essence, an entity is required to prove not only that the future transaction is highly probable to happen and will lead to a recognised financial asset or financial liability (ie the occurrence is highly probable), but also that it is highly probable the future transaction will be of a certain amount and will be priced at a particular time in the future at a pre-determined rate (ie the timing, amount, and the rate specified are highly probable). Given the specificity required, we continue to believe that it is necessary to require such future transactions to be highly probable.

### ***Refinancing or reinvestment***

23. Moving the focus on to the reinvestment of proceeds from the existing financial assets and refinancing of existing financial liabilities, risk management activities are based on the entity maintaining stable funding and lending levels. As such, when the underlying items managed under the DRM model are identified, usually the risk management objective does not solely focus on existing financial assets or financial liabilities, but also considers what will happen at maturity of those financial assets and financial liabilities. As risk management is focused on understanding how interest income and expense will be impacted by interest rates over time, risk management will consider how interest income can change when maturing assets are reinvested and maturing liabilities are refinanced during the managed time horizon as defined in the entity's risk management strategy.

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24. Although not expected to be common, if pricing has already happened for the reinvestment or refinancing of existing financial assets or financial liabilities, an entity would have effectively already committed to the reinvestment or refinancing at a pre-determined interest rate at a specified future date. As a result, it is similar to the situation described in paragraph 21 where the growth has been priced. The highly probable requirement is still necessary in such a scenario.
25. However in most cases, the reinvestment or refinancing of existing financial assets or financial liabilities would only be priced in the future at the prevailing market interest rates on the current instruments' maturity date. Such maturity dates are likely to be based on contractual terms, but may also be based on expectations or internal models, for example in the case of prepayable assets or core demand deposits.<sup>8</sup> In other words, the timing and amount of such future transactions are already known (either based on contract terms or based on expected cash flows generated based on reasonable and supportable prepayment assumptions), while the interest rate will be variable based on the prevailing benchmark interest rate the entity manages using the DRM model (ie the managed risk, see agenda paper 4B for the April 2023 meeting).
26. In the context of future transactions, pricing refers to the determination of the actual interest rate for these future transactions. For example, the refinancing of an existing debt (when it expires in two years' time) is considered as not yet priced even if the entity has already decided that the replacement would be issued as a fixed rate debt. In this example, since the entity will only decide the actual fixed rate in future based on the then prevailing market interest rates, it has the same interest rate risk exposure today as an entity that plans to refinance by issuing a floating rate debt in two years' time.
27. During the 2020 outreach, some participants commented that from an interest rate risk management perspective, the reinvestment or refinancing of existing financial assets

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<sup>8</sup> An entity may determine the maturity profile of a portfolio of prepayable financial assets based on expected maturity rather than contractual maturity basis, considering the potential impact of possible prepayments.

or liabilities is in reality almost ‘certain’, especially when such reinvestment or refinancing will occur at the prevailing market interest rate (ie not yet priced). This is because risk managers consider the entity as a going concern when assessing interest rate risk exposures, and therefore at a minimum, an entity is able to place the proceeds from matured financial assets with the central bank and earn the prevailing benchmark interest rate upon reinvestment. Similarly, in the absence of any information to the contrary, an entity would have to refinance itself at the prevailing benchmark interest rate when the existing financial liabilities mature. The credit risks and liquidity risks associated with the reinvestment or refinancing process are not considered as part of the DRM model, as the DRM model reflects the effect of interest rate risk management only.

28. As a result, we question whether the high hurdle of satisfying the highly probable requirement for future transactions that are purely the reinvestment or refinancing of existing financial assets or financial liabilities and yet to be priced, would achieve the objective of the DRM model.
29. However, we believe that some assessment is still necessary to ensure an entity would continue to apply the DRM model to interest rate risk exposures that are expected to affect future interest income and expense during the managed time horizon.<sup>9</sup> This helps to avoid situations where the DRM model is used to mitigate interest rate risk that does not exist in the first place, for example, when an entity decides not to reinvest some of its financial assets, but rather to use the proceeds to purchase other non-interest generating assets (such as head office building) or cover future expenses.
30. Therefore, we are of the view that an entity should focus on assessing whether reinvestment or refinancing of existing financial assets or financial liabilities are *expected to occur*, instead of being highly probable to occur.

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<sup>9</sup> Future transactions will only affect the economic value of equity once they are priced.

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31. From an interest rate risk management perspective, an entity would have exposure to variable rate financial assets or financial liabilities from the reinvestment or refinancing date, as long as the reinvestment or refinancing is expected to occur.<sup>10</sup>
32. In our view, such an assessment would be less onerous than the highly probable assessment as described in paragraph 21 for future transactions relating to growth and in paragraph 24 where pricing has already happened for the reinvestment or refinancing. Requiring future transactions that are reinvestment or refinancing to be based on expectations would also ensure consistency with how prepayable assets and core demand deposits are included in the CNOP, which are based on their expected timing and amount.
33. When assessing whether future transactions that are the reinvestment or refinancing of existing financial assets or financial liabilities 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 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;

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<sup>10</sup> This is because the reinvestment or refinancing will happen at the prevailing market interest rate, and the associated credit risk and liquidity risks are not considered under the DRM process for interest rate risks.

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- (e) the likelihood of using other alternatives to the reinvestment and refinancing;  
and
  - (f) the entity's business plan.
34. Therefore, the staff recommend the IASB:
- (a) require future transactions that are the reinvestment or refinancing of existing financial assets or financial liabilities at the prevailing market interest rate to be included in the CNOP when they are expected to occur; and
  - (b) retain the requirement for all other future transactions to be highly probable to occur.

### Question for the IASB

**Question for the IASB**

Does the IASB agree with the staff recommendations set out in paragraph 7 of this paper?

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## Appendix A—Implementation Guidance F.3.7 of IAS 39

A1. We have included Implementation Guidance F.3.7 of IAS 39 in this Appendix for reference purposes because the IASB decided not to carry forward this Implementation Guidance. However, paragraph BC6.95 of Basis for Conclusions on IFRS 9 explains that not carrying forward the Implementation Guidance did not mean that the IASB had rejected that guidance.

### F.3.7 Hedge accounting: forecast transaction

**For cash flow hedges, a forecast transaction that is subject to a hedge must be ‘highly probable’. How should the term ‘highly probable’ be interpreted?**

The term ‘highly probable’ indicates a much greater likelihood of happening than the term ‘more likely than not’. An assessment of the likelihood that a forecast transaction will take place is not based solely on management’s intentions because intentions are not verifiable. A transaction’s probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

- a) the frequency of similar past transactions;
- b) the financial and operational ability of the entity to carry out the transaction;
- c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);
- d) the extent of loss or disruption of operations that could result if the transaction does not occur;

- e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of ordinary shares); and
- f) the entity's business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer

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expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.