Introduction

1. In the context of the DRM model, designated derivatives are derivatives (as defined in Appendix A of IFRS 9 Financial Instruments) that are traded with external counterparties and are being used for executing an entity’s risk management strategy.

2. At the June 2018 meeting, the IASB discussed the use of derivative financial instruments in the core DRM model, and tentatively decided that:
   
   (a) the DRM model should permit the use of interest rate swaps, including basis swaps, forward starting swaps and forward rate agreements;
   
   (b) options would be considered in the second phase of the model depending on the feedback from stakeholders;
   
   (c) the DRM model should require formal designation and documentation of such derivatives; and
   
   (d) the DRM model should require all designated derivatives to have a counterparty external to the reporting entity.
3. We have also summarised other relevant tentative decisions relating to the designated derivatives in paragraphs 25 to 30 of Agenda Paper 4A of this meeting.

4. These tentative decisions are still relevant to the current DRM model, as the recent tentative decisions made by the IASB did not directly affect the requirements for designated derivatives. Therefore, consistent with our July 2022 project plan, this paper focuses on two technical aspects relating to the designated derivatives:

   (a) whether non-linear derivatives (such as interest rate options) are eligible for designation in the DRM model—this is consistent with the tentative decision noted in paragraph 2(b) of this paper; and

   (b) whether ‘off-market’ derivatives are eligible for designation in the DRM model—stakeholders asked whether, and if so, how off-market derivatives can be designated in the DRM model.

5. This paper is structured as flows:

   (a) Section A – Designation of non-linear derivatives in the DRM model

      (i)  background;

      (ii) staff analysis;

      (iii) staff recommendation; and

      (iv) question for the IASB.

   (b) Section B – Designation of off-market derivatives in the DRM model

      (i)  background;

      (ii) staff analysis;

      (iii) staff recommendation; and

      (iv) question for the IASB.
Section A—Designation of non-linear derivatives in the DRM model

Background

Feedback from stakeholders

6. A designated derivative is an important element of the DRM model because it is the instrument an entity uses to mitigate the interest rate risk. The designated derivatives are also used to evidence an entity’s risk mitigation intention (RMI), and directly affect the measurement of the DRM adjustment.

7. In most cases, when an entity applies the DRM model, the timing and amount of the cash flows from the underlying positions can be determined based on the contractual terms. However, it is not uncommon for some financial assets or financial liabilities to contain prepayment options that could affect the timing and amount of contractual payments. For the purposes of the DRM model, entities are therefore required to include prepayment assumptions when determining their current net open risk position (CNOP) based on reasonable and supportable information that is available to the entity at the time it determines its CNOP.¹

8. In practice, many entities manage the interest rate risk arising from these prepayable financial assets or financial liabilities based on the expected timing and amount of the cash flows (ie ‘linearising’ the interest rate risk). Most of the preparers that participated in the outreach, indicated that they predominately use linear interest rate derivatives (such as vanilla interest rate swaps) to mitigate the interest rate risk in their portfolio. These entities typically have more comprehensive data and experience about expected prepayment rates at a portfolio level and are thus able to develop risk management strategies based on expected cash flows.

¹ When determining the effects of prepayment assumptions, entities need to consider all reasonable and supportable information, such as the historic data of customer behaviours and other economic estimates or models.
9. However, some stakeholders said that in some circumstances they may have to use non-linear derivatives (such as interest rate options with non-linear cash flows), particularly when the underlying positions contain non-linear cash flows or there is significant uncertainty about the expected cash flows from their underlying positions. For example, in some jurisdictions, customers may be granted variable interest rate loans with embedded interest rate caps, which are funded by a plain vanilla variable rate inter-bank borrowing. Although there is no customer optionality involved in such a scenario, the economic nature of the contract means that the cash flows from the loan could switch between variable (when the market rate is lower than the interest rate cap) and fixed (when the market rate is higher than the interest rate cap), while the funding liability is always at variable rate.

10. Some preparers suggested that using an option-based risk management strategy is arguably more effective in mitigating the interest rate risks than relying on expected cash flows, and thus a valid and suitable risk management strategy in some cases. They are of the view that the DRM model should be able to faithfully reflect the effect of using these non-linear derivatives on the financial statements.

11. In addition, some stakeholders also noted that IFRS 9 permits the designation of interest rate options as hedging instruments applying the general hedge accounting requirements. Therefore, these stakeholders are of the view that the DRM model should permit the designation of non-linear derivatives as well, on the basis of consistency with the requirement under the general hedge accounting.

**Staff analysis**

*The reasons for using non-linear derivatives in the dynamic risk management process*

12. First, we consider why an entity might use non-linear derivatives for its dynamic interest rate risk management purposes, even though they are inherently more complex and costly than linear derivatives. Entities may have many different
justifications for using non-linear interest rate derivatives, but ultimately, in our view, there are two main reasons:

(a) to take a position on the potential gains or losses arising from market interest rate movements when the entity does not have an ‘organic’ non-linear interest rate risk to mitigate (for example, an entity enters into a purchased payer swaption position to get a pay fixed, receive variable rate swap because the entity expects interest rates to rise); or

(b) to mitigate the entity’s non-linear interest rate risk in its underlying financial assets and financial liabilities when the entity is unable to linearise such risk or wants to avoid the potential model errors when linearising the cash flows based on expectations. In this case, the financial assets or financial liabilities are usually with contractual terms that either lead to non-linear cash flows (such as a variable rate financial asset with an interest rate cap) or grant the counterparty an option that leads to non-linear changes to its interest rate risk exposures (such as a fixed rate asset that can be prepaid).

13. In our view, non-linear derivatives entered into for the purpose as set out in paragraph 12(a) are essentially used for ‘trading’ purposes, because such derivatives cannot be consistent with an entity’s interest rate risk management strategy. Although economically the entity is not exposed to losses in excess of the initial premium paid, these derivatives effectively still create rather than mitigate the interest rate risks. These derivatives cannot evidence the RMI at the beginning of the DRM period, because there is no organic non-linear interest risk in the CNOP to mitigate. Consequently, such derivatives are not eligible to be designated in the DRM model.

14. On the other hand, considering the circumstances described in paragraph 12(b), prohibiting the use of non-linear derivatives when they are executed to mitigate the inherent non-linear cash flows in the underlying positions would be inconsistent with the objective of the DRM model (which is to better reflect the effect of dynamic interest risk management activities in the financial statements).
15. In our view, the challenges with using non-linear derivatives in those situations are not directly related to the conceptual merits of designating or measuring these derivatives in the DRM model. In most cases, there is a liquid market structure for such positions, and an entity is able to reliably measure the cumulative fair value gains or losses from these non-linear derivatives and calculate the DRM adjustment accordingly (as described in paragraph 51 of Agenda Paper 4A of this meeting). Similarly, an entity would be able to calculate the accrual profile resulting from those non-linear derivatives and determine the subsequent measurement of the DRM adjustment.²

16. Instead, the challenges are more related to how the CNOP and RMI are determined when an entity uses an option-based strategy that involves non-linear derivatives. This is because a risk management strategy that makes use of non-linear derivatives means an entity allocates cash flows into time buckets based on their contractual tenors and not based on the expected timing and amount of cash flows as described in paragraph 8 of this paper. Consequently, any change in the timing or amount of contractual cash flows due to prepayments is mitigated by the non-linear derivatives.

17. Under the DRM model, the measurement of the DRM adjustment and the recognition of any misalignment in profit or loss are based on the ‘lower-of test’, which focuses on the cumulative fair value changes in the benchmark derivatives and designated derivatives. Since the benchmark derivative is just a mathematical expedient for measuring the RMI, reflecting the non-linear interest rate risk in the CNOP and determining the extent of interest rate risk being mitigated as RMI are important considerations.

² For example, a swaption would not have any accrual until exercised. Once exercised, the accrual profile can be determined based on the terms of the resulting interest rate swap.
**Challenges in determining CNOP and RMI**

18. The CNOP is the net open interest rate risk position (by time bucket / repricing time period) 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. Ultimately, the CNOP represents the organic net interest rate risk exposure an entity has from the eligible financial assets and financial liabilities (ie the underlying positions).

19. 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. When there are non-linear interest rate risks from the underlying positions, a change in interest rates affects the underlying positions in two ways:

   (a) it affects the timing and amount of contractual cash flows; and

   (b) it affects the expectation on the likelihood of the embedded prepayable option being exercised.

20. As noted in paragraph 8 of this paper, in practice many entities determine their CNOP by allocating cash flows from underlying financial assets and financial liabilities to time buckets based on expected repricing dates, rather than on a contractual basis. In other words, the risk management strategy of these entities meant that a position that economically has non-linear risk would be displayed and managed as a position with only linear risk (based on its models and expectations).

21. The linearisation of interest rate risk based on expected cash flows simplifies the process of aggregating interest rate risk from all relevant underlying positions to form the holistic net interest rate risk exposures, without the need to identify which particular underlying position contributed to the extent of interest rate risk that is managed under the DRM model.

22. However, if an entity is unable to linearise its interest rate risk or wants to avoid the potential model errors when linearising the cash flows based on expectations, it would
inevitably have to manage segmented interest rate risks that reflect the specific contractual terms and optionality within each of the underlying positions. In other words, the entity would have to monitor and manage the interest rate risks based on the contractual terms of underlying items. This would make the holistic interest rate risk view more complex. Consequently, an entity is also likely to have a combination of both linear and non-linear interest rate risk in its CNOP under such circumstances, which is inherently more difficult to monitor and track over time.

23. Practically, such an entity is required to monitor and manage the interest rate risk exposures that exist in the CNOP based on the contractual terms of the underlying positions. The entity may have to use multiple risk metrics to segment interest rate risks from underlying financial assets and financial liabilities with different contractual terms and assess whether derivatives are used for risk mitigation purposes accordingly.

24. The determination of the RMI is also more challenging. As the RMI represents the extent of interest rate risk an entity intends to mitigate using derivatives, such interest rate risk must exist in the CNOP and be evidenced by the designated derivatives traded.

25. When an entity does not linearise its interest rate risk from underlying positions but instead tries to include all the non-linear risks as defined in the contractual terms in the CNOP, it has to set multiple ‘targets’ based on the different risk metrics within the underlying positions. Reflecting non-linear cash flows from the underlying position in the CNOP and determining the RMI accordingly may be challenging. In many circumstances, it would also make the accounting for the DRM model more complicated, and the accounting outcome more difficult to explain. Therefore, it could reduce the benefit and increase the cost of applying the DRM model.

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3 For example, if an entity has prepayable assets with different contractual terms (eg some are prepayable after 5 years, whilst others are prepayable after 10 years), they need to be captured separately and segmented from each other in order to faithfully reflect the underlying interest rate risk exposures.
26. Nevertheless, we want to emphasize that a benchmark derivative is constructed as a mathematical expedient to measure the RMI, and thus must reflect the economic features of the RMI rather than imputing the terms of a designated derivative.

27. When used for risk management purposes, a non-linear derivative typically provides non-linear protection to the underlying positions. For example, an interest rate cap or payer swaption protects against the effects of a rise in interest rates, while an interest rate floor or receiver swaption protects against the effect of a drop in interest rates. As a result, it would only mitigate the non-linear (ie one-sided) interest rate risks that exist in the CNOP.

28. Therefore, a non-linear derivative would not be able to evidence an RMI if an entity has already ‘linearised’ all its prepayment risks based on expected cash flows. Despite the requirement for the benchmark derivatives to faithfully represent the RMI, there is an increased risk for an entity to impute the terms of the non-linear derivatives onto the RMI and thus onto the benchmark derivatives, when an entity uses an option-based strategy.

**Possible ways to manage non-linear interest rate risk within the DRM model**

29. While we acknowledge that an entity could manage non-linear interest rate risks in many different ways, the objective of the DRM model is to reflect the effects of how an entity manages these risks in financial statements. Therefore, an entity is required under the DRM model to reflect its non-linear interest rate risk in the underlying financial assets and financial liabilities using an approach that is consistent with its risk management strategy.

30. While determining the CNOP, using the expected cash flows are the most commonly adopted approach based on the outcome of our outreach, we are of the view that this is not the only possible way to manage non-linear interest rate risk. Such an approach is in essence a proxy method for measuring the actual effect of the entire financial asset or financial liability, including any embedded prepayment option that is attributable to changes in interest rates, or any contractual terms that lead to non-linear cash flows.
Conceptually, an entity is also able to reflect the effect of their non-linear interest rate risk using other methods as long as they are consistent with the entity's risk management strategy. However, to avoid the risk of double counting the effect of non-linear contractual terms (such as prepayment option terms), an entity cannot not use expected cash flows and include non-linear risks in the CNOP simultaneously.

**Managing non-linear interest rate risk outside of the DRM model**

31. In our view, some entities may focus only on managing the linear interest rate risks under the DRM model, while dealing with the non-linear (one-sided) interest rate risks or other prepayment assumptions using the IFRS 9 general hedge accounting requirements. In many cases, an entity adopting an option-based risk management strategy has to consider the use of non-linear derivatives for each of individual portfolios separately given the different contractual terms in those portfolios, and as a result, the general hedge accounting requirements may be more appropriate in reflecting the effects of such strategies.

32. Applying the IFRS 9 hedge accounting requirement, the entity may also choose, according to paragraph 6.2.4(a) and 6.5.15 of IFRS 9, to separate the intrinsic value and time value of the interest rate options and designate only the change in intrinsic value of the options as a hedging instrument, and account for the time value of options as cost of hedging.

33. Assuming the IASB tentatively agrees with our staff recommendation for Agenda Paper 4B of this meeting, to permit the inclusion of hedged exposures (ie the hedged items and the derivatives designated in an hedging relationship in accordance with IFRS 9), we think it would also be possible for an entity to manage the non-linear interest rate risk outside of the DRM model. The entity could then designate the combined effect of the hedge exposure (which only has linear interest rate risk) in the CNOP.
**Consideration on a net written option**

34. As discussed in paragraph 13 to 14 of this paper, we are of the view that non-linear derivatives are only eligible to be included as designated derivatives when they are used to mitigate the organic risk that exist in the CNOP.

35. Consistent with the requirement in paragraph 6.2.1 of IFRS 9, we think that a net written option cannot be eligible as a designated derivative under the DRM model. This is because such a net written option would in most cases not mitigate an entity’s organic interest rate risk exposure, but is more likely to create interest rate risk exposures, as the potential loss on an option that an entity writes could be significantly greater than the potential gain in value of the underlying positions.

36. There is an exception in IFRS 9 when a written option is designated as an offset to a purchased option. Similarly, a written option may be eligible in the DRM model when it is used to offset a purchased option that was previously designated as part of the designated derivatives already. In such circumstances, the entity would not have a net written option but instead would have a nil position or net purchased option as designated derivatives. This is because the written option fully or partially closes out the open risk exposure from the purchased option (for example a written call option used to close out a purchased call option previously designated in the DRM model).

37. Consequently, we suggest the DRM model excludes net written options to be eligible designated derivatives. This means that if an entity designates written options as designated derivatives, it needs to ensure the net risk positions of designated derivatives do not result in a net written option.

**Staff recommendation**

38. In our view, using non-linear derivatives might be inherently more complicated than using linear derivatives and may thus only be suitable for entities with sophisticated risk management tools, comprehensive valuation techniques, and well-established risk management processes and controls.
39. However, considering that the objective of the DRM model is to better reflect the effect of the entity’s risk management activities in the financial statements, we recommend that non-linear derivatives, except for net written options, are eligible as designated derivatives when their use is consistent with an entity’s risk management strategy and faithfully represents the entity’s risk management activities.

**Question for the IASB**

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<td>1. Does the IASB agree with the staff recommendations set out in paragraphs 38 – 39 of this paper?</td>
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**Section B—Designation of off-market derivatives in the DRM model**

**Background**

*Feedback from stakeholders*

40. Although stakeholders did not raise many questions regarding the eligibility requirements for designated derivatives, some asked whether off-market derivatives would be eligible, and if so, how fair value changes arising before the designation are treated regarding the measurement of the DRM adjustment.

41. Currently it is not uncommon for entities to designate one of their existing derivates as a hedging instrument in a new hedge relationship (applying the general hedge accounting requirements in IFRS 9 *Financial instruments* or IAS 39 *Financial instruments: Recognition and measurement*), provided the relevant qualifying criteria is met. In such a scenario, the derivative is unlikely to have a zero fair value at the
date it is designated in the new hedge relationship. This is because the market conditions at this date are likely to be different to the market conditions at the date the derivative contract was entered into, i.e., the derivative has off-market terms on the day of the new hedge relationship designation.

42. As outlined in Agenda Paper 4 for the July 2022 IASB meeting, some stakeholders raised a concern that such a designation may cause further complications under the DRM model, given the complexities around determining the accrual profile of a derivative that has a non-zero fair value at the date of designation compared to the accrual profile of one that has a zero fair value at the date of designation.

43. Similarly, the potential impact of early termination of derivative contracts or derivatives trade compression would also need to be considered. Such termination/compression activities are usually requested by the counterparty or organised by a central clearing house, and from a risk management perspective, the resulting changes in risk may be replaced by a new derivative (one with an ‘on-market’ interest rate). However, such activities would change the contractual terms of the designated derivatives as well as their total fair value, and therefore may have an impact on the calculation of the DRM adjustment and its subsequent measurement.

Previous tentative decisions

44. In Agenda Paper 4B for the April 2023 meeting, the IASB discussed and tentatively agreed that the benchmark derivative is constructed to be on-market at the time of designation, using the managed risk for rate calibration.

45. The DRM adjustment is recognised in the statement of financial position, in absolute amounts, as the lower of:

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4 In this context, derivatives trade compression refers to a process of reducing gross notional of a derivative portfolio by replacing multiple off-setting derivative contracts with fewer derivative contracts of the same net risk.
(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 RMI attributable to repricing risk from inception of the DRM model. This would be calculated using the benchmark derivatives as a proxy.

46. This means in essence that 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.

**Staff analysis**

*Designation of off-market derivatives*

47. In the DRM model, the benchmark derivative is a theoretical derivative representing the entity’s RMI for measurement purposes, and therefore would always be set with on-market terms. If the entity is using a designated derivative that is off-market at the designation date to evidence its RMI (ie the extent of risk the entity wants to mitigate for the period), the difference in the terms of the designated derivative and the benchmark derivative could result in misalignment.

48. In many cases, an off-market derivative would have a similar effect in mitigating an entity’s repricing risk due to changes in interest rates, because they have the same effect as an on-market derivative in transforming fixed cash flows and variable cash flows. Consequently, in the staff’s view, excluding the designation of such an off-market derivative in the DRM model would be inconsistent with the objective of reflecting the effects of risk management activities better, when the use of such an off-market derivative is in line with the entity’s risk management strategy.

49. Some people might argue that when an entity enters into a new derivative contract with off-market terms (eg an interest rate swap with an off-market interest rate), the nature of the derivative is economically equivalent to an ‘embedded financing
element’ within the derivative. That is to say, a derivative asset can be thought of as containing an ‘embedded loan receivable’, and a derivative liability as containing an ‘embedded loan payable’.

50. For example, consider an entity entering into an off-market interest rate swap with a receive EURIBOR leg and a pay 5 per cent fixed leg. The entity would receive an upfront premium of, for example, CU10 million from the counterparty in cash, because the current yield curve indicates that a swap with the same economic terms should have a fixed leg of 3 per cent. In this scenario, the 2 per cent difference in the pay leg may be considered as paying loan instalments equal to 2 per cent of the notional of the swap to the swap counterparty on an amortising loan of CU10 million (ie embedded loan payable) every period. Assuming the derivative contract is at arm’s-length, it should have an initial negative fair value of CU10 million, that equals to the amount of premium received. Alternatively, it may be considered as a 2 per cent fixed annuity on the notional of the swap, compensating the counterparty for the payment of the upfront premium of CU10 million.

51. However, in our view, it is important that all qualifying derivatives are designated in their entirety, (ie as a single unit of account), in the DRM model. In other words, it is not appropriate to bifurcate an embedded financing component (ie the compensation for the off market element) that has a non-zero fair value at the time of designation and account for it as a separate amortising loan.5

Implications on the accounting for the DRM model

52. We also considered whether designating off-market derivatives in the DRM model could negatively affect the accounting and the measurement of the DRM adjustment, as tentatively agreed by the IASB and summarised in paragraph 45 of this paper.

5 Similarly, an entity cannot bifurcate any other components from a derivative either, for example valuation adjustments. A derivative must be designated in its entirety in the DRM model.
53. The measurement of designated derivatives in the DRM model are not different to other derivatives, ie they continue to be measured at fair value in the statement of financial position, with their gains or losses recognised in the statement of profit or loss. As such, whether a designated derivative has off-market terms or not, should not affect the measurement of that derivative directly. This is because the DRM adjustment is determined based on the cumulative fair value gains or losses since inception of the DRM model, therefore the initial fair value from an off-market derivative does not affect the calculation of the DRM adjustment directly.

54. In the example in paragraph 50 of this paper, the initial negative fair value of the derivative is recorded in the statement of financial position with a corresponding cash entry, ie no fair value gains and losses are recognised in the statement of profit or loss at the time of the designation. If the entity was designating an existing derivative with a non-zero fair value at the time of the designation (ie with no cash payment/receipt, similar to the example in paragraph 41 of this paper), the fair value gains or losses up to the date of designation would have already been recognised in the statement of profit or loss, or in other comprehensive income if the derivative was designated in an effective cash flow hedge relationship.

55. Therefore, in the staff’s view, whether the designated derivative has an initial fair value or not, should not impact the measurement of the DRM adjustment.

56. However, we also need to consider the implication of having off-market designated derivatives when considering the recognition of the DRM adjustment in profit or loss (as described in paragraph 46 of this paper), and any impact this may have on mitigating the variability in the net interest income. This is because, comparing the accrual profile of an on-market benchmark derivative with the one of an off-market derivative would not be ‘comparing like with like’ and may result in artificially higher or lower amounts being recognised in the net interest income through the utilisation of the DRM adjustment.

57. As illustrated in paragraph 50 of this paper, when an off-market derivative is being entered into as a new arm’s-length contract, the initial fair value amount of the off-
market derivative effectively represents the discounted difference in future cash flows when compared with an on-market derivative. These excess cash flows are to be received/paid over the remaining life of the instrument as compensation for the initial cash premium paid (sometimes referred to as the off-market element). Therefore, in the staff’s view, any gains or losses relating to those excess cash flows are not to be considered when determining the protection/benefit to the net interest income provided by the DRM adjustment, but should continue to be recognised as net trading income similar to those from any other derivative. Consequently, an entity should exclude the accrual impact of these off-market elements when recognising the DRM adjustment in profit or loss.

58. In our view, an off-market derivative may be designated in the DRM model, provided the entity has implemented the relevant procedures and controls to ensure it does not recognise more protection/benefit from the unwinding of the DRM adjustment than the extent it has actively managed under the DRM model.

59. Although we expect that designation of off-market derivatives in the DRM model would happen occasionally, we do not expect such designations to be frequent given derivatives held for trading could not be designated in the DRM model. Furthermore, the more frequently an entity rebalances its positions within the DRM model, the less likely it would have to designate an off-market derivative with significant initial fair value at a designation date. Consequently, we do not anticipate entities having to follow procedures regarding off-market designated derivatives on a regular basis.

**Early termination and trade compression**

60. As noted in paragraph 43 of this paper, there may be occasions when an entity may have to terminate a derivative contract early upon request from its counterparty or may need to compress its existing derivatives.

61. In the staff’s view, for the purposes of accounting for the DRM model, early termination of a derivative contract and trade compression activities (where several derivative contracts are terminated and replaced) are conceptually similar to
designation of an off-market derivative within the DRM model and therefore should also be permissible under the DRM model.\(^6\)

62. To illustrate, let’s assume the entity had designated an interest rate swap with a receive EURIBOR leg and a pay 7 per cent fixed leg in the DRM model. The entity decided to terminate the interest rate swap contract and the fair value at the termination date is negative CU100 million because the current yield curve indicates that a swap with the same economic terms should have a fixed leg of 5 per cent. The entity will settle the contract by cash on the termination date.

63. Although the original derivative contract would be terminated, the entity would have to enter into a new derivative contract with on-market terms to replace the terminated derivative, which would be used to evidence its RMI for the next period.

64. Let’s assume the entity enters into a new interest rate swap with a receive EURIBOR leg and a pay 5 per cent fixed leg—on-market terms with a maturity matching the remaining term of the original swap. The new swap is designated in the DRM model upon origination and has a zero fair value on designation date.

65. The termination of the original swap, and its cash settlement, would not have a direct impact on the DRM adjustment, because it would not result in any additional gains or losses being recognised, ie all gains or losses up to the point of termination or settlement would have already been accounted for within the model—similar concept to the recognition and designation of an off-market derivative in the DRM model as discussed in paragraphs 52 to 59 of this paper.

66. However, the accrual profile of the designated derivative has now changed as a result of the termination of the original swap and its replacement with the new swap, whilst

\(^6\) A designated derivative is likely to be off-market when it is early terminated or compressed, as the market interest rate would have changed since the derivative contract was first entered into. In our view, de-designating an off-market designated derivative would have a similar effect as designating an off-market designated derivative. This is because in both cases the total interest rate risk and the total fair value of the designated derivatives would change. In comparison, when an ‘on-market designated derivative is designated, only the total interest rate risk would change, but the total fair value would not be impacted.
the accrual profile of the benchmark derivative remained the same (the benchmark derivative was constructed with on-market terms when the interest rate risk was first mitigated). Therefore, the entity would need to implement relevant procedures and controls to ensure that the benefit of the DRM adjustment that is driven by the interest rate changes in the previous periods is not lost and continues to be recognised in the future.

67. In the staff’s view, the current DRM model can accommodate the termination and/or replacement of a designated derivative, notwithstanding any operational complexities associated with such activities.

Staff recommendation

68. For the reasons explained in paragraphs 47–59 of this paper, we recommend that:
   
   (a) off-market derivatives (for example derivatives that have a non-zero fair value at the time of the designation) are eligible as designated derivatives in the DRM model, provided such a designation is in line with the entity’s risk management strategy and faithfully represents the entity’s risk management activities (see paragraphs 47–51 of this paper); and
   
   (b) only fair value changes of the designated derivatives after the date of the designation are considered as part of the measurement of the DRM adjustment (see paragraphs 52–59 of this paper).

Question for the IASB

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