Introduction

1. In November 2017, the IASB tentatively decided that the objective of the DRM project is to better reflect the effects of dynamic risk management activities in an entity’s financial statements. The application of the DRM model would provide useful information that will enable users of the financial statements to understand:

   (a) the entity’s interest rate risk management strategy and how it is applied to manage interest rate risk;

   (b) how the entity’s interest rate risk management activities may affect the amount, timing and uncertainty of future cash flows; and

   (c) the effect that applying the DRM model has had on the entity’s financial position and financial performance.

2. In developing the DRM model, the IASB aimed to address the challenges entities are facing when applying the general hedge accounting requirements in IFRS 9 (and IAS 39), such as:

   (a) the lack of transparency about management’s approach for managing interest rate risk, especially the re-pricing sensitivities of interest cash flows;
(b) the inability to designate some sources of funding, such as the demand deposits, that could be insensitive to changes in interest rates, as hedged items;

(c) the dynamic nature of assets and liabilities that expose entities to interest rate risk (which leads to fair value or cash flow variability), requiring constant designation, de-designation, re-designation of hedge accounting relationships and the associated amortisations of hedge adjustments/reserves which are becoming inherently complex, costly and prone to operational error; and

(d) the inability of users of financial statements to assess of how efficiently and effectively the entity’s management have discharged their responsibility to use the entity’s resources, given the challenges described in (a)–(c) above.

3. Although the DRM model is addressing these challenges through elements such as the target profile, current net open risk position, risk mitigation intention and DRM adjustment, applying the model would only provide the useful information set out in paragraph 1 of this paper if it is applied in the appropriate circumstances to the appropriate risk management activities. For example, applying the DRM model would not better reflect an entity’s risk management activities or provide useful information to the users of financial statements if an entity is not managing interest rate risk dynamically.

4. The purpose of this paper is to set out our preliminary views on the scope of the DRM model, that is the type of risk management activities for which the application of the DRM model would be appropriate and provide useful information. We are not asking the IASB to make any decisions at this meeting but welcome questions or comments on the potential scope of the DRM model.

5. This paper is structured as flows:

(a) scope of the 2014 Discussion Paper
(b) staff analysis
(c) question for the IASB
Scope of the 2014 Discussion Paper

6. One of the key features of dynamic risk management is the continuous reassessment of the net open risk position(s) (ie the current net open position) arising from the underlying portfolio(s). Dynamic risk management may be undertaken by a wide range of entities, from financial institutions to utilities or even some manufacturing entities. Likewise, the types of risks that can be dynamically managed vary and may include interest rate risk, commodity price risk and foreign exchange (FX) risk.

7. However, when developing the 2014 Discussion Paper (2014 DP) the IASB tentatively decided to focus on the way in which banks dynamically manage their interest rate risk as a starting point for the DRM project. This was because interest rate risk from a bank’s interest-generating assets and interest-bearing liabilities is a common example of a risk for which dynamic risk management is undertaken. It was also because of the feedback that many entities in the banking industry are most likely to apply the DRM model given they are currently applying the ‘macro’ cash flow hedge accounting or the fair value hedge accounting for a portfolio hedge of interest rate risk in IAS 39.

8. The 2014 DP discussed and analysed two potential approaches to describe the scope of the DRM project:

(a) focussing on dynamic risk management; and

(b) focussing on risk mitigation. 2

9. The first approach was considering a model that captures all elements of dynamic risk management activity, ie risk identification, analysis and mitigation through hedging. Under this approach the presence of any one of these elements would result in an entity applying the portfolio revaluation approach (PRA), with the objective being to faithfully represent such activities in the financial statements.

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2 See section 5 of the 2014 DP.
10. The other alternative considered was an approach that captures dynamic risk management only when all three elements of dynamic risk management are undertaken by an entity, i.e., risk identification, analysis and mitigation through hedging. Consequently, even when risk identification and analysis has been undertaken, under this approach PRA would only be applied when an entity has undertaken risk mitigation using derivatives.

11. In essence, the key difference between these approaches related to the treatment of the unhedged portion of the underlying portfolios, but both approaches presented issues and challenges which were often interrelated. Respondents’ views were mixed at the time although many preferred a scope focused on risk mitigation to a scope focused on dynamic risk management activities.  

12. Some respondents also said that there was a need for an accounting approach that addresses challenges with dynamic interest rate risk management encountered by industries other than banks. For example, the insurance sector said that neither a scope focused on dynamic risk management nor one focused on risk mitigation is satisfactory, because both alternatives are based on an analysis of banks whose assets and liabilities are mainly measured at amortised cost. They suggested that accounting solutions need to be developed in order to address problems specific to the insurance industry, as they tend to manage interest rate risk dynamically and holistically too even if most of their assets are not measured at amortised cost.

**Staff analysis**

13. The potential effects of the two scope alternatives discussed in the 2014 DP were considered carefully during the development of the DRM model, which was developed with both scope alternatives in mind and in our view, combine the best characteristics of each alternative.

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3 The comment letter analysis can be found in Agenda Paper 4B and 4C for the February 2015 IASB meeting.
14. The current net open risk position (CNOP) requires an entity to aggregate all cash flows, consistent with its risk management strategy, from its eligible financial assets and financial liabilities to determine the net open risk exposure. Identifying the CNOP is the starting point in the DRM model as it aggregates the variability of an entity’s financial assets and financial liabilities attributable to changes in a particular benchmark interest rate (ie the managed rate), in the same way as how an entity usually monitors and manages its net interest rate risk in practice.

15. The CNOP ensures greater consistency between what is reflected in the financial statements and what the entity does from a risk management perspective and therefore enables users of financial statements to understand the inherent interest rate risk exposures from the entity’s organic positions prior to any risk mitigation. As a result, entities are able to provide information on the effects of risk management activities directly rather than relying on the use of ‘proxy hedging’ techniques. Therefore, the DRM model retains the advantage of a scope focused on dynamic risk management as mentioned in the 2014 DP.

16. On the other hand, the risk mitigation intention (RMI) represents the extent to which an entity intends to mitigate the CNOP through the use of derivatives and is required to be evidenced by real actions taken in the market, such as the external derivatives entered into for risk mitigation. Unlike the PRA proposed in the 2014 DP, an entity only measures the changes in the fair value of the RMI as the basis for the DRM adjustment (using the lower-of test as tentatively agreed by the IASB in May 2022). This ensures the measurement of DRM adjustment reflects the extent to which the entity’s has been successful in its risk mitigation activities.

17. As a result, the DRM model also shares many advantages with the risk mitigation approach described in the 2014 DP. For example, it resolves the accounting mismatch

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4 In November 2021, the IASB 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.
to the extent an entity successfully mitigated risk, and makes no adjustments when risks are not mitigated. It also ensures the users of the financial statements can better understand how interest rate risk management activities affect the amount, timing and uncertainty of an entity’s cash flows and interest accruals.

18. In addition, the RMI also ensures that the DRM model is more consistent with how entities manage interest rate risk in practice. Risk managers usually focus on the ‘fungible’ benchmark interest rate risk that exist in the underlying portfolios. By referring to the extent of risk an entity intends to mitigate, the entity is not required to identify a sub-portfolio or a proportion of total portfolio for measurement purposes.

19. From investors’ perspective, the DRM model would provide holistic information on how an entity monitor and manage its interest rate risk and separate the net interest income contribution from the entity’s non-leveraged organic financial positions and those from the derivatives positions. It also provides information on how changes in benchmark interest rate would affect the entity’s net interest income in future through the expected realisation of the DRM adjustment over time.

20. While developing the DRM model, it is relatively straight forward from a standard-setting perspective to only focus on how banks manage interest rate risk, IFRS Accounting Standards are principles-based and not industry-specific. Therefore, determining the scope of the DRM model has to be principles-based and focussing on the relevant characteristics of the risk management strategy that will enable the DRM model to better reflect an entity’s interest rate risk management activities in the financial statements.

**Relevant characteristics of the risk management strategy**

21. In our view, the relevant characteristics of a risk management strategy and activities can be inferred from the elements of the DMR model, such as the CNOP and the RMI, as well as the business activities that give rise to the interest rate risk exposure. However, the fact that an entity might hold underlying portfolios that meet the qualifying criteria for determining the CNOP, would not automatically result in
application of the DRM model better reflecting the effects of an entity’s risk management activities in all circumstances.

22. For example, an entity may have issued a fixed rate corporate bond which is recognised as a financial liability at amortised cost and used derivatives to mitigate the interest rate risk in that financial liability. Although the debt position meets the qualifying criteria for determining the CNOP, applying the DRM model for such a stand-alone position would not provide information that is more useful to investors than applying the general hedge accounting requirements, even if the entity’s risk management objective is changing from time to time.

23. On the contrary, it may also be common for some entities to not mitigate interest rate risk despite holding a number of financial assets that meet the qualifying criteria for the CNOP. In that case, applying the DRM model would not be appropriate because it would not be consistent with the entity’s risk management strategy. Similarly, it would not be appropriate for an entity whose risk management strategy does not focus on the net interest rate risk exposure from financial assets and financial liabilities holistically to apply the DRM model either.

24. Although the risk management strategies and the detailed risk management activities may differ between different entities, we observed the following common characteristics among the banks that manages interest rate risks dynamically:

- (a) business activities that lead to the recognition of financial assets and financial liabilities that generate and bear interest at different rates and over different maturities, which exposes the entity to repricing risk;
- (b) a dynamic risk management strategy that is based on an aggregated (ie combined or net) repricing risk over a pre-determined period rather than focussing on individual risk positions generated by assets and liabilities;
- (c) an established and systematic process to determine the net repricing risk exposures from interest-generating assets and interest-bearing liabilities and
make adjustments to the risk mitigation activities on a dynamic/frequent basis; and

(d) free access to a liquid interbank market or money market that enables the entity to raise funding or invest excess cash at the prevailing benchmark interest rate if and when needed;

**Business activities that give rise to repricing risk**

25. Dynamic interest rate risk management is usually more relevant to entities that engage in frequent borrowing and lending as part of its main business activities—for example an entity that borrows money as short-term liabilities and lend the money out as longer term assets—to earn a premium for the risk taken (also referred to as maturity transformation). This leads to entities inherently being exposed to significant repricing risk because the interest-generating assets would reprice to a different rate or have different repricing frequency to the interest-bearing funding liabilities.

26. In this context, repricing risk refers to the risk that, when financial assets or financial liabilities reprice at different times, changes in interest rates result in variability in the net interest income or the fair value of underlying items in the current net open risk position.

27. Repricing risk exists most commonly in banks because of the dynamic nature of the financial assets and financial liabilities that expose them to repricing risk; their business activities mean they usually borrow or lend based on their customers’ requirements. In addition, banks also typically provide both fixed rate and variable rate loan and deposit products for customers to choose from. As a result, banks are inherently exposed to repricing risk given the maturity and repricing mismatch between their financial assets and financial liabilities, resulting in the use of interest

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5 The financial process where entities borrow and lend funds with different maturities simultaneously is commonly referred to as maturity transformation. In addition to interest rate risk, maturity transformation also leads to liquidity risk and credit risk to an entity, although those are not considered in the context of the DRM model.
rate derivatives being essential to ensure they are not adversely impacted if market interest rates have changed when the financial assets or financial liabilities reprices.

28. We acknowledge that business activities that give rise to repricing risk could also be undertaken by entities other than banks, as part of their main business activities. For example, an entity might be specialised in investing in fixed income financial instruments and thus engage in business activities that result in it holding interest-generating financial assets funded by interest-bearing financial liabilities that also have exposure to repricing risk.

29. However, despite those business activities, a typical non-banking entity might have more control over the maturity of its financial assets and financial liabilities and have a choice between fixed rate and variable rate. In addition, the entity might generally be able to determine its funding needs based on its business plan and funding requirements, and invests excess cash in interest-generating assets for a desired maturity. In other words, the financial assets and/or financial liabilities that give rise to repricing risk might be more stable, or less dynamic, than those of a bank.

30. It is worth noting some non-banking entities may have a specialised subsidiary which acts as the treasury function to raise finance and provide funding to the whole group like an internal bank, focusing on managing intra-group loans and deposits on a frequent and dynamic basis. In such circumstance, the subsidiary might have business activities that give rise to repricing risk even if it is not applicable to the group as a whole.

31. In our view, applying the DRM model would only be appropriate when an entity engages in maturity transformation (see paragraph 25) as its key business activities and manages dynamic portfolio(s) of financial assets and financial liabilities with an intention to manage the repricing risk the entity is exposed to.
Dynamic risk management strategy to mitigate the net exposure to repricing risk

32. As noted in paragraph 21 of this paper, we think that the relevant characteristics of a risk management strategy and activities for which the DRM model would provide useful information, can be inferred from the elements of the DMR model, such as the CNOP and the RMI.

33. The DRM model is developed as an accounting model for managing the repricing risk, which was caused by the combination of fixed and variable exposures from both financial assets and financial liabilities. In this context, the CNOP aggregates the underlying portfolios of financial assets and financial liabilities on which the entity is managing the repricing risk. Although the DRM model specifies the criteria for items to be eligible for inclusion in the CNOP, the starting point for the CNOP is the portfolios of financial assets and liabilities on which repricing risk is managed on a net basis in accordance with the entity’s risk management strategy.

34. Therefore, the DRM model would only be relevant when an entity’s risk management strategy is based on managing an aggregated/net exposure from the financial assets generating interest income and financial liabilities generating interest expenses.

35. As the financial assets and financial liabilities in the underlying portfolios could be referenced to different interest rates (as described in paragraphs 25–31 of this paper), to manage the repricing risk effectively, an entity’s risk management strategy typically specifies a particular benchmark rate against which repricing risk is determined, ie the managed rate. For the purposes of the DRM model, the inclusion of the underlying portfolios in the CNOP and the allocation of expected or contractual cash flows into time buckets, are done based on the entity’s exposure to repricing risk based on the managed rate.

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6 As discussed in Agenda Paper 4A for the February 2022 IASB meeting
36. The risk management strategy also describes the risk limits within which an entity’s net open risk exposure with regards to the managed rate, have to be managed within. The risk limits are important for the purpose of the DRM model because one of the requirements for the designation of the RMI is for it to transform the CNOP to a residual risk position that is within the target profile, being the risk limits described in the risk management strategy.

37. Therefore, another relevant characteristic of a risk management strategy for which the DRM model would provide useful information on, is the description of the managed rate against which the entity’s risk limits are defined.

38. In our view, further relevant characteristic is a risk management strategy that focuses on mitigating variability in net interest income based on pre-defined risk limits. This is because mitigating volatility in net interest income is the main reason for an entity’s dynamic risk management activities.

39. Although many entities consider both variability in NII (ΔNII) and variability in economic value of equity (ΔEVE), consistent with the requirement of the Interest Rate Management in Banking Book framework (IRRBB) as defined by the Bank of international Settlement, variability in future net interest income from underlying financial assets and financial liabilities are what an entity ultimately tries to mitigate using the DRM model. Entities use a combination of these two KPIs because the ΔEVE view focuses on the present value impacts today by protecting the fair value of financial assets and financial liabilities, while the ΔNII view focus on the cash value impacts in the future when benchmark interest rate changes. However, in essence the two KPIs are just different perspectives of the entities’ future variability in net interest income.

40. Therefore, we expect net interest income to be a key performance indicator or an important parameter that determines the risk management activities an entity might take to mitigate repricing risk.
41. Net interest income is usually only a key performance indicator or an important parameter for entities that provide financing to customers or carry out deposit taking as their main business activities. Those entities consider the interest revenues from its financial assets and the interest expenses from its financial liabilities holistically. In other words, these entities focus on earning from the spread difference in their interest-generating assets and interest-bearing liabilities, which makes the dynamic interest rate risk management important and essential for maintaining its profitability or mitigating the risk of making losses.

42. For most other entities, interest paid is usually considered as costs of financing while interests received as returns on investments. Interest income and interest expenses are also typically caused by different business activities, and it is therefore unlikely that the entity would try to manage the net interest income from its financial assets and financial liabilities holistically, and users of the financial statements usually analysed the interest income and interest expense separately too.

43. Moreover, the existence of variability in net interest income was also one of the key reasons why the IASB tentatively agreed in February 2023 that financial assets measured at fair value through other comprehensive income (FVOCI) are eligible for designation in the DRM model, but financial assets measured at fair value through profit or loss (FVPL) are not. Therefore, applying the DRM model would not be appropriate unless an entity has a risk management strategy that focuses on managing net interest income. In our view, that would naturally exclude many entities which already reflect the effects of interest rate changes in the statement of profit or loss using fair value measurements.

Established and systematic risk aggregation processes

44. The business activities described in paragraphs 25–31 lead to underlying financial assets and liabilities which are continuously originated and maturing. This means an entity needs to have an established and systematic risk aggregation process that is also dynamic and continuous. For many entities, the origination of the underlying
portfolios occurs within different business units across the entity. To aggregate the interest rate risk from different business units within an entity and to generate a holistic interest rate risk view from the underlying positions, an entity usually relies on internal funding or transfer pricing mechanisms. The fund transfer pricing process usually operates in such a way that interest rate risk arising in the individual business units is mitigated by transferring it to a centralised treasury function. During the 2020 outreach, most preparers said that their internal transfer pricing mechanisms are based on their managed rate which is a benchmark interest rate, either by creating an internal derivative position, or a proxy internal loan/deposit position between the business units and treasury department to replicate the interest rate risk from the underlying financial assets or financial liabilities.

45. One unique feature of this risk aggregation process is that, despite the different contractual details of various financial assets and financial liabilities, interest rate risk exposures in all relevant business units are grouped based on their expected maturity and interest rate features, and measured against the managed rate. Financial assets and financial liabilities in the same group are usually deemed as fully fungible for the purposes of interest rate risk management—for example, a 5-year fixed rate treasury bond is considered as equivalent or nearly equivalent to a 5-year fixed rate consumer loan.

46. In our view, unless there is an established and systematic risk aggregation process, an entity won’t be able to form a holistic interest rate risk view, and thus won’t be able to manage its interest rate risk holistically at an entity level. Such an entity-wide risk aggregation process would also have to be more fundamental than simply combining a few portfolios and manage them together, which could be better reflected using the general hedge accounting requirement for a group of items under IFRS 9.

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7 The role of transfer pricing was discussed in detail in section 4.2 of the 2014 DP.
Access to a liquid market for raising funding and investing excess cash

47. While large financial institutions usually have access to an interbank market that provides sufficient liquidity as long as they are willing to pay the prevailing market interest rate, such a liquid market may not be accessible to all entities. For example, when a corporate entity has a 3-year fixed rate financial asset, and a 2-year fixed rate financial liability, it may not have access to a liquid market to raise the funding after two years, and as a result, it may not have variability in net interest income after two years. Therefore, applying dynamic risk management may not be possible in such circumstances.

48. The access to a liquid market for raising funding and investing excess cash is also the reason that banks tend to use a benchmark interest rate as the basis of its transfer pricing process (as explained in paragraphs 44–46) and economically manage their fixed rate positions back to variable rate. In contrast, it is more common for non-bank corporates to economically manage their variable rate positions back to fixed rate for planning and budgeting purposes.

49. In addition, when the IASB tentatively decided in April 2023 that future transactions that are the reinvestment or refinancing of existing financial assets or financial liabilities at the prevailing market interest rate need to be expected, rather than highly probable, one of the reasons was the consideration that most banks would be able to raise funding or deposit excess cash in the interbank market at the prevailing interest rate when they are considered as a going concern. However, this assumption may not be true unless the entity has access to a liquid market for raising funding and investing excess cash.

50. We are therefore of the view that access to a liquid market for raising funding and investing excess cash, is also a relevant characteristic of the business and risk management activities for which the DRM model would provide useful information on.
### Question for the IASB

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