
IASB[®] meeting

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Project	Dynamic Risk Management (DRM)
Topic	Notional alignment of designated assets and liabilities
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Introduction

1. At this meeting, the IASB will be asked to reconsider its tentative decision taken during the development of the DRM core model that the notionals (of what was originally called the asset and the target profile) are required to be the same. This is because of feedback received during the outreach on the DRM core model.
2. This paper is structured as follows:
 - (a) [summary of the relevant discussions to date](#);
 - (b) [feedback from outreach](#);
 - (c) [staff analysis and recommendation](#); and
 - (d) [question for the IASB](#).

Summary of relevant discussions to date¹

3. For the purpose of the DRM core model, the asset profile consisted of a combination of designated financial assets and eligible future transactions, while the target profile specified the repricing dates for the asset profile based on an entity's risk management strategy, considering the entity's financial liabilities to ensure that the target profile is achievable.
4. When the DRM core model was developed, the IASB tentatively decided in March 2018 that the notional² of the asset profile has to be the same as the notional of the target profile, although the tenors were not required to be the same.

¹ See Agenda Paper [4B](#) of the March 2018 IASB meeting.

² Notional in this context refers to the principal amount of a financial instrument used to calculate payments made on that instrument.

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5. At the time, the IASB's view was that if the notionals of the target and asset profile are not aligned, it implies either:
- (a) the target profile represents something other than the specified repricing dates, based on an entity's risk management strategy, for the assets designated in the asset profile. This is because part of the definition of the target profile was a combination of the risk management strategy and objective, meaning that an entity could have aspired to a particular target notional level, thereby creating leverage (or synthetic risk) in the underlying position. For example, if the asset profile of an entity is comprised of CU1,000 7-year fixed rate financial assets, the target profile could not be set as CU1,200 for a 7-year fixed rate re-pricing profile. Otherwise, the derivatives required for transformation would need not only to transform the repricing dates (ie timing) of the asset profile, but also to increase the amount of assets to be transformed by the excess CU 200 notional. This is referred to as 'leverage' in the April 2019 Agenda paper;³ or
 - (b) financial assets within the asset profile are funded by financial liabilities that are outside the scope of the entity's interest rate risk policies and procedures. As stated in paragraph 28 of Agenda Paper [4B](#) of the March 2018 IASB meeting this would imply the risk management objective is to merely manage interest income as opposed to the net interest income (NII). For example, when there was an excess of floating rate assets, derivatives would be used to alter the interest income profile of the excess assets rather than managing the repricing gap between interest income and expenses.
6. The IASB also tentatively decided in [March 2018](#) that the tenor of the asset profile and the target profile are not required to be the same. In fact, it is this misalignment in tenors that gives rise to the repricing risk for which an entity then decides how much to mitigate using derivatives. Therefore, we believe this tentative decision continues to be relevant for the refined DRM model and we are recommending not making any changes for tenor misalignment.

Feedback from outreach

7. Several participants questioned the requirement for notional alignment of the asset and the target profile during outreach on the DRM core model. They identified situations when the notional of the assets and liabilities, that are managed holistically for risk management purposes, might not be aligned naturally. These participants were of the view that notional

³ Refer to Agenda Paper [4B](#) of the April 2019 IASB meeting chart 3.

alignment would not be possible in practice, considering the IASB's tentative decision on the qualifying criteria for designation of assets, liabilities and future transactions into an entity's asset or target profile. These participants said that notional alignment is not possible, for example, when:

- (a) equity is used as a source of funding for the designated assets, but is currently ineligible for designation in the DRM model;
 - (b) other financial instruments are included for interest rate risk management purposes but are currently ineligible for designation in the DRM model (for example financial assets which are not measured at amortised cost);
 - (c) interest rate risks from financial assets or liabilities are managed and hedged individually using the general hedge accounting requirements in IFRS 9 and are therefore ineligible for inclusion in the DRM model;
 - (d) there is a mismatch in currencies between financial assets and financial liabilities. As such they cannot be designated in the same DRM model and therefore the notionals might be different; or
 - (e) funding is raised on an entity wide basis while designated assets are originated on an individual business unit basis.
8. The situations described in paragraphs 7(a)–7(d) are consequences of the IASB's tentative decisions about the qualifying requirements for items to be eligible for designation in the DRM core model. Many respondents stated that equity (representing the residual after deducting an entity's liabilities from its assets) is a large source of funding for a bank and accounts for the largest part of any potential notional misalignment. Agenda paper 4A for this IASB meeting analyses whether equity should be eligible for designation in the DRM model. Other consequences of previous tentative decisions about eligible items will be analysed for discussion at future meetings.
9. With regards to the situation outlined in paragraph 7(e) of this paper, participants stated that interest rate risk resulting from funding liabilities might be based on an entity's internal transfer pricing system, which is used to transfer benchmark interest rate risk from a business unit into a centralised treasury function to externalise the entity's net interest rate exposure. As a result, the origination of assets cannot be directly matched to the relevant funding liabilities and therefore respondents may find it difficult to identify and allocate the funding liabilities needed for each (sub)portfolio to achieve notional alignment.

Staff analysis and recommendation

Is notional alignment still necessary in the refined DRM model?

10. As discussed in paragraph 5 of this paper, notional alignment requirement in the DRM core model was needed to achieve the objectives of the model and prevent leverage in the target profile or the creation of synthetic risk through the use of derivatives.
11. Considering these reasons for requiring notional alignment, it is natural to think this requirement should now be carried over into the refined DRM model, by requiring notional alignment of the designated assets and liabilities, that determine the current net open risk position.⁴
12. In this context, we think it is important to note that the notionals of the assets and liabilities and eligible future transactions that determine the current net open risk position, are a matter of fact; it is the organic risk position or net interest rate risk exposure of the entity based on its actual assets and liabilities. Under the refined DRM model an entity's desired residual risk position within the target profile is represented through the determination of risk mitigation intention. In comparison, the target profile in the DRM core model would have taken into account the entity's risk management strategy, which meant it needed to reflect the extent to which the entity wanted to mitigate the risk.⁵
13. When forecasting the expected cash flows of the assets and liabilities that are included in determining the current net open risk position, an entity would normally look at the notional amounts of the positions recognised on the balance sheet at that particular date. Eligible future transactions for budgeted growth, where the designated future transactions are assumed to result in floating rate assets and liabilities (ie pricing will take at the prevailing rate at the time of origination or issuance), do not impact the calculation of an entity's risk exposure and therefore do not need to be included in the cash flow forecast.⁶ In other words, it is common for entities to not manage the interest rate risk exposure expected from future growth as both the future asset and the future liability will be priced and originated at future market

⁴ The IASB introduced the concept of current net open risk position in November 2021 as the net open interest rate risk position (by time bucket) derived from the combination of an entity's assets and liabilities (including core demand deposits) and eligible future transactions over the period the entity is managing such risk. Despite the new name, the current net open risk position is simply the net risk position derived from assets that were previous in the assets profile, as well as the liabilities that were previously part of the target profile.

⁵ Refer to Agenda Paper [4B](#) of the March 2018 IASB meeting.

⁶ For example, if the future transaction included would result in a floating rate liability in the future, it would also generate (at a minimum) a floating rate asset at the time of future issuance. Hence such an assumption results in notional alignment for this particular transaction and no risk exposure from a delta present value or net interest income perspective.

rates, unless one side has been priced already in which case this interest rate risk exposure must be included in the current net open risk position.⁷

14. However, every eligible existing position is included in the cash flow forecast, depending on the risk metric used and its cash flows allocated over the managed time horizon.
15. Reflecting the economic reality, an entity's balance sheet positions will, for a profitable entity, typically result in a net asset position because of the presence of equity and therefore is likely to lead to notional misalignment of designated assets and liabilities. There are two possible scenarios of notional misalignment:
 - (a) the total notional amount of designated assets that affect the cash flows across the time buckets, exceeds the total notional amount of designated liabilities (for example some of the designated assets may have been funded by equity that are not included in the DRM model); or
 - (b) the total notional amount of designated assets that affect the cash flows across the time buckets is less than the total notional amount of designated liabilities (for example the amount of core demand deposits is higher than the designated assets). However, because entities are likely to have used equity as a funding source as well, this is the less likely outcome.
16. Based on the feedback from preparers summarised in paragraphs 7 and 9 of this paper, and the staff analysis in paragraphs 10 to 14 of this paper, notional alignment between assets and liabilities included in the current net open risk position is not a natural outcome in the DRM model. This brings into question whether continuing to require notional alignment, would achieve the objective of the DRM model and provide useful information to the users of the financial statements about the effect of an entity's interest rate risk management strategy and activities.
17. In analysing this question, we first analyse potential ways in which notional alignment could be achieved if it was to be required, before analysing potential implications of not requiring notional alignment.

Notional alignment continues to be required

18. As discussed in paragraph 15 of this paper, the presence of equity could be the most significant reason why the notionals of assets and liabilities will not naturally be the same. If

⁷ Refer to Agenda Paper [4B](#) of the February 2018 IASB meeting paragraph 65.

the IASB agrees with the staff recommendation in Agenda Paper 4A of this meeting and does not allow inclusion of equity as an eligible item, notional alignment of assets, liabilities and eligible future transactions designated in the current net open risk position could only be achieved in our view by either excluding the excess amount of assets or liabilities, or requiring the shortfall to be treated as a deemed floating or fixed interest rate exposure.

Excluding the excess from designation in the current net open risk position

19. The first approach is to exclude the excess amount of assets or liabilities from designation in the current net open risk position. This could be achieved by requiring the assets and liabilities included in the current net open risk position for a particular period, to be limited to the lower of the notionals of assets or liabilities.
20. To illustrate this approach, assume an entity has a portfolio of assets with a total notional of CU100 (of which CU60 is fixed rate for five years and CU40 is fixed rate for only two years), and a portfolio of floating rate liabilities with a total notional of CU80. In applying this alternative approach, the entity would need to identify underlying assets with a total notional of CU20 to be excluded from the current net open risk position, so that there is notional alignment between the assets and liabilities

Example A	Float	20X1	20X2	20X3	20X4	20X5	Total
Assets			40			60	100
Liabilities	(80)						(80)
Difference	(80)		40			60	20

21. Conceptionally, aligning the notionals of assets and liabilities might seem to be consistent with the notion that an entity is managing the repricing risks between its assets and liabilities in the DRM model. However, enforcing notional alignment using this approach could also give rise to outcomes that are not consistent with an entity's risk management strategy and activities in addition to some practical challenges, for example:
 - (a) this could limit the entity's ability to designate the risk mitigation intention as evidenced by the derivatives used to externalise the risk. It will therefore not be consistent with the IASB's tentative decisions about the risk mitigation intention in paragraphs 18–26 of [Agenda paper 4A](#) for the November 2021 meeting. It will also not achieve the objective of better reflecting entities' interest rate risk management activities in the financial statements. This is because limiting the notionals of assets and liabilities designated for

a particular period to the lower of the assets or liabilities, means the entity is unable to reflect the interest rate risk faithfully as the current net open risk position and thus affects the outcome of prospective and retrospective assessment. Considering the example in paragraph 20, excluding CU20 of fixed rate assets would artificially reduce the entity's exposure to variability in economic values of equity.

- (b) when determining the assets and liabilities to be included in the current net open risk position, an entity is not considering the individual items to be designated and might be using one of its risk metrics to determine its exposure to risk. Therefore, this approach would take the focus away from an interest risk perspective and in effect would mean a move back towards designating underlying assets and liabilities.
- (c) decisions about which assets or liabilities to exclude (depending on the circumstances at that particular date) would be completely arbitrary and could create opportunities for 'cherry picking' exposures to achieve a particular accounting outcome. Considering Example A in paragraph 20, whether to exclude CU20 of 2 years fixed assets, or 5 years fixed assets, or some combination of assets with a total notional of CU20, would significantly change the calculation of the current net open risk position. Therefore, to apply this approach in an appropriate way that is free from bias, would require entities to identify and match all designated assets to its specific funding source.
- (d) this approach may lead to an entity having to designate a hedging relationship applying IFRS 9 or IAS 39 for the excess of assets and liabilities that is not eligible for inclusion in the DRM model. Such hedging relationships will not necessarily be consistent with the entity's risk management strategy as interest rate risk is considered holistically and therefore would not result in useful information about an entity's interest risk management activities being provided to users of financial statements.

22. As a result, we are of the view that a requirement that involves the arbitrary allocation of funding and/or designation of assets and liabilities simply to achieve notional alignment cannot provide information that is relevant and a faithful representation of the entity's risk management strategy to users of the financial statements. We therefore do not recommend pursuing such an approach in the DRM model.

Require the shortfall to be treated as a deemed interest rate exposure

23. The second approach to achieving notional alignment would be to require any shortfall in the notionals to be treated as a 'deemed' floating rate or fixed rate item depending on the circumstances on a particular date.

24. Achieving notional alignment through the use of a ‘deemed’ floating rate financial instrument could be supported with the argument that banks can usually manage their funding excess or shortfall by lending or borrowing at the prevailing market rate. It is therefore reasonable to use a deemed floating rate asset or liability as the basis to achieve notional alignment. Some might also argue that this ‘deemed’ floating rate position faithfully represents the economic phenomenon that, for example, excess cash can be invested at the prevailing market interest rate, or potential additional funding may be raised at the prevailing market rate if necessary.
25. Considering Example B where an entity has a portfolio of floating rate assets with a total notional of CU100 and funded by a portfolio floating rate liabilities with a total notional of CU80 and equity with a notional amount of CU20. The table below excludes the equity consistent with the staff recommendation in Agenda paper 4A for this meeting that it is not an eligible item for designation in the current net open risk position. Therefore, applying this approach, the entity would need to ‘plug in the gap’ with an additional CU20 of deemed floating rate liabilities, to achieve notional alignment between the assets and liabilities.

Example B	Float	20X1	20X2	20X3	20X4	20X5	Total
Assets	100						100
Liabilities	(80)						(80)
Difference	20						20

26. While including this portfolio of ‘deemed’ floating rate liabilities in the DRM model has no impact when measuring risk exposure on a present value basis (ie no variability in economic value terms), it would inevitably create variability in NII although this interest income or expense would not be realised in actual (ie cash) terms. In this example, economically the entity would be exposed to NII variability on the difference of CU20 assets and risk managers may decide to mitigate that risk using derivatives. However, if the CU20 of ‘deemed’ floating liabilities in included in the DRM model, it would imply that there was no variability in NII terms (CU100 floating assets offset CU100 floating liabilities). This would mean any derivative mitigating the economic risk from the difference of CU20 would not be eligible for designation in the DRM model as the prospective assessment would require the risk mitigation intention to be to zero. In our view such an outcome would in fact be misleading and not reflect the actual effect of risk management.
27. Similarly, the shortfall could be deemed as a portfolio of fixed rate assets or liabilities, which does not generate deemed NII variability. However, in our view this would cause a similar

problem as described in paragraph 26, but from the perspective of variability in economic value. Using another example, Example C, where an entity has a portfolio of five-year fixed rate assets with a total notional of CU100 funded by a portfolio of five-year fixed rate liabilities with a total notional of CU80 and equity with a notional amount of CU20. If the entity includes a deemed five-year fixed rate position of CU20, it would seem as if there was no variability in economic value, which is not a faithful representation of the actual risk exposure economically.

Example C	Float	20X1	20X2	20X3	20X4	20X5	Total
Assets						100	100
Liabilities						(80)	(80)
Difference						20	20

28. Some banks say that equity (which might be the biggest source of notional misalignment) should be modelled like a fixed rate liability. However, in our view while a modelled fixed rate liability creates an economic value exposure to the changes in interest rate, equity itself does not have exposure to changes in market interest rates. Please refer to Agenda Paper 4A of this meeting for a discussion of equity as an eligible item for designation in the current net open risk position.
29. As a result, we are of the view that considering the shortfall as a deemed fixed or floating rate interest risk exposures to achieve notional alignment, does not provide useful information to the users of financial statements in general and could even be misleading in some cases as illustrated in Examples B and C. Therefore, we do not recommend pursuing such an approach in the DRM model either.

Notional alignment is no longer required

30. As discussed in paragraphs 7 to 9, notional alignment would not occur naturally in the DRM model for various reasons, neither does there appear to be an approach to achieve notional alignment that are consistent with the objectives of the DRM model and would provide useful information to users of financial statements. This third approach therefore considers including the actual (organic) risk positions managed via the entity's interest rate risk management process that are consistent with the objective of the DRM model to better reflect the actual risk management activities.
31. Using the same example as in paragraph 20 (Example A), applying this alternative, the entity would include in the current net open risk position the actual risk exposures derived from the

CU60 of 5-year and CU40 of 2-year fixed assets, combined with the CU80 of floating rate liabilities. Based on these inputs, an entity then determines the current net open risk position using the risk metrics chosen by the entity in its risk management strategy.

32. Not requiring notional alignment between the assets and liabilities in the current net open risk position, avoids:
- (a) the arbitrarily allocation of funding to asset portfolios to achieve notional alignment as described in paragraphs 19–22 of this paper; and
 - (b) the problem of non-existent or ‘deemed’ interest rate risk exposure to NII or EVE as described in paragraphs 23–29 of this paper.
33. With regards to leveraged positions, we do not think the concern about leverage in the current net open risk position, as originally raised during the deliberations on the DRM core model and referenced in paragraph 5(a) of this paper, is still relevant in light of the refinements to the DRM model. This is because all the underlying positions forming the current net open risk position are actual exposures, ie any difference in the notionals is ‘organic’ and not created through derivatives and therefore are not leveraged.⁸
34. However, this third approach also gives rise to two concerns that need to be considered:
- (a) accepting notional misalignment might mean that an entity is not only mitigating variability in the net of interest income or expense but also the income/expense driven by the excess of funding or interest-generating assets; and
 - (b) to the extent that there is notional misalignment, there might be an incentive for an entity to selectively designate derivatives depending on the risk metric the entity is managing.
35. Essentially these two challenges point to the original concern of the DRM core model discussed in paragraph 5(b) of this paper, that an entity would not pursue the dual objective of managing Δ NII and Δ EVE at the same time. To the extent notionals of assets and liabilities align, an entity would manage the Δ NII and Δ EVE simultaneously. However, when notionals are not aligned, an entity has to choose its interest rate risk management priority between mitigating Δ NII and Δ EVE, based on its risk management strategy, and the risk limits defined under both risk metrics.
36. Referring to the dual objective of the DRM model, applying this approach, entities may have different views of the interest rate risk inherent in the current net open risk position, depending

⁸ When the target profile represented a ‘desired’ single position, notional alignment was required to prevent leverage.

on the typical nature of an entity's assets and liability exposures and how they manage their interest rate risks. Using Example A in paragraph 20, the entity has variability in EVE mainly driven by the CU100 of fixed rate assets, and variability in NII mainly driven by the CU80 of floating rate liabilities. Whatever risk mitigation activity the entity decides to execute, it will have to consider the variability from both perspectives due to the notional misalignment. This means the entity needs to select a point where it is comfortable with the residual open interest rate risk position.

37. Typically, it is an entity's risk management strategy that determines which risk metric (for example Δ NII and Δ EVE) takes precedent at a particular risk point. It will therefore be reflected through risk limits which defines the extent of the 'compromise' or 'trade off' between conflicting risk metrics. As such, the use of a particular risk metric for a shortfall in the notionals in the current net open risk position, is not a free choice that could be exploited. When considering the example in paragraph 36 in this context, the notional misalignment does not mean the dual objective of the DRM model is no longer valid or has been disregarded. Instead, it represents the economic reality of an entity's balance sheet structure and its approach to manage the risks from the excess assets or liabilities.

Preliminary staff view

38. Although none of the three approaches discussed in paragraphs 19 to 37 of this paper provides the perfect solution with regards to notional alignment, on balance we are of the view that faithful representation of the economic phenomena and provision of relevant information about an entity's interest rate risk management activities can be best achieved by not requiring notional alignment for the current net open risk position.
39. Therefore, we recommend that the IASB to amend its original tentative decision to not require the notionals of eligible assets, liabilities and future transaction for designation in the current net open risk position to be the same.

Question for the IASB

Questions for the IASB

Does the IASB agree with the staff recommendation set out in paragraph 39 of this paper?