Applying IFRS

The IASB has outlined its proposed new dynamic risk management accounting model

November 2022

Building a better working world

Contents

What you need to know

- The IASB has now completed its initial deliberations on what may become the future hedge accounting model for interest rate risk for many banks. At a subsequent stage, the model may be extended to cover a wider range of risks for entities other than banks.
- The IASB has sought to align the accounting model with the approach actually used for risk management, so as to limit any inconsistencies between them. In particular, the Dynamic Risk Management (DRM) model has moved away from traditional hedge accounting models that focus on a specific hedged amount, to a risk management strategy that sets out an acceptable range (using risk limits) within which the risk exposure can vary.
- Whereas the IASB had previously intended to apply an accounting approach similar to cash flow hedge accounting, giving rise to volatility of Other Comprehensive Income (OCI), the DRM adjustment is now proposed to be recorded on the balance sheet. Part of the reason for this was that it is unclear whether or not the regulatory filters currently in place for the cash flow hedge reserve would have been replicated for a DRM reserve.
- It is now possible to understand, at a high level, how the model is expected to work. However, a number of important details have yet to be determined and the IASB has set out a project plan to address these issues, commencing in the fourth quarter of 2022 to work towards an Exposure Draft.

1. Introduction

At its meeting in May 2022, the International Accounting Standards Board (the IASB or the Board) completed its deliberations on the outline of the proposed Dynamic Risk Management (DRM) hedge accounting model. It has now moved the project from its research programme to its standard-setting programme. We are, therefore, able to set out our high-level understanding of how the model would work.

In October, the IASB Staff produced a webcast that summarises the model as currently proposed.[1]

However, a number of points of detail have yet to be discussed and agreed before the Board can issue an Exposure Draft (ED). At its July meeting, the Board discussed its plan for its next steps, starting in the fourth quarter of 2022. The topics and the order in which they are expected to be brought to the IASB are:

- Eligible hedged items and the determination of the current net open risk position
- Performance assessment and subsequent unwinding of the DRM adjustment
- The target profile and its alignment with an entity's risk management strategy
- The risk mitigation intention and the construction of benchmark derivatives
- Designated derivatives
- Other considerations
- Presentation and disclosure requirements

No date has yet been set for when an ED will be published.

It has been the IASB's intention that once this model is completed, entities will no longer be permitted to apply the IAS 39 *Financial Instruments: Recognition and Measurement* hedge accounting guidance, including the portfolio fair value hedge accounting model.[2]

Once the DRM model has been finalised for interest rate risk management, one of the areas noted by the Staff for consideration would be whether the model is suitable to be applied to risks other than interest rate risk or by entities other than banks.[3]

2. Background to the project

The IASB began its macro hedging project in September 2010, because of the difficulties associated with applying the normal hedge accounting requirements to a dynamically managed portfolio with continuous or frequent changes in the risk positions that are being hedged. These difficulties, as described by the IASB Staff[4], include the following:

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1 IFRS - Webcast series: Dynamic Risk Management
2 IFRS 9 BC6.103-104.
3 Ibid.
4 Staff Paper AP4B, May 2022. AP4B: Project Direction (ifrs.org)

i) The normal hedge accounting requirements are designed for 'closed portfolios', in which specific hedging instruments are designated as hedges of specific hedged item for a set period of time, after which there is a discontinuation of the hedge accounting relationship and the designation of new ones. This does not cater well for so called 'open portfolios', which are dynamically managed, with continuous or frequent changes in the risk positions that are being hedged. Among other issues, it gives rise to operational complexities because hedge accounting relationships need to be tracked and hedge adjustments need to be amortised.

ii) It is common for banks to manage interest rate risk arising from a combination of financial assets and financial liabilities on a net basis. However, normal hedge accounting requires portfolio hedges to be designated on a gross basis.

iii) This net interest rate risk position arises from a combination of variable and fixed-rate exposures. Accordingly, the economic mismatch has both fair value and cash flow variability and banks try to manage both aspects together. However, normal hedge accounting requires the designation of the hedging relationship as either a fair value hedge of the fixed rate items or as a cash flow hedge of the variable rate items, even though neither would faithfully depict the complete economic phenomenon in financial reporting.

iv) Because it is common for customers to maintain demand deposit accounts for an extended period of time, risk managers often identify a part of the demand deposit portfolio that is considered to be stable and treat these 'core demand deposits' as a fixed interest rate liability for risk management purposes. However, because the fair value of demand deposits is deemed to be constant for accounting purposes, fair value hedge accounting is precluded.

3. Summary of the DRM model

The objective of the DRM model is to provide useful information to enable users of financial statements to understand:

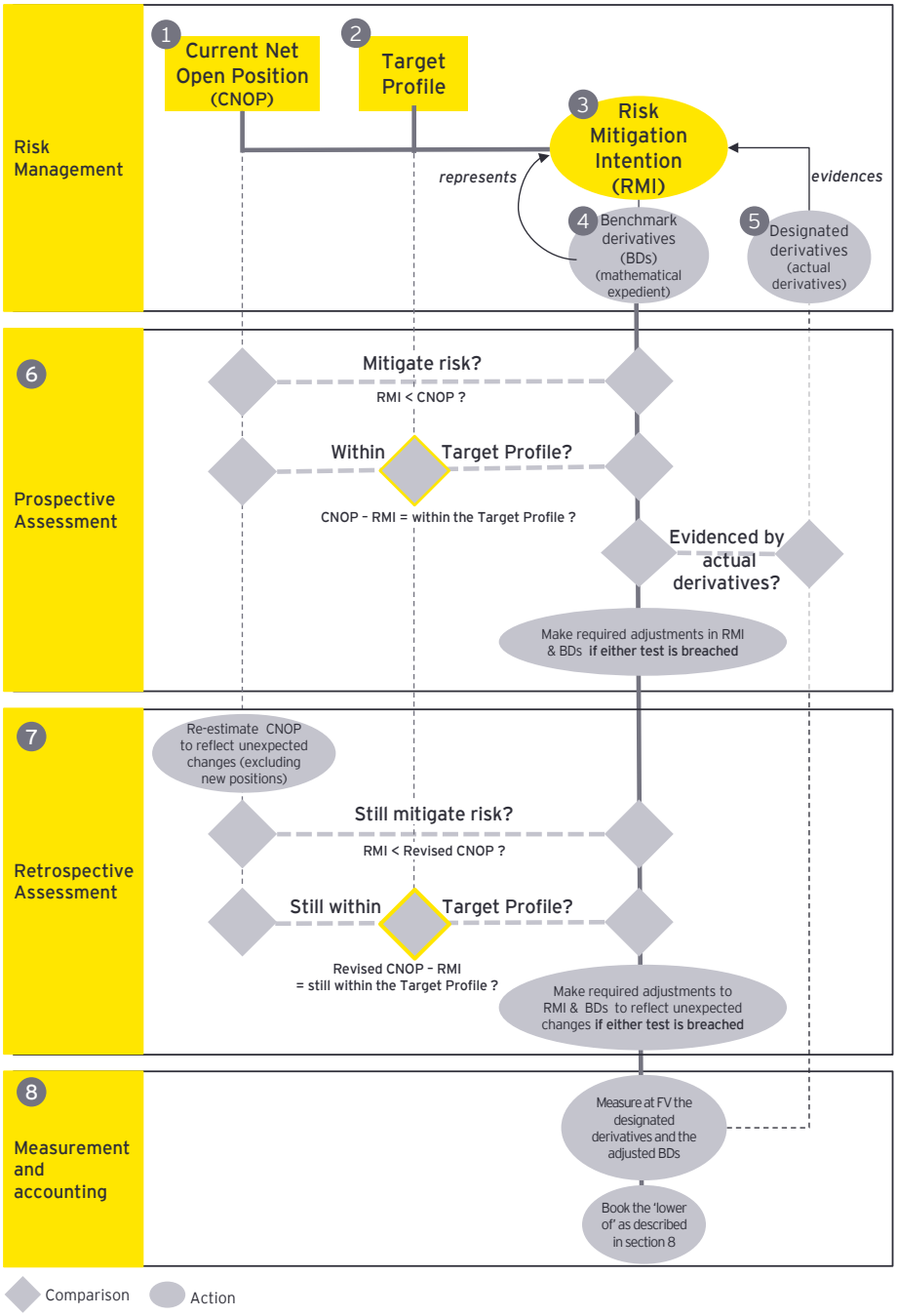
(a) The entity's dynamic risk management strategy and how that strategy is applied to manage repricing risk due to changes in interest rates;

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

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

To achieve this objective, the Board has tentatively agreed to a number of significant conceptual changes in the accounting approach. These are set out in more detail in Section 5.

Overview of the DRM model



The proposed DRM model requires the following eight steps:

1. The entity must first decide what financial assets and liabilities would be managed within the scope of the DRM model.

   The IASB has so far tentatively decided the qualifying criteria to be:

   (a) financial assets or financial liabilities must be measured at amortised cost under IFRS 9;

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

(c) future transactions must be highly probable;

(d) future transactions must result in financial assets or financial liabilities that are classified as subsequently measured at amortised cost under IFRS 9;

(e) items already designated in a hedge accounting relationship are not eligible under the DRM accounting model; and

(f) items must be managed on a portfolio basis for interest rate risk management purposes[5].

Importantly, 'core' demand deposits, paying a minimal or very low rate of interest and so treated as, in effect, fixed rate, are in the scope of the model.

The July 2022 Staff Paper also noted that some more clarification will be required as to what types of risk management activity would be eligible. Possible items that have not yet been discussed, include:

(a) own equity balances (such as, equity reserves and equity instruments with characteristics of debt - see below);

(b) financial assets classified as fair value through other comprehensive income (FVOCI); and

(c) financial assets that are classified as fair value through profit or loss (FVPL) as a result of not having contractual cash flows that are solely payments of principal and interest (SPPI), but nevertheless have contractual payments of interest.[6]

Another type of instrument that needs to be considered for inclusion is loan commitments.

The assets and liabilities within the scope of the model are represented by what is referred to as the **current net open risk position (CNOP).** This is the interest rate risk position (by time bucket), reflecting both expected (i.e., modelled) cash flows from assets, liabilities (including core demand deposits) and eligible future transactions over the period in which the entity manages its repricing risk. This excludes derivatives. 'Behavioural' models would be used to determine the deemed fixed rate risk of items such as core demand deposits and prepayable loans.

The notional amount of demand deposits treated as 'core' and their associated tenor must be based on reasonable and supportable information, which means they are derived from the bank's internal models and assumptions. However, there has been limited discussion so far on how the effects could be captured in the DRM model when there are changes in model assumptions for core demand deposits[7].

As already mentioned, one important issue that has not yet been debated is whether the deemed interest rate risk exposure in a bank's equity can be

[5] As summarised in Staff Paper AP4 July 2022 AP4: Project Plan (ifrs.org).
[6] Ibid.
[7] Ibid.

included in the DRM model. As equity is non-interest bearing, if a bank uses equity to finance a portfolio, say, of floating rate assets, the DRM model as described so far would not enable the bank to obtain hedge accounting for derivatives that 'lock in' its future interest rate margin. Although, currently, banks are often able to obtain hedge accounting by designating floating rate assets in a cash flow hedge, some banks have stressed that including the equity model book in the DRM model would achieve closer alignment with their risk management view. Therefore, it is argued, they would meet the objective of the DRM model, as well as being consistent with the regulatory framework[8].

The Staff has also received questions on whether an entity could have more than one DRM model for one particular interest rate, for example, when risk management in a single entity is segregated for different business units. Another issue is whether an entity always needs to have a separate DRM model for each currency. For example, a bank may obtain funding in a currency different to the one they use for their main operations and convert this via cross currency swaps, and then manage the interest rate risk together with other assets and liabilities denominated in its functional currency[9].

2. The entity must next establish a **target profile**, defined as the range (using risk limits) within which its CNOP can vary. That is, it is the amount of the risk the entity is willing to tolerate, which is clearly documented in its risk management strategy. As an example, the target profile for a particular time bucket might be that interest risk cannot exceed a certain level, plus or minus, set either in terms of notional value or the present value of a movement in interest rates.

   The target profile must be directly linked to the entity's documented risk management strategy (in a similar manner to the normal IFRS 9 hedge accounting model). Furthermore, the target profile should reflect the approach actually used by the entity to manage risk. For instance, if it assesses repricing risks and sets risk limits based on sensitivities to movements in rates, or nominal amounts across different time buckets, these should be reflected in the target risk profile. It is possible that the target risk profile may differ for different time buckets.

   The IASB Staff, in their October 2022 webcast, set out the following key elements of the risk management strategy that would need to be documented and kept constant throughout the life of the DRM model:

   - The process to approve and amend the strategy
   - Risk management levels and scope
   - Risk metrics used
   - Range of acceptable risk limits (i.e., the target profile)
   - Risk aggregations method and risk management time horizon

[8] Staff Paper AP4D April 2021.
[9] Staff Paper AP4 July 2022.

- Methodologies to estimate expected cash flows or core demand deposits

There is an expectation in the outlined DRM model that the target profile is sufficiently granular, consistent with what is expected under an effective interest rate risk management framework. Therefore, some preparers have raised the concern whether the model will continue to work if an entity only has one overall risk limit that is not allocated into time buckets, or its risk buckets are very broad. Another concern is that entities may have different risk limits at different levels within the organisation, and these risk limits are likely to have different levels of granularity. The Staff intend to do further research, with the objective of identifying a common principle to be used by all entities for the allocation of risk limits in the context of the target profile[10].

The Board has tentatively decided that any changes to an entity's risk management strategy that results in a change to the entity's target profile would result in the discontinuation of the hedge relationship.[11] One of the reasons that the risk management strategy must specify the time horizon is to establish the period over which any DRM adjustment (see step 8) would be amortised if the relationship were to be discontinued. Changes in an entity's risk management strategy and, therefore, its target profile (risk limits) are expected to be rare in practice. However, some preparers are concerned that entities may occasionally need to respond to the changes in their balance sheet structure and general market conditions. These preparers have suggested the IASB to consider whether it is possible to relax the requirements around changes of target profile or risk management strategy.[12]

3. In each period, the entity must establish a risk mitigation intention (RMI). This is the extent to which an entity intends to mitigate the CNOP so as to be within the target profile, through the use of derivatives. Even when the CNOP is already within the target profile, an entity may still choose to mitigate risks further.

   In practice, the risk mitigation intention needs to be evidenced by actual derivatives traded in the market. The actual externalisation of the risk mitigation intention is a useful indicator of the extent of risk the entity wants to mitigate. The RMI would be calculated in a manner consistent with the entity's actual risk management practices. The RMI may be adjusted, prospectively, over time.

   The RMI is constrained by the following:

   - It cannot exceed the CNOP determined for each time bucket; and
   - It transforms the CNOP so that the target risk profile is achieved (this requirement establishes the minimum amount that the entity must designate as its RMI to be consistent with its risk management strategy);

[10] Staff Paper AP4 July 2022.
[11] Staff Paper AP4A November 2021.[12] Staff Paper AP4 July 2022.
[12] Staff Paper AP4 July 2022.

- It is evidenced by real actions taken to mitigate risk (e.g., the designated derivatives traded in the market – see step 5).

Some outreach participants highlighted a situation where, for example, an entity uses one-year time buckets and has a CNOP in the 9-year bucket but there is a very limited market for a 9-year interest rate swap. As a result, the entity may choose to mitigate the 9-year risk using a 10-year swap, which is more commonly available in the market and so less expensive. Given that the DRM model, as currently described, requires the RMI to be satisfied for each time bucket, these outreach participants have asked whether the IASB could provide more flexibility in the DRM model to address this situation.

4. In order to be able to measure the effects of the DRM model, the risk mitigation intention is represented by benchmark derivatives (i.e., mathematical expedients to enable measurement of the risk mitigation intention). These are not reset for every period, but at the beginning of any period new benchmark derivatives are added to those brought forward from the previous period, so as to increase or reduce the risk mitigation, in line with the current RMI. In addition, as discussed under steps 6 and 7, the benchmark derivatives may need to be revised to satisfy certain retrospective assessment criteria. The benchmark derivatives may be based on the designated derivatives (i.e., the derivatives actually entered into to mitigate the risk - see step 5) in risk terms, but will not necessarily be the same, since the benchmark rate, tenor, maturity and volume must be consistent with the RMI which, in turn, is constrained by the CNOP and target profile (see step 6). As with hypothetical derivatives under IFRS 9, benchmark derivatives cannot simply impute the terms of the designated derivatives which are not reflective of the risk management intention.

   The hedge accounting requirements in IFRS 9 and IAS 39 allow entities to designate a risk component as the hedged risk as long as such risk component is separately identifiable and reliably measurable (SIRM) in the hedged item. However, when entities apply dynamic risk management strategies for interest rate risk, it is common to manage all positions for interest rate risk against changes in a particular benchmark interest rate, for example the bank's internal interest transfer pricing or funding rate. The Staff intends to conduct further research and analysis to consider if a test similar to the SIRM is needed.[13]

   Meanwhile, it has yet to be discussed whether special consideration is needed within the DRM model for underlying assets and liabilities that have a sub-benchmark interest rate, which would have been especially relevant in the low interest rate environment experienced over the last few years.[14]

   The Staff considers that further clarification also needs to be given on the principles for constructing benchmark derivatives, such as how to determine the notional, tenor, reset terms, benchmark rate etc.[15]

[13] Staff Paper AP4 July 2022.
[14] Ibid.
[15] Ibid.

How we see it

We understand that new benchmark derivatives will be expected to be at the market rates as at the beginning of the period with a zero fair value, as with hypothetical derivatives under IFRS 9.

5. The entity enters into **designated derivatives** with external counterparties in order to manage its risks, in accordance with its risk mitigation intention and its target profile.

   Such derivatives would include swaps, basis swaps and forward rate agreements, (and, hopefully, futures) but whether and how non-linear derivatives such as interest rate options can be included in the model has not yet been discussed. It is likely that the 'credit risk must not dominate' restriction will be applied to all the designated derivatives as for the assets and liabilities (see step 1).

How we see it

- The starting point to determine the designated derivatives will be those derivatives actually used to manage interest risk, but some derivatives will need to be excluded if they hedge exposures that are excluded from the DRM model (see step 1).
- For some banks, possibly the biggest challenge in aligning the DRM model with their actual risk management would be the requirement that all designated derivatives are entered into with third parties. Given that banking risk is often managed by entering into 'internal' derivatives with the trading desk, application of the DRM will be most straightforward if the trading desk enters into specific external derivatives to offset these internal trades. However, in contrast, the trading desk may choose to trade the position (within its own limits), such that there may be no direct relationship between the internal and external derivatives. Hence, the designated derivatives selected would need to be those that most closely reflect the risk management intention (see step 3). Although banks may be able to leverage existing methods used to demonstrate that derivatives have been externalised, any differences may lead to recorded hedge ineffectiveness (see step 8). Some preparers have raised this issue as a concern and have asked for further guidance.[16]
- The DRM model as currently envisaged would seem to allow new business and new derivatives to be added only at the beginning of each period, meaning that it may be necessary to run the model daily if that is how often the portfolio is updated.

6. The risk management intention is subject to a **prospective assessment** at the beginning of the period to ensure it meets the criteria set out at 3 above, which must be documented. The first two of these criteria are described as the DRM boundaries. If the risk management intention does not satisfy these criteria, the risk management intention and, hence, the benchmark derivatives must be adjusted accordingly.

[16] Staff Paper 4A July 2022.

7. Two **retrospective assessments** must be also performed at the end of the period under assessment, as to whether the DRM boundaries have actually been satisfied, specifically that:

   - The entity has mitigated interest rate risk (i.e., an entity may not over-hedge its CNOP); and
   - The target profile has been achieved.

   The retrospective assessments must be made based on the portfolio as at the beginning of the period (i.e., excluding new business), but by updating the expectations and assumptions used in projecting the expected cash flows. For example, the opening CNOP will be adjusted if prepayments during the period are greater or less than expected.

   In case that either of the retrospective assessments fail, the benchmark derivatives set at the beginning of the period must be adjusted retrospectively, so as to satisfy the DRM boundaries. For example, if more prepayments have occurred in a specific time bucket resulting in the net of the CNOP and the RMI being outside the risk limits, the benchmark derivatives need to be adjusted so as to bring the mitigated position (i.e., the net of the CNOP and the RMI) back within the risk limits. In their October webcast on the DRM model, the IASB Staff suggested that a way to adjust the initial benchmark derivatives could be by building additional hypothetical derivatives based on prevailing market rates as at the beginning of the period with a zero fair value to reflect the extent that unexpected cash flows cause the retrospective tests to fail.

   As the actual designated derivatives traded in the market cannot be adjusted retrospectively, the consequence of amending the benchmark derivatives may be that there will be ineffectiveness to record in profit or loss (see step 8). However, a key feature of the model is that there is no need to measure the effects of unexpected changes in the CNOP if such changes do not cause the retrospective assessments to fail.

   This approach using the RMI and a target profile based on risk limits is designed, in part, to help address prepayment risk. It resolves the issue of whether it would be permitted to designate a 'bottom layer' (a stable portion of such loans) for risk management purposes. This is because the RMI would enable an entity to decide the extent of the CNOP to mitigate by using derivatives within the target profile. Prepayment risk would, therefore, be captured by requiring the CNOP to be modelled on a behavioural basis, rather than by reflecting prepayment risk in the benchmark derivatives (see step 4). As a consequence, there will be no ineffectiveness to record as result of changes in prepayment behaviour, as long as this change does not cause the RMI to exceed the CNOP or the CNOP less RMI to fall outside the target profile (see steps 7 and 8 and Section 4). Hence, the IASB saw no need to accommodate the concept of a bottom layer.

   In its July 2022 paper, the Staff have documented some of the concerns raised by constituents, as a result of which the retrospective test may need to be modified. In particular, some stakeholders are of the view that

capturing the effect of an unexpected change in the CNOP may result in an entity recognising more (rather than less) gains or losses from designated derivatives as the DRM adjustment. Also, as currently formulated, the test is focused on the risk view and makes no reference to any comparison of the fair values of the benchmark and designated derivatives. In contrast, this forms an important part of the effectiveness tests under IAS 39 and IFRS 9.[17]

8. The **accounting mechanics** of the DRM model require:

   a) The designated derivatives to be measured at fair value in the statement of financial position;

   b) A DRM adjustment to be recognised in the statement of financial position, measured as the lower of (in absolute amounts):

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

      ii) The cumulative change in the fair value of the benchmark derivatives (i.e., reflecting the risk mitigation intention as well as the effects of any unexpected changes, attributable to repricing risk) from inception of the DRM model; and

   c) The difference between the net gain or loss from the designated derivatives calculated in accordance with (a) and the DRM adjustment calculated in accordance with (b) is recognised in profit or loss.

How we see it

A critical feature of the model is that the DRM adjustment is recorded in the statement of financial position, similar to a fair value hedge, even though the 'lower of' requirement is more similar to a cash flow hedge (see Section 5).

The DRM model does not require the extent of risk mitigated to be directly linked to individual underlying items, if an entity chooses to partially mitigate its current net open risk position. As a result, although not clear from the Staff Papers, we understand that an entity is not required to track the individual assets and liabilities which formed the CNOP from the inception of the DRM model. The cumulative change in fair value of the benchmark derivatives (i.e., reflecting the risk mitigation intention as well as the effects of any unexpected changes attributable to the repricing risk) from the inception of the DRM model used to measure the DRM adjustment would be calculated by accumulating the changes in the fair values of the benchmark derivatives, as calculated in each period from the inception of the DRM model.

The benchmark derivatives that need to be fair valued to determine the accounting entries are after any adjustments made as result of the prospective and retrospective assessments (see steps 6 and 7). If the designated derivatives are completely consistent with the retrospectively adjusted benchmark derivatives, there will be no hedge ineffectiveness to record in profit or loss. However, if the designated derivatives are

[17] Staff paper AP4 July 2022.

more sensitive to changes in fair value than the benchmark derivatives, ineffectiveness will need to be recorded (see Example A scenario 3). Note that, although the prospective and retrospective assessments must be made separately for each time bucket, the DRM adjustment is calculated by comparing the changes in fair values of the designated and benchmark derivatives across all the time buckets. Hence, for the purposes of measurement, there will be a degree of offset from over-hedges in some time buckets against under-hedges in others (see Example B).

The DRM adjustment, therefore, represents the extent to which the designated derivatives mitigate (i.e., reduce) the variability in both the fair value of, and the net interest income from the risk mitigation intention. The latter is achieved as the DRM adjustment unwinds over time through the 'pull to par', recognised in net interest income. However, there has as yet been no detailed discussion on how this unwinding would work, and what will be the presentation requirements for profit or loss in subsequent periods.

A significant area which the Staff believes needs further consideration is where prepayments or unexpected changes in the CNOP significantly change the fair value or future net interest income within the underlying assets and liabilities that were caused by previous market movements. While the risk managers would re-balance the net risk exposures prospectively, it is less straightforward how to reflect such unexpected changes in the DRM adjustment. The IASB tentatively decided in November 2021 that the effects of unexpected changes need to be included in assessing the performance of the DRM model and affect the measurement outcome but have so far not discussed how this might be achieved.[18]

Another issue is whether and how off-market designated derivatives can be used in the DRM model, and whether special requirements are needed for measurement purposes, as well as the subsequent unwinding of the DRM adjustment to net interest income. There is also the potential impact from early termination of designated derivatives or trade compression exercises. These activities would change the contractual terms of the designated derivatives as well as their total fair value, and thus may affect the calculation of the DRM adjustment and how it subsequently unwinds.[19]

4. Examples

A. Simple example, assuming with only one time bucket.

Step 1 At the start of a period, a bank's Current Net Open Risk Position (CNOP) is modelled to be +12. The figures in these examples could represent currency units or a sensitivity measure such as PV01, while the + or – signs indicate whether the fair value of the financial instruments involved goes down if the interest rate increases or falls.

Step 2 The bank has set a target profile for the time bucket of within +5 to -5.

[18] Staff Paper AP4 July 2022.
[19] Ibid.

Step 3 The bank chooses to mitigate this risk by entering into derivatives that have a risk of -9. The Risk Mitigation Intention (RMI) is therefore to reduce the risk by 9, so that the CNOP less the RMI is +3.

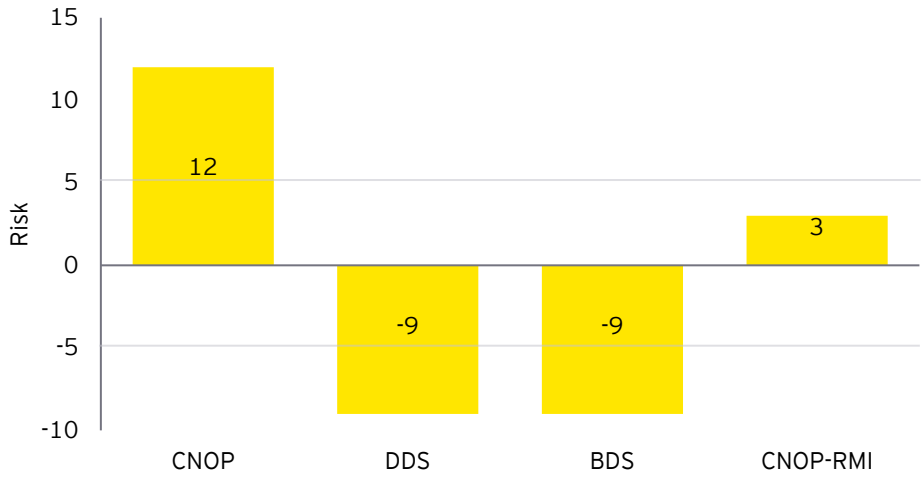
Step 4 The benchmark derivatives (BDs) would have a risk of -9 as well.

Step 5 The bank enters into designated derivatives (DDs) in accordance with the RMI with a risk of -9.

Step 6 This fact pattern satisfies the prospective assessment criteria:

- The RMI of -9 is less (in absolute terms) than the CNOP of +12
- The CNOP less the RMI (i.e., +3) is within the target profile of +5 to -5
- The bank has entered into DDs consistent with the RMI.

At the start



Step 7 At the period end the CNOP is re-estimated. We set out three scenarios:

- **Scenario 1**

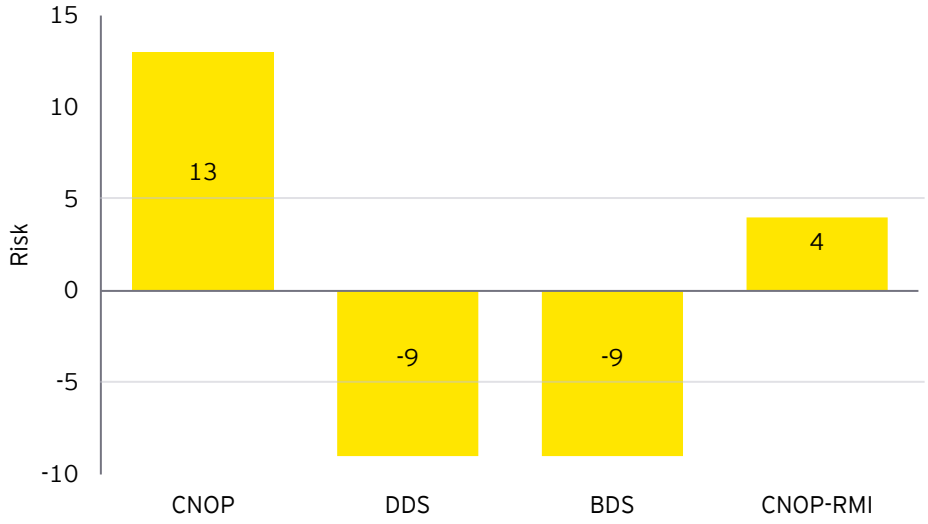
  The CNOP is re-estimated to be +13.The fact pattern satisfies the retrospective assessment criteria:

  - The RMI of -9 is still less than the revised CNOP of +13
  - The revised CNOP less RMI of +4 is still within the target profile of + 5 to -5.

  In **step 8**, the DRM adjustment will be the lower of:

  - The cumulative change in fair value of the DDs with a sensitivity of -9 and
  - The cumulative change in fair value of the BDs with a sensitivity of -9.

  Given the similar sensitivities of the DDs and the BDs, the consequence is that hedge ineffectiveness, if any, will be restricted to differences in the terms of the DDs and the BDs.



- **Scenario 2**

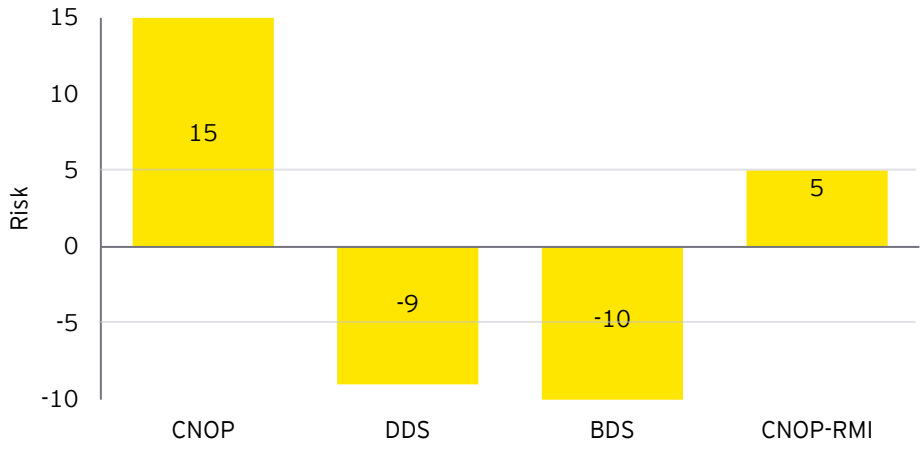
  The CNOP is re-estimated to be +15. Applying the retrospective assessment criteria:

  - The RMI of -9 is still less than the revised CNOP of +15, but
  - The revised CNOP less RMI of +6 is outside the target profile of +5 to -5
  - Therefore, the BDs will need to be adjusted to have a sensitivity of -10, to bring the CNOP less RMI to +5.

  In **step 8**, the DRM adjustment will be the lower of:

  - The cumulative change in fair value of the DDs with a sensitivity of -9 and
  - The cumulative change in fair value of the revised BDs with a sensitivity of -10.

  Since the change in fair value of the DDs is likely to be less than that of the BDs, the consequence is that there is unlikely to be any hedge ineffectiveness to record. However, as mentioned above under step 8, the Staff intends to explore further how unexpected changes in the CNOP need to be included in assessing the performance of the DRM model and how they may affect the measurement outcome.



- **Scenario 3**

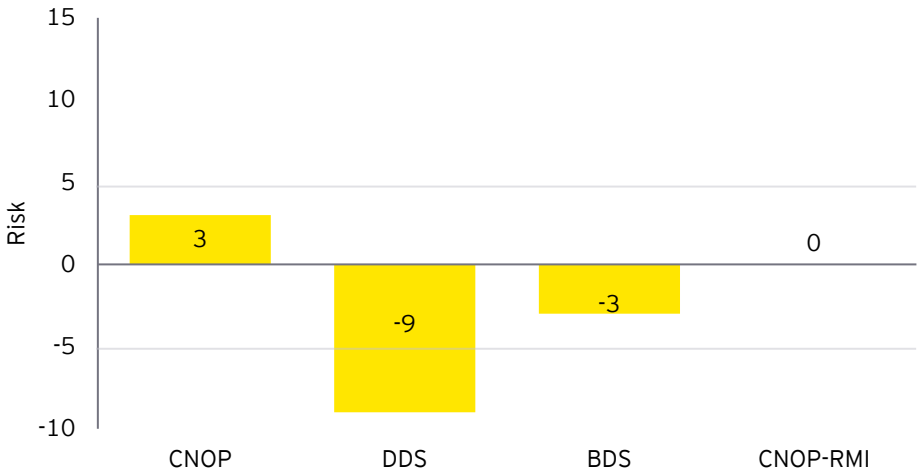
  The CNOP is re-estimated to be +3. Applying the retrospective assessment criteria:

  - The RMI of -9 is greater (in absolute terms) than the revised CNOP of +3 and
  - The CNOP less the RMI of -6 is outside the target profile of +5 to -5
  - Therefore, the BDs will need to be adjusted to have a sensitivity of -3, which would bring the CNOP less RMI to nil.

  In **step 8**, the DRM adjustment will be the lower of:

  - The cumulative change in fair value of the DDs with a sensitivity of -9 and
  - The cumulative change in fair value of the revised BDs with a sensitivity of -3

  As the DDs will show a greater change in fair value, there is likely to be significant hedge ineffectiveness to record.



B. More complicated example, with two time buckets

Initially the CNOP is estimated as +3 for bucket 1 and +8 for bucket 2. The target profile is within +5 to -5 for each time bucket. The risk managers enter into derivatives with external parties with a sensitivity of -9 for bucket 2, giving an RMI of -9 for bucket 2, but do not seek to mitigate the risk in bucket 1.

The prospective assessment criteria must be applied separately for each time bucket:

Bucket 1

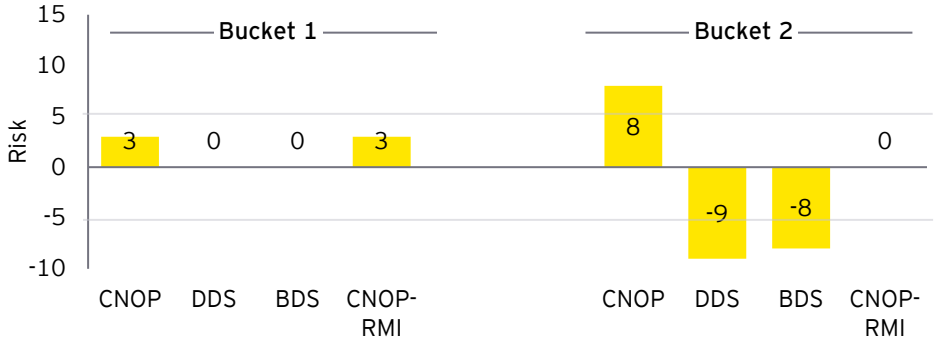
- The RMI of nil is less than the CNOP of +3
- The CNOP less the RMI of +3 is within the target profile of +5 to -5
- Hence, even though no derivatives have been entered into that affect this time bucket, as the risk is within the target profile, the criteria are satisfied

Bucket 2

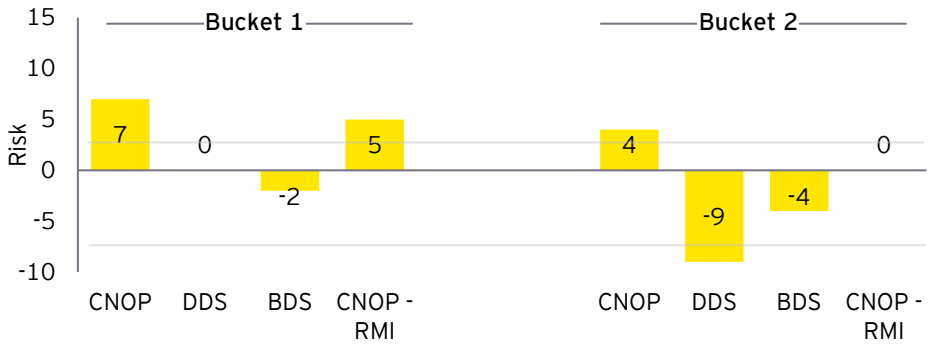
- The RMI of -9 is greater than the CNOP of +8
- The CNOP less RMI of -1 is within the target profile of +5 to -5
- Hence, the first criterion is not satisfied, and the BDs will need to be adjusted to have a sensitivity of -8, so as not to exceed the CNOP, which would bring the CNOP less the RMI to nil

At the period end, the CNOPs are re-estimated to be unchanged in aggregate, but amended by time bucket, so that the exposures for time buckets 1 and 2 are revised to be +7 and +4.

At the start



At period end



Applying the retrospective assessment criteria for each time bucket:

Bucket 1

- The RMI of nil is still less than the revised CNOP of +7, but
- The revised CNOP less RMI of +7 is outside the target profile of +5 to -5
- Because the second criterion is now not satisfied, new BDs will need to be added with a sensitivity of -2 in this time bucket, to bring the CNOP less RMI to 5

Bucket 2

- The RMI of -9 is higher than the revised CNOP of +4,
- The revised CNOP less RMI of -5 is at the limit of the target profile of +5 to -5

- Because the first criterion is not satisfied, the BDs will need to be adjusted to have a sensitivity of -4, which brings the CNOP less RMI to nil

The DRM adjustment will be the lower of:

- The cumulative change in fair value of the DDs with a sensitivity of -9 in bucket 2

  And

- The cumulative change in fair value of the revised BDs with a sensitivity of -2 in bucket 1 and -4 in bucket 2

Because the DDs are likely to show a greater change in fair value than the revised BDs, the consequence is that there is likely to be significant hedge ineffectiveness to record. Although the accounting effect of the over-hedge in bucket 2 is offset against the under-hedge in bucket 1, the BDs had to meet the assessment criteria separately for each time bucket.

5. Changes to the model compared to earlier proposals

Target profile

One of the biggest changes in the evolution of the DRM model has been to move away from the idea that the target profile should be a defined single outcome, to a range of possible outcomes, within risk limits. Compared to the current IFRS 9 hedge accounting concepts, the target profile now represents the risk management strategy (the range of acceptable risk limits within which the current risk exposure can vary) rather than the risk management objective. In any period, this is represented by the risk mitigation intention (the extent of risk the entity intends to mitigate using derivatives).

Adjustment to the statement of financial position rather than to OCI

By requiring the DRM adjustment to be reflected as an asset or liability, DRM activity would have no effect on equity (except through any ineffectiveness recorded in profit or loss). This avoids the concern that there might be a consequential impact on regulatory capital, given that it is unclear whether or not the regulatory filters currently in place for the cash flow hedge reserve would have been replicated for a DRM reserve. (Regulators may, of course, wish to consider the regulatory capital treatment of the DRM adjustment).

The Staff Paper describing this approach[20] accepts that recognition of the DRM adjustment as an asset or a liability would not necessarily be consistent with the definition of an asset or a liability in the Conceptual Framework. However, the Staff rejected the OCI approach because an adjustment to OCI would have "an impact on equity that is not a faithful representation of the economic phenomenon of dynamic risk management" and the balance sheet approach provides more useful information. The Paper goes on to stress that this argument does not apply to traditional cash flow hedges, where recognising gains and losses in OCI does faithfully represent the effect of the hedge on the entity's financial performance — "consistent with the sole purpose of a cash flow hedge to manage cash flow variability."

[20] Staff Paper AP4A, May 2022.

Although the DRM adjustment will be reflected in the statement of financial position, the DRM model is based on a 'lower of test', similar to cash flow hedges. The Staff Paper explains that, if the entire change in fair value of the benchmark derivatives were required to be reflected in the DRM adjustment, this would "faithfully represent only a part of the purpose for which entities do dynamic risk management – that is, to achieve offset (i.e., reduce variability) in the fair value of entity's underlying items. It fails to faithfully represent the dual purpose because it does not fully represent the reduced variability of net interest income." The 'lower of test' approach is considered to provide more useful information. The consequence is that ineffectiveness will only be reported in profit or loss to the extent that the change in fair value of the designated derivatives is greater than that of the retrospectively adjusted benchmark derivatives.

6. Disclosures

In its meeting in July 2019[21], the IASB tentatively agreed areas of focus for disclosures that should assist users to:

- Understand and evaluate an entity's risk management strategy. This would be a combination of qualitative and quantitative disclosures, including the target profile, explaining why the target profile is as defined and what that implies for the future earnings and cash flows.
- Evaluate management's ability to achieve that strategy.
- Understand the impact on current and future economic resources. This might include quantitative disclosures that compare the designated derivatives with the benchmark derivative throughout the period.
- Understand the impact on an entity's financial statements from the application of the model.

How we see it

- The IASB should be commended for having worked hard to arrive at a conceptually novel hedge accounting model which should go a long way to aligning hedge accounting with actual risk management.
- However, as with all such projects, it will be important for banks and auditors to review the wording of the ED once published to ensure that it is clear and that the requirements are workable. This is likely to require some field testing.
- It will also be necessary for entities other than banks that currently apply the IAS 39 portfolio fair value hedge accounting model to engage with this process.
- A key element of any project to implement the DRM model will, of course, also be the disclosures that banks are required to give.
- It is hoped that completion of the DRM model will enable banks to follow a globally consistent accounting approach, using a single DRM model, in contrast to the current situation where banks apply either IFRS 9, IAS 39 or the EU carved-out version of IAS 39 for hedge accounting.

[21] Staff paper AP4D July 2019.

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