IFRS™

STAFF PAPER

July 2022

IASB® meeting

Project	Dynamic Risk Management (DRM)
Paper topic	Project plan

CONTACT(S)	Zhiqi Ni	zni@ifrs.org
	Matthias Schueler	mschueler@ifrs.org
	Iliriana Feka	ifeka@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

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Introduction

1. At its May 2022 meeting, the IASB completed the deliberations on the three key challenges identified during 2020 outreach with preparers, and decided to move the DRM project to the standard-setting programme.

2. In this paper, we set out the areas and topics that need to be further considered in order to complete the development of the DRM model together with a proposed order of future discussions for the next stage of the project. These areas and topics include the remaining issues highlighted during the 2020 outreach (ie matters other than the three key challenges), as well as items the IASB previously decided to discuss in the next phase of the project and potential disclosures. These areas and topics are discussed further in more detail in paragraph 10–59.

3. This paper is structured as follows:

   (a) proposed project plan

   (b) areas and topics to be considered further;

   (c) order of future discussions; and

   (d) question for the IASB.

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Proposed project plan

4. The decision to move the DRM project to the standard-setting programme is a significant milestone, reflecting the positive progress made in developing an accounting model that would better reflect the effect of dynamic risk management in the financial statements. The preliminary feedback also suggests that a feasible framework has been identified to further develop the model.

5. However, moving to the standard-setting programme only means the IASB will deliberate issues with the aim of publishing an exposure draft in the future. We are fully aware of the complexity of the model and the implications it may have to existing practices and systems. As a result, we will continue the careful deliberations on the remaining areas and topics to develop the DRM model further, with the aim of publishing a complete model for public consultation once this has been completed. We think this would be the most efficient approach and would also allow continuous interaction with stakeholders throughout this process.

6. We acknowledge that many of these topics identified are only relevant in particular circumstances, or only apply to entities that apply particular risk management practices that are prevalent in some jurisdictions. Some of the topics listed in this paper are matters specific to the application of the model rather than the principles of the model. However, we think a transparent discussion on these areas and topics will help to clarify how the DRM model would work in particular situations, and thus improve the general understanding of the model.

7. Throughout the history of the project, it has always been a challenge to develop a model that will better reflect risk management and provide useful information to users of financial statements, while at the same time being practical and retaining robustness in accounting terms. It is worth noting that listing a particular topic to be considered does not necessarily mean the staff is of the view that such a matter will ultimately be incorporated into the DRM model so that it is aligned to all risk management practices. Instead, we will assess each matter carefully against the overall objective of the project, and there may be cases that it is not possible to *fully* reflect the risk management in order to maintain the robustness of the DRM model and ensure useful information is provided.

8. Given the long history of the project and the volume of feedback we have already gathered, the IASB decided that a dedicated consultative group is not needed at this stage. However, the staff will maintain the working relationship with stakeholders and seek informal feedback as we continue. We will also utilise the IASB's existing consultative groups, including drawing on the expertise from Accounting Standards Advisory Forum (ASAF) and Capital Markets Advisory Committee (CMAC) when needed.

9. In addition, as we mentioned before, we acknowledge that there may be entities in industries other than banking that might be applying similar risk management strategies for interest rate risk or other types of risks. However, in our view, it is important to firstly focus on developing a viable dynamic risk management model for interest rate risk before exploring whether it could apply to other types of risk.

Areas and topics to be considered further

10. In this section, we explore the areas we've identified so far that require clarification or further analysis to complete the DRM model. These are grouped based on the elements of the DRM model, and include:

    (a) eligible items and the determination of the current net open risk position;

    (b) target profile and its alignment with an entity's risk management strategy;

    (c) designated derivatives;

    (d) risk mitigation intention and the construction of benchmark derivatives;

    (e) performance assessment and subsequent unwinding of DRM adjustment;

    (f) other considerations; and

    (g) presentation and disclosure requirements.

11. We have also listed the detailed topics to be considered under each of the areas, explaining further the issues to be addressed, as well as set out the relevant IASB's tentative decisions, for reference. However, this is our preliminary assessment and additional topics may be identified during the course of the project.

Eligible items and the determination of the current net open risk position

Eligible items

12. 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) over the period the entity is managing such risk. In other words, this is the 'organic' interest rate risk position from the entity's underlying positions before considering any derivatives.

13. 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. As before, positions may be included based on expected rather than strictly contractual basis, considering the potential impact of prepayments and/or cash flow modelling of core demand deposits. The IASB tentatively decided to group the assets and liabilities together as this better reflects the fact that entities monitor and manage the net interest rate risk from underlying assets and liabilities holistically.

14. When developing the core DRM model, the IASB has tentatively decided what the qualifying criteria would be for financial assets and liabilities to be eligible for designation in the DRM model, which were:

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

    (b) the effect of credit risk does 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 purpose.

15. However, we are of the view that further analysis might be necessary to consider whether other items could be eligible for inclusion in the DRM model as part of the current net open risk position, including:

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

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

    (c) other 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 for interest.

16. When considering whether these items shall be eligible in the DRM model, there is an inherent tension between the objective to better reflect the risk management view in the financial statements and the constraints of a robust accounting framework. For example, in terms of own equity balances, we understand that some entities (in particular banks) treat own equity as a source of funding and manage the 'deemed' interest rate risk exposure that arises from their own equity. However, as equity is defined as the residual interest in an entity and any dividend payments are fully discretionary, there is no interest rate risk from an accounting perspective.

17. Feedback from stakeholders also indicate that many entities manage the interest rate risk from other assets (such as FVOCI instruments) holistically as part of the dynamic interest rate risk management process, together with those financial assets classified as amortised cost. Although these instruments are recognised at fair value in the statement of financial position, the interest recognised under the effective interest method from such instruments will still impact net interest income.

18. Furthermore, in analysing and considering own equity instruments that have characteristics of debt (for example interest-like coupon payments), we will also need to consider items that are measured at FVPL because they do not have SPPI cash flows.

Modelling of core demand deposits

19. As discussed at the April 2018 IASB meeting, entities can include core demand deposit as part of the target profile as a deemed fixed rate exposure for a specified period, as the

interest expense on these core demand deposits can be insensitive to changes in market interest rates during that period. They are different to the treatment of the rest of the demand deposit balances for risk management purposes, as those balances are usually considered for DRM purposes as overnight deposits (ie floating rate financial liabilities).

20. The IASB tentatively decided that the notional amount of demand deposits treated as 'core' and the associated tenor must be based on reasonable and supportable information, which means they are usually derived from entities' internal models and assumptions. Although there was a preliminary view that the effects of when an entity inappropriately treats deposits as core demand deposits should be captured in performance assessment, there has been limited discussion and guidance on how the effects could be captured in the DRM model when there are changes in model assumptions for core demand deposits.

Notional alignment and future transactions

21. The IASB tentatively decided in March 2018 that the notional of the asset profile and the target profile in the core DRM model should be aligned, although the tenors do not require alignment.[1] Accordingly, it would be natural to require the current net open risk position to contain assets and liabilities that have aligned notional amounts too. Such expectation is also consistent with the purpose of dynamic interest rate risk management, because entities typically look at funding liabilities together with the interest generating assets, as the combination of the two is the source of any repricing risk.

22. However, some feedback suggested that such notional amounts may not always be aligned in practice for several reasons. For example, when a bank issues a 5-year fixed rate loan, it may have secured the corresponding funding in full for the first 3 years, but only part of funding for the remaining 2 years. The expectation is to fund the remaining part of funding in the last 2 years either via its own profit (ie own equity), or via borrowing from the wholesale market at a later date. Other preparers said that the eligibility criteria summarised in paragraph 14 of this paper may also cause situations

[1] The target profile here refers to the target profile as described in the core DRM model, ie prior to the refinements to the target profile discussed at the IASB's November 2021 meeting.

where it's not possible to align the notional of assets and liabilities. For example, entities may choose to manage the large funding liabilities in individual fair value hedging relationships but include the interest earning assets in the DRM model.

23. As a result, it may be necessary to do further research and analysis of whether the requirement for notional alignment remains appropriate, or whether it may cause potential deviation from the risk management strategy (and if so, what the implications might be). We note that the decision on this topic might also have implications on the eligibility for designation of future transactions[2].

Defining the hedged risk

24. 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, ie it requires disaggregation of pricing components of the contractual interest rate.

25. 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 (ITP) or funding rate. As such, we will do further research and analysis to consider if a test similar to the SIRM is needed.

26. In addition, some preparers raised the question of whether special consideration is need within the DRM model for underlying assets and liabilities that have sub-benchmark interest rate, given the current low interest rate environment. Essentially, the question is how to treat an embedded floor or cap in the contractual interest rates of the underlying assets and liabilities.

Unexpected changes

27. The last topic relates to the impact of potential prepayment/early termination of positions or changes to the expected cash flows in the current net open risk position. Consistent with the dual objective (of mitigating both changes in fair value and net interest income), in the DRM model, the fair value changes of the designated

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[2] Using the example in paragraph 22, the decision on notional alignment may also have implication on whether the entity needs to demonstrate the remaining part of funding for the last 2 years is highly probable.

derivatives are recognised in the statement of financial position, and only unwind into net interest income, when these designated derivatives provide mitigation to the variability of the entity's underlying assets and liabilities.

28. However, prepayment or unexpected changes may 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 reflecting the risk impact from unexpected changes, it is less straightforward for accounting purposes to reflect the economic effects of such unexpected changes in the financial statements, in particular how such unexpected changes affect the DRM adjustment.[3]

29. 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. In our view, the extent of unexpected changes[4] to be reflected in the DRM model requires further consideration especially as it is also closely linked to the performance assessment discussed in paragraphs 46–50 of this paper.

Target profile and its alignment with an entity's risk management strategy

Criteria for determining the target profile

30. The definition of the *target profile* was refined by the IASB in its November 2021 meeting in order to incorporate the concept of risk limits. The target profile is now defined as the range (risk limits) within which the current net open risk position can vary while still being consistent with the entity's risk management strategy. In other words, it is the amount of the risk the entity is willing to tolerate, which is clearly documented in its risk management strategy.

31. There is an expectation in the DRM model that the target profile is sufficiently granular, consistent with what is expected under a good interest rate risk management framework. For example, an entity may assess repricing risks across different time buckets, which

[3] While the risk managers only have to be concerned by ineffectiveness from the point of readjusting the risk position accountants need to reflect measurement impact in addition to risk position impact.

[4] In this context, the extent of unexpected changes refers to the number of 'look-back periods' when assessing the effects from unexpected changes.

are determined upfront, consistent with the entity's risk management strategy and the characteristics of the underlying risk positions (ie consistent with how the entity aggregates and manages risk). However, some preparers raised the question of whether the model will continue to work if an entity only has one overall risk limit that does not break down to each time bucket, or the risk buckets were set very broadly. This may have implication on how the prospective and retrospective assessments are applied, and thus in turn affect the robustness of the model.

32. In addition, some other preparers also mentioned that entities may have different risk limits at different levels within the organisation, and these risk limits are likely to have different level of granularity. The staff will therefore do further research in this area 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.

Changes in target profile and risk management strategy

33. Changes in an entity's risk management strategy and therefore its target profile (risk limits) are expected to be rare in practice. Prior to the refinements to the definition of the target profile and the introduction of the risk mitigation intention, the IASB tentatively decided that when an entity changes its risk management strategy (or the target profile), the DRM model will be discontinued prospectively and the accumulated adjustment in OCI should be reclassified to profit or loss over the life of the target profile as defined prior to the change in risk management strategy.

34. However, some preparers are of the view that entities may occasionally need to respond to the changes in its balance sheet structure and general market conditions. Although these are not expected to be as frequent as the change of risk mitigation intention, repeated changes are still possible in some situations, and they suggest the IASB to consider whether it is possible to relax the requirements around changes of target profile or risk management strategy. They also mentioned that in most cases, the update to the target profile (risk limit) is expected to be incremental, and would not have a significant impact on the current the risk management activities. As such, it may not seem cost-effective to treat such changes as a discontinuation of the DRM model.

Designated derivatives

Non-linear derivatives

35. Although most of the preparers who participated in the outreach indicated that they predominately use linear interest rate derivatives (such as vanilla interest rate swaps) to mitigate the interest rate risk in their portfolio, some entities may choose to use non-linear derivatives (such as interest rate options etc.) when they have significant uncertainty about the expected cash flow from its underlying positions.

36. It is necessary to consider the challenges caused by the use of non-linear derivatives and assess how widely such derivative instruments are used in practice, before deciding whether further refinements are justified to incorporate the non-linear derivatives in the DRM model.

Impact from off-market derivatives

37. Under particular circumstance, entities may need to designate derivatives that have off-market contractual interest rates (and thus non-zero fair value at designation date). For example, instead of entering into a new derivative with on-market rates, entities may choose to re-purpose an existing derivative that was previously entered into. Such derivative is likely to have a different accrual profile than a derivative with on-market rate at the designation date, which may cause further complication to the DRM model.

38. Some preparers asked whether such derivatives can be used in the DRM model, and whether special requirements are needed for measurement purposes as well as subsequent unwinding of the DRM adjustment to the net interest income.

39. Similarly, some other preparers asked about the potential impact from early termination of designated derivatives or trade compression exercises. These activities are usually requested by the counterparty or organised by the central clearing house, and from risk management perspective the resulting changes in risk may be replaced by a new derivative (with a prevailing interest rate). However, these activities would change the contractual terms of the designated derivatives as well as their total fair value, and thus may have impacts to the calculation of DRM adjustment and its subsequent unwinding into net interest income.

Risk mitigation intention and the construction of benchmark derivatives

Evidence the risk mitigation intention

40. The *risk mitigation intention* represents the extent of risk an entity intends to mitigate using derivatives. In practice, the risk mitigation intention needs to be evidenced by the designated derivatives relating to a specific interest rate risk point[5], as the actual externalisation of the risk mitigation intention is a useful indicator of the *extent of risk* the entity wants to mitigate.

41. The prospective assessment restricts the extent of risk an entity can mitigate in each time bucket. In each time bucket, the maximum amount of risk an entity can mitigate is capped by the current net open risk position stemming from organic risk in that bucket, while the minimum amount is determined by the entity's target profile.

42. However, some outreach participants are concerned about the impact of these requirements in practice, especially when entities choose to mitigate interest rate risk in some adjacent time buckets instead of the time bucket where the current net open risk sits. Such practice is usually driven by the availability of market liquidity over a specific period. For example, an entity may have a current net open risk position in the 9-year bucket while there may be a very limited market for a 9-year interest rate swap (or such bespoke swap is much more expensive). 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. These outreach participants asked whether the IASB could provide more flexibility in the DRM model to address such situation.

43. In addition, the use of internal derivatives may also cause some operational difficulty in evidencing the amount of risk an entity intends to mitigate. The IASB tentatively decided in June 2018 that only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated within the DRM accounting model. This is also consistent with the general hedge accounting requirements in IFRS 9 and IAS 39.

44. However, when risk managers mitigate interest rate risk via a centralised trading desk instead of directly with an external counterparty, the trading desk may decide to retain

[5] This means the risk in the designated derivatives against changes in the chosen benchmark interest rate for each time bucket the entity is managing.

some risks either to offset other customer flows or for their own proprietary trading purposes. As such, the actual derivatives traded with external counterparty may be different to the original intention of the risk managers. As a result, some preparers were seeking further guidance from the IASB on the requirement of 'the risk mitigation intention needs to be evidenced by real actions taken to mitigate risk (eg the actual derivatives traded in the market)'.

Requirement for constructing benchmark derivatives

45. The requirements for the construction of benchmark derivatives were also revised by the IASB so that the benchmark derivatives represent the risk mitigation intention (ie they are mathematical expedients to enable measurement of the risk mitigation intention). The benchmark derivatives cannot simply impute the terms of the designated derivatives which are not reflective of the risk mitigation intention. Instead, they would be constructed based on specific defined principles. We think that further clarification on these principles for constructing benchmark derivatives, such as how to determine the notional, tenor, reset terms, benchmark rate etc., will help to ensure consistent application of the DRM model.

Performance assessment and subsequent unwinding of DRM adjustment

Retrospective assessment and effect of unexpected changes

46. The refinements tentatively agreed by the IASB in November 2021 introduced the prospective and retrospective assessments to ensure the robustness of the DRM model. The retrospective assessments are performed at the end of each DRM period under assessment, in order to determine whether:

    (a) the entity has mitigated interest rate risk; and

    (b) the target profile has been achieved.

47. However, there were questions on whether the second retrospective assessment (ie the assessment of whether the entity achieved the target profile) is appropriate, in the context of new mechanics of the DRM model as tentatively decided by the IASB in May 2022. While acknowledging the importance of such assessment prospectively to avoid designating activities that are not in line with an entity's risk management strategy, some stakeholders are of the view that the capturing the effect of failing the

second retrospective assessment may be counter-intuitive. For example, when an entity fails to achieve the target profile retrospectively due to an unexpected increase in the current net open risk position, capturing the effect of such unexpected change may result in an entity recognising more (rather than less) gains or losses from designated derivatives as the DRM adjustment in the statement of financial positions.

48. In addition, the performance assessments under the DRM model are focused on the risk view[6], which are different to the effectiveness requirements in IFRS 9 and IAS 39 that focus on the changes in fair values of the hedged items attributed to the hedged risk. Therefore, stakeholders are asking for guidance from the IASB on how the retrospective assessments would be applied in practice, in addition to the illustrative example in Agenda Paper 4B for the September 2021 meeting. For example, some stakeholders are interested in whether the risks used in the assessments should reflect the impact from time decay (also known as 'theta' in risk management).

49. Some stakeholders are asking how to balance the faithful representation of the impact from unexpected changes in the risk exposure during the period, with the cost and operational effort required to apply the retrospective assessment. In particular, some suggest that extending the retrospective assessments to more periods would more faithfully reflect the unexpected changes in the current net open risk position. Since the risk mitigation intention may be changed frequently at the discretion of the entity, there may be cases that some changes in the current net open risk position may have no direct impact on the most recent period, but do affect previous periods[7]. In their view, the measurement effects under such situations need to be captured too.

50. One of the challenge in determining the effects of unexpected changes lies in that 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, when unexpected changes happen on some individual underlying items, it might be difficult to determine whether risks from those items were

[6] An entity would compare the total interest rate risk in the current net open risk position with that of the risk mitigation intention for prospective assessment and compare it with the total interest rate risk in the designated derivatives for retrospective assessment. Both assessments do not involve calculation of changes in fair values.

[7] For example, an entity decided to mitigate 90 out of the 100 risks in the first period, and there had been no unexpected changes during the first period. The entity then prospectively changed the risk mitigation intention to 80 for the second period. The question arises whether and how should the entity capture the impact if there was an unexpected change during the second period that amended the current net open risk position to 85.

mitigated or not, and hence difficult to quantify the direct effect of unexpected changes in the DRM model, and the resulting impacts on performance assessments and measurement.

Clarification on subsequent unwinding of DRM adjustment

51. When the IASB considered the mechanics of the DRM model and tentatively decided to retain the 'lower of test' for the purpose of recognising the DRM adjustment in the statement of financial position, the discussion was more focused on the mechanics in the period when changes in fair value arise. Although there was mentioning of the subsequent unwinding of the DRM adjustment that would help to reduce the variability in net interest income, there was no detailed discussion on how the mechanics would work in that perspective, and what is the presentation requirement for profit or loss in subsequent periods.

52. There had been some relevant discussion in Agenda Paper 4C of the April 2019 IASB meeting, and we think most of the principles discussed there are still applicable under the new DRM model mechanics. However, in our view a more structured revisit of the topic and further clarification on some detailed requirements may provide better guidance to stakeholders.

Other considerations

Applicability of the DRM model

53. In addition to the eligibility criteria for the underlying items as discussed in paragraphs 12–18, we think the circumstances when the DRM model is applied should be clarified further, ie the activities/types of risk management strategies the DRM model could be applied to. Previous discussions indicate that the DRM model is developed to account for effects of *dynamic interest rate risk management* which usually has the following characteristics:

    (a) interest rate risk management is undertaken for open portfolio(s), to which new exposures are frequently added and existing exposures mature; and

    (b) as the interest rate risk profile of the open portfolio(s) changes, risk management is updated on a timely basis in reaction to the changed net risk position.

54. In addition, there are also questions on whether an entity could have more than one DRM model for one particular interest rate risk exposure. This may be required, for example, when risk management in a single entity is segregated for different business units, and different (dynamic) portfolios were managed separately using different risk management strategies.

55. The question on the applicability of the DRM model also covers whether an entity needs to have separate DRM model for each currency. When the core DRM model was developed, the IASB's tentative decision allows an entity to include a portfolio of assets with similar risk characteristics where that same risk is managed on a collective basis. For example, a financial asset denominated in USD will be managed separately with a financial liability denominated in EUR in two separate DRM models, as they would have interest rate exposure to different interest rate benchmarks.

56. However, it is common for banks to obtain funding in other currencies different to the currency used for their main operation via cross currency swaps, and then manage the interest rate risk in its functional currency holistically with other assets and liabilities denominated in its functional currency. Questions were raised on whether and how the DRM model may be applied for entities using these funding strategies, where the cross currency swaps change the underlying interest rate risk exposure from one currency to another currency.

Transition requirements

57. Some preparers that are currently applying the portfolio fair value hedging requirements are also concerned about the potential transition requirements, as they currently hold large amount of hedge accounting adjustments in their financial statements. They were concerned about the potential effect if the requirements were to be applied retrospectively.

58. As with any other standard-setting project, the IASB will need to consider the transition requirements of the DRM model.

Presentation and disclosure requirements

59. Once the areas and topics listed above are considered, we will explore potential presentation and disclosure requirements relating to the DRM model. The disclosures

will be based on the elements of the DRM model, and we plan to conduct some targeted outreach with users of financial statements to assess what additional information will be useful to their decision-making.

Order of future discussions

60. The following table illustrates the order in which the staff expect to bring the analyses of topics and issues to the IASB for its deliberations and tentative decisions. There are more topics in the first two areas, and in our view they are also more significant to the overall result of the DRM model. Therefore, we plan to spend more time on them than the remaining areas and topics.

61. We plan to start the preliminary discussions on the first topic in Q4 2022, the project timing on other topics is currently uncertain because we might need to conduct further outreach or research before proceeding the deliberations. Furthermore, due to the interactions amongst these topics, we envisage there may be a need to assess the linkage of the decisions between different areas as the project progresses.

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

Question for the IASB

62. We would like to ask the IASB the follow question:

Question for the IASB
Do IASB members have any comments or questions on the project plan set out in this paper?