

## STAFF PAPER

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<b>Project</b>	Dynamic Risk Management (DRM)	
<b>Paper topic</b>	Mechanics of the DRM model	
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (IASB). This paper does not represent the views of the IASB or any individual IASB member. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS® Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB® Update.

## Introduction

1. At its February 2022 meeting, the IASB discussed [feedback and staff analysis on the mechanics of the DRM model](#), in other words how to account for the DRM model in the financial statements (ie which amounts are recognised in the financial statements and where). In response to the feedback and concerns raised by stakeholders, the staff also presented [two alternative approaches](#) to obtain the IASB's initial views to direct our further analysis.
2. In this paper, the staff presents further analysis on the alternative approaches to the mechanics, considering the feedback from the February 2022 IASB meeting. Our analysis specifically considers which approach, in our view, would provide the most useful information about the DRM model for users of financial statements.
3. This paper is structured as follows:
  - (a) [summary of staff recommendation and question for the IASB](#);
  - (b) [economic phenomenon of dynamic risk management](#);
  - (c) [objective of the DRM model and the fundamental qualitative characteristics of useful information](#);

- (d) [analysis of the current approach for the mechanics of the DRM model](#);
  - (e) [analysis of alternative approaches for the mechanics of the DRM model](#); and
  - (f) [the recognition of the DRM adjustment in the statement of financial position](#).
4. The paper also includes three appendices:
- (a) [Appendix A—Illustrative Example: Economic phenomenon of dynamic risk management](#);
  - (b) [Appendix B—Illustrative Example: Reflection of the economic phenomenon in the financial statements](#); and
  - (c) [Appendix C—A reminder of the elements and robustness of the DRM Model](#).

### Summary of staff recommendation and question for the IASB

5. For the reasons described in paragraphs 45–55, the staff recommend that the IASB change the mechanics of the DRM model to require:
- (a) the designated derivatives to be measured at fair value in the statement of financial position.
  - (b) the DRM adjustment to be recognised in the statement of financial position, 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 risk mitigation intention attributable to repricing risk from inception of the DRM model. This would be calculated using the benchmark derivatives as a proxy.
  - (c) the net gain or loss from the designated derivatives calculated in accordance with (a) and the DRM adjustment calculated in accordance with (b) would be recognised in the statement of profit or loss.

#### Question for the IASB

Does the IASB agree with the staff recommendation in paragraph 5 of this paper?

## Economic phenomenon of dynamic risk management

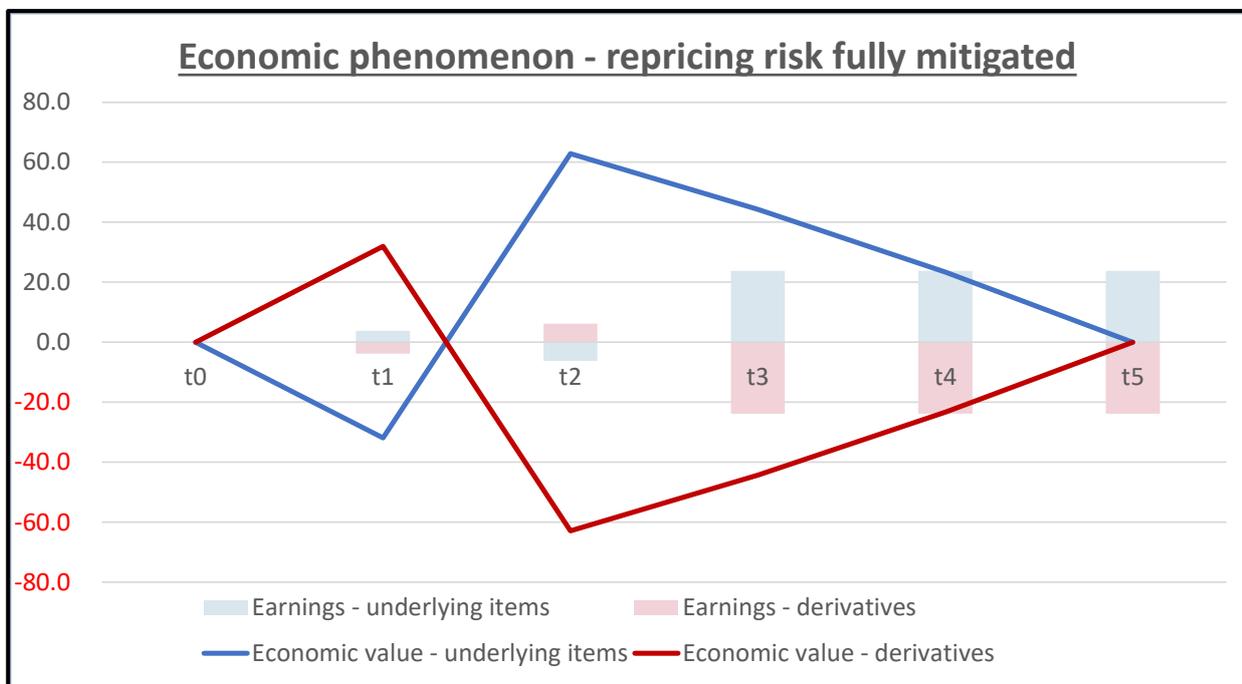
6. As discussed in [Agenda Paper 4A](#) of the February 2022 meeting and several previous IASB meetings, for those entities applying dynamic risk management of repricing risk due to changes in interest rates (hereafter referred as ‘dynamic risk management’), the risk management activities typically look at the funding liabilities together with the interest generating assets, as the combination of the two is the source of any repricing risk.
7. During this process, an entity typically adopts a holistic approach that is based on the notion of an aggregated (ie combined or net) repricing risk position rather than focussing on individual risk positions generated by assets and liabilities.
8. The refinements to the DRM model such as the definition of the current net open risk position and the risk mitigation intention are based on this aggregated risk (amount) view (also see Appendix C for a summary of the IASB’s tentative decisions on these elements).
9. Entities typically use derivatives to manage this entity-wide risk position in line with the entities’ risk management strategy. To the extent that derivatives are successful in mitigating repricing risk, an entity achieves a ‘protection/benefit’ in the form of **reduced variability**<sup>1</sup> from both earnings and economic value perspectives:
  - (a) earnings perspective—by ‘stabilising’ the net interest income (ie reducing variability in the difference between interest income and expense when the benchmark interest rate changes), an entity has essentially reduced exposure to variability in its earnings for a chosen period of time;<sup>2</sup>
  - (b) economic value perspective—by ‘protecting’ the fair value of its assets, liabilities and future transactions, an entity has essentially reduced exposure to changes in economic value of its assets, liabilities, and future transactions when the benchmark interest rate changes.

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<sup>1</sup> The reduced variability in earnings and economic values refers to the economic outcome as a result of the risk management activities, and shall not be confused with smoothening accounting outcomes of perceived artificial accounting volatility.

<sup>2</sup> This is under the assumption that the effective interest rate for accounting purposes aligns largely to the contractual interest rate for the (benchmark) interest rate component hedged.

10. To illustrate this economic phenomenon, we use the example in the Appendix A to this paper where the repricing risk is fully mitigated.<sup>3</sup> In that situation, when the benchmark interest rate changes, the entity is no longer exposed to changes in earnings during the period as the future cash flows on the two swap legs are fully aligned with the expected cash flows of the fixed-rate asset and the floating rate liability. Similarly, the entity is also not exposed to changes in economic value, as the changes in the swap valuation will offset the changes in the valuation of the underlying risk position caused by the changes in the benchmark interest rate. This **economic relationship**, ie the value of the underlying items and designated derivatives systematically change in response to movements in the benchmark interest rate and generally move in the opposite direction, is also illustrated in the below diagram.



### Objective of the DRM model and the fundamental qualitative characteristics of useful information

11. The objective of the DRM model is to better reflect an entity’s dynamic risk management strategies and activities (ie the economic phenomenon discussed in paragraphs 6–10) in the financial statements. In other words, the application of the

<sup>3</sup> The staff acknowledges that entities may choose to retain some risks (ie not fully mitigate the repricing risk), but we think the example of fully mitigating repricing risk is helpful to illustrate the economic effects of the DRM activities.

DRM model should 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.

12. This objective is consistent with the objective of general purpose financial reporting as stated in paragraph 1.2 of the IASB's *Conceptual Framework for Financial Reporting (Conceptual Framework)*, which is to provide financial information about the reporting entity that is useful to existing and potential investors and creditors (primary users).
13. The staff consider that it is important to retain the classification and measurement of the designated derivatives as at fair value through profit or loss. Given that derivatives themselves expose an entity to risk and are sensitive to changes in market factors or other risks, information about changes in their fair value is important to users of financial statements,<sup>4</sup> even if these derivatives are used for risk management purposes. Similarly, retaining the original classification and measurement of the underlying items provides useful information to the users of financial statements about the nature and extent of risks the entity is exposed to and is arising from the items, and thus would provide predictive value, confirmatory value or both.
14. The staff therefore think that useful information about how an entity's dynamic risk management affected the nature, timing and uncertainty of future cash flows, as well as the effect it had on the entity's financial statements, is best provided through the DRM mechanics. However, we acknowledge that it might be challenging to provide all the useful information in the primary financial statements given the complexity of dynamic risk management. Consequently, in our view, the DRM mechanics must provide the most *direct* information in the primary financial statements, while supplemented by a robust disclosure framework which would be based on available information from the

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<sup>4</sup> See paragraph 6.51 of the Conceptual Framework.

elements of the DRM model. The details of possible disclosure requirements will be discussed and determined by the IASB at a later stage in the project.

15. The *Conceptual Framework* also states that if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent—neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps financial statement users make good decisions.<sup>5</sup> In our view, any mechanics adopted for the DRM model should provide:
- (a) *faithful representation of the economic phenomenon* described in paragraph 6–10—that is, faithfully represent the economic effects of dynamic risk management; and
  - (b) *relevant information about the effectiveness of dynamic risk management*—that is, enable users of financial statements to understand an entity’s risk management strategy and how that affects the nature, timing and uncertainty of future cash flows.

### ***Faithful representation of the economic phenomenon***

16. The *Conceptual Framework* states that, in order to achieve a faithful representation of an economic phenomenon, the mechanics used for the DRM model must provide a depiction of the substance of the economic phenomenon that is complete, neutral and free from error.<sup>6</sup> In our view, a faithful representation of an entity’s dynamic risk management needs to depict the dual aspect of the ‘protection/benefit’ from both earnings and economic value perspectives, discussed in paragraph 9 of this paper.
17. Achieving reduced variability in both fair value and net interest income is not an effect of considering the underlying items or designated derivatives on their own. Rather, it is based on the combined economic effect of (ie economic relationship between) the underlying items and designated derivatives that are monitored and managed together through a documented risk management strategy. For example, in the extreme case where the designated derivatives are fully mitigating the repricing risk in the underlying

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<sup>5</sup> Paragraph 2.4 and 2.20 of the *Conceptual Framework*.

<sup>6</sup> See paragraph 2.12 and 2.13 of the *Conceptual Framework*.

items, the entity would not recognise any additional gains or losses due to changes in the benchmark interest rate (as discussed in paragraph 10).

18. Although the reduced variability in fair value and net interest income is the result of the combined economic effect of both the underlying items and designated derivatives, we do not think a faithful representation of that reduced variability could be achieved by treating the underlying items and designated derivatives as a single unit of account. This is because, the underlying items and the designated derivatives are all separate transactions with different contractual terms and economic characteristics.

### ***Provision of relevant information to users of financial statements***

19. Relevant financial information is capable of making a difference in the decisions made by users of financial statements—that is, if such information has predictive value (ie can be used by users of financial statements as an input to predict future outcomes), confirmatory value (ie provides feedback about previous evaluations), or both.<sup>7</sup>
20. The staff understand that the most relevant information about dynamic risk management is about the effects of reduced variability driven by the entity’s risk management strategy and risk mitigation activities, covering the dual aspect of the DRM activities.
21. From a fair value perspective, the most relevant information is about the extent to which the designated derivatives were successful in achieving the entity’s target profile and mitigate the fair value changes in the risk mitigation intention. From a net interest income perspective, the most relevant information is the extent to which designated derivatives (both in terms of timing and amount) are successful in reducing the variability in net interest income (ie the contribution made by the designated derivatives to net interest income) over time.

### **Analysis of the current approach for the mechanics of the DRM model**

22. In this section we analyse the current approach for the mechanics of the DRM model to assess whether it meets the objective and the fundamental qualitative characteristics of useful information set out in paragraph 15.

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<sup>7</sup> See paragraphs 2.6–2.9 of the Conceptual Framework.

**Current DRM (core) model**

A separate component of equity associated with the DRM model is adjusted using the ‘lower-of’ test—that is, the lower of the following (in absolute amounts):

- (a) the cumulative gain or loss on the designated derivatives from the inception of the DRM model; and
- (b) the cumulative change in the fair value of the risk mitigation intention attributable to the repricing risk from inception of the DRM model. This would be calculated using the benchmark derivatives as a proxy.

The ‘lower-of’ test is therefore used to determine the aligned portion which is recognised in other comprehensive income (OCI).

Any remaining gain or loss on the designated derivatives would be the misaligned portion and be recognised in profit or loss.

The amounts recognised in OCI would be reclassified to profit or loss over time.<sup>8</sup>

*Description of the DRM adjustment*

23. The aligned portion—which is the DRM adjustment in this approach—represents the extent to which designated derivatives are successful in mitigating repricing risk and achieving the target profile (ie changes in fair value of the risk mitigation intention have been offset by changes in the fair value of the designated derivatives).

*Do these mechanics provide a faithful representation?*

24. Applying the current approach, the aligned portion will be recognised in OCI. Although outside the statement of profit or loss, these fair value gains or losses would still represent income or expenses and thus affect the entity’s financial performance for that period. This is one of the main concerns raised by preparers in the 2020 outreach, because such income or expenses recognised in OCI would give rise to significant volatility in equity. See paragraph B1 of Appendix B for illustration of this analysis through an example.

<sup>8</sup> The pull-to-par effect on the derivative combined with the reclassification of interest accruals to the statement of profit or loss ensure no balance is deferred beyond the contractual maturity of the derivative.

25. However, items recognised in OCI, which is part of the statement of profit or loss and other comprehensive income, provide information only about entity's financial performance, not about its financial position. Therefore, mechanics that focus on recognising the aligned portion in OCI would provide a faithful representation of the reduced variability in net interest income but fail to depict the effect of reduced variability in fair value. At the same time, it has an impact on equity that is not a faithful representation of the economic phenomenon of dynamic risk management.
26. This is a shortcoming of this approach, particularly for entities with risk management strategies that focus more on reducing the variability in the fair value (ie current economic value) of the underlying items.
27. Accordingly, this approach would not provide a faithful representation of the economic phenomenon of dynamic risk management on an entity's financial statements.
28. As noted in agenda paper 4A of the February 2022 meeting, the staff analysis in paragraphs 25–27 does not apply to accounting for a cash flow hedging relationship where the gains or losses recognised in OCI do faithfully represent the effect of the hedge on entity's financial performance—consistent with the sole purpose of a cash flow hedge to manage cash flow variability.

*Do these mechanics provide relevant information?*

29. During the 2020 outreach, participants said that volatility in equity arising from recognising the aligned portion in OCI does not provide relevant information about the economic phenomenon of dynamic risk management. This is because such volatility is not a true reflection of the overall effects of the economic relationship described in paragraphs 9–10 of this paper, ie the results are counterintuitive. Participants therefore said that it is difficult to explain to users of financial statements volatility in IFRS equity by linking it to changes in the aligned portion. Regardless of whether it is an increase or a decrease, the fact that an aligned portion is recognised means that this is the extent/portion by which an entity is managing its repricing risk effectively and the entity is therefore not exposed to variability in equity.
30. Therefore, in our view, the current approach does not fully meet the fundamental qualitative characteristics of useful information set out in paragraph 15, and an alternative approach needs to be developed in order to meet the objective of the DRM model.

## Analysis of alternative approaches for the mechanics of the DRM model

31. Developing accounting mechanics that would faithfully reflect the economic phenomenon of dynamic risk management, that is at the same time operationally feasible and provide useful information to users of financial statements, has been a long-standing challenge in this project. Many approaches had been considered and rejected by the IASB to date. For example, the IASB considered whether dynamic risk management shall be treated as another business model for the purposes of classification and measurement in IFRS 9. It also considered providing an exception that permitted accrual accounting for derivatives that are used for dynamic risk management, or requiring entities to measure all dynamically risk managed exposures at fair value through profit or loss.<sup>9</sup>
32. More recently, the IASB also explored mechanics that are similar to the current fair value hedge requirements (ie the Portfolio Revaluation Approach (PRA) set out in the 2014 DP), and mechanics that are similar to the current cash flow hedge requirements (ie the DRM core model (see paragraphs 22–30)). Feedback suggests that neither mechanics would be able to both faithfully represent the economic phenomenon (discussed in paragraphs 6–10) and provide users of financial statements with relevant information to support their decision making. As such, they would neither achieve the objectives as set out in paragraph 11 nor alleviate concerns raised by stakeholder during the 2020 outreach.
33. To address this challenge, the staff developed and presented two alternative approaches in [Agenda Paper 4B](#) of the February 2022 IASB meeting. In this section, we will assess each of those alternative approaches against the criteria set out in paragraph 15.

### Approach A

Mechanics
The designated derivatives would continue to be recognised at fair value in the statement of financial position, with gains or losses recognised in statement of profit or loss.

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<sup>9</sup> See paragraph 1.22 to 1.28 of the [Discussion Paper Accounting for Risk Management: a Portfolio Revaluation Approach to Macro Hedging](#) published in 2014.

The risk mitigation intention would be recognised at fair value as a separate line item in the statement of financial position, with gains or losses recognised in statement of profit or loss.

*Description of the DRM adjustment*

34. Applying Approach A, the DRM adjustment would represent the fair value of the risk mitigation intention (attributable to repricing risk) that would be recognised in the statement of financial position with any changes in fair value to be recognised in the statement of profit or loss. The measurement of the designated derivatives would not change. Therefore, it leads to a gross and symmetrical recognition of the risk mitigation intention and designated derivatives in the statement of financial position and the statement of profit or loss.

*Do these mechanics provide a faithful representation?*

35. The fair value (attributable to repricing risk) of the risk mitigation intention recognised in the statement of financial position would provide a faithful representation of what it purports to represent, which is the changes in the fair value (attributable to repricing risk) of the extent of risk exposures the entity decided to mitigate using derivatives. This, along with information about the fair value of designated derivatives, would enable users of the financial statements to calculate the extent to which the changes in the fair value of the risk mitigation intention are offset by the changes in the fair value of the designated derivatives.
36. However, in our view, this information faithfully represents only *a part* of the purpose for which entities do dynamic risk management—that is, to achieve offset (ie 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 (see paragraph 9(a)). In our view, it is difficult to faithfully represent the reduced variability in entity’s (future) net interest income using Approach A because:
- (a) the amount of the DRM adjustment in Approach A—being the fair value of the risk mitigation intention—is recognised regardless the extent to which risk mitigation is achieved through derivatives.
  - (b) it would be challenging to determine a clear basis to calculate the unwinding of the DRM adjustment to be recognised in net interest income because the

risk mitigation intention could change frequently and there is also no direct link between that and the underlying items. This is different to Approach B where such unwinding would be calculated based on the accruals and pull-to-par effects of the benchmark or designated derivatives.

37. In addition, we note that Approach A could have a potential implication for items the IASB plans to discuss in the second phase of developing the DRM model. Specifically, the IASB has previously decided that in the second phase it will consider whether a financial asset that is measured at fair value (for example, measured at fair value through OCI in accordance with paragraph 4.1.2A of IFRS 9) could be designated in the DRM model. If the IASB were to allow such designations, applying Approach A could give rise to additional challenges as these assets are already measured at fair value in the statement of financial position. Therefore, this could risk double-counting a portion of the fair value as there is no direct link between the risk mitigation intention and the underlying items (also see paragraph 39 of this paper).

*Do these mechanics provide relevant information?*

38. The fair value (attributable to repricing risk) of the risk mitigation intention provides relevant information in relation to the value of a portion of risk exposures an entity decided to mitigate using derivatives for that particular period. Arguably, this provides useful information about the extent to which an entity decided to mitigate repricing risk.
39. However, in our view, there are some shortcomings of this information in context of the DRM model, namely:
- (a) the fair value (attributable to repricing risk) of the risk mitigation intention does not provide information about the changes in fair value of the underlying items. As discussed at the [February 2022 IASB meeting](#), there is no direct link between the risk mitigation intention at a point in time and the underlying individual items that it is comprised of. It is also for this reason, that the fair value (attributable to repricing risk) of the risk mitigation intention cannot be regarded as simply a change in measurement basis of the underlying items. As explained in paragraph 37, this could potentially lead to double-counting in some instances.
  - (b) the fair value (attributable to repricing risk) of the risk mitigation intention is recognised in financial statements regardless of whether an entity is

successful in mitigating the related repricing risk. In addition, the risk mitigation intention is simply a portion of the current net open risk position the entity wants to mitigate which can frequently change based on entity’s risk management strategy (ie based on an entity’s discretion). Therefore it does not directly provide information about the effectiveness of the DRM model and the potential to reduce variability in net interest income.

In summary, in our view, the fair value (attributable to repricing risk) of risk mitigation intention does not provide the most decision-useful information for users of financial statements—it neither provides insights about the fair value due to hedged risk of the underlying items (the approach the IASB explored in the 2014 DP), nor does it provide direct information about the extent of offset achieved between the risk mitigation intention and designated derivatives which could have some predictive value to users of the financial statements.

40. On the basis of this analysis, in our view, Approach A does not fully meet the fundamental qualitative characteristics of useful information set out in paragraph 15.

**Approach B**

Mechanics
<p>(a) the designated derivatives would continue to be measured at fair value in the statement of financial position.</p> <p>(b) the DRM adjustment would be recognised in the statement of financial position, as the lower of (in absolute amounts):</p> <ul style="list-style-type: none"> <li>(i) the cumulative gain or loss on the designated derivatives from the inception of the DRM model; and</li> <li>(ii) the cumulative change in the fair value of the risk mitigation intention attributable to repricing risk from inception of the DRM model. This would be calculated using the benchmark derivatives as a proxy.</li> </ul> <p>(c) the net gain or loss from the designated derivatives calculated in accordance with (a) and the DRM adjustment calculated in accordance with (b) would be recognised in the statement of profit or loss.</p>

*Description of the DRM adjustment*

41. This approach is similar to the current mechanics of the DRM model, however the DRM adjustment is recognised in the statement of financial position instead of OCI. This is consistent with the fact that the purpose of the DRM model is to reduce both variability in net interest income and in fair value of the risk mitigation intention.
42. As noted in paragraph 9, the ‘protection/benefit’ of dynamic risk management is realised in the form of a reduced variability in both fair value and net interest income. This benefit results from the economic relationship between the risk mitigation intention and the designated derivatives, not from the designated derivatives or the risk mitigation intention on their own. The economic relationship is established by documenting the entity’s risk management strategy and objective for managing repricing risk due to changes in interest rates.
43. As discussed in Agenda paper 4B for the February 2022 meeting, the DRM adjustment resulting from applying this approach therefore represents the extent to which the derivatives mitigated the variability in both the fair value of and the net interest income from the risk mitigation intention. The latter is achieved through the unwinding of the DRM adjustment over time which will be recognised in net interest income, therefore creating some offset to the net interest income generated from the underlying items.
44. The DRM adjustment would be measured using the ‘lower of’ test, to ensure that cumulative changes in fair value of the designated derivatives that exceed the cumulative changes in fair value of the risk mitigation intention attributable to repricing risk are immediately recognised in profit or loss. Accordingly, the ‘lower of’ test prevents the recognition of cumulative changes in fair value of designated derivatives in statement of financial position, in excess of the cumulative changes in fair value of the risk mitigation intention attributable to repricing risk.

*Do these mechanics provide a faithful representation?*

45. Recognition of the DRM adjustment in the statement of financial position provides a faithful representation of the dual purpose of dynamic risk management of repricing risk, namely:
  - (a) reduced variability in fair value is reflected by recognising in the statement of financial position the extent to which an entity successfully mitigated

repricing risk due to changes in interest rates through the designated derivatives; and

- (b) reduced variability in net interest income is reflected through the subsequent unwinding of the DRM adjustment to the net interest income (see paragraph 43).

46. In addition, we note that Approach B would not have the additional challenges discussed in paragraph 37 even if IASB were to allow the designation of a financial asset that is measured at fair value. In applying Approach B, there is no risk of double-counting because the fair value of risk mitigation is not recognised in the statement of financial position.

*Do these mechanics provide relevant information?*

47. In applying Approach B, direct information would be provided about:
- (a) the extent to which an entity achieved the objective of mitigating repricing risk—the DRM adjustment is recognised in the statement of financial position only for the aligned portion of the fair value changes of the designated derivatives (as described in paragraph 23); and
  - (b) the extent it did not achieve that objective—the misaligned portion would be recognised in statement of profit or loss.

This conveys direct information how the risk management actions have affected the entity’s current and future economic resources. Ultimately, this information would facilitate financial statement users’ understanding of effectiveness of an entity’s dynamic risk management activities and the nature, timing and uncertainties of future cash flows.<sup>10</sup>

48. In addition, in applying Approach B, the DRM adjustment recognised in the statement of financial position would also provide direct information about the present value of the future ‘offset’ to net interest income from the underlying items which will be provided by the designated derivatives. This ‘offset’ will unwind to net interest income over time and therefore reduce net interest income variability. This would help users of

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<sup>10</sup> As noted in [Agenda Paper 4](#) of November 2017 meeting, one of the objectives of the DRM model is to provide understandable and reliable information about the effectiveness of dynamic risk management activities.

financial statements to better understand the designated derivatives' contribution to net interest income (ie has predictive value), and overall better understand how the entity's dynamic risk management strategy affects its financial statements.

49. On balance, the staff think, that of the three approaches discussed in this paper, Approach B best meets both fundamental qualitative characteristics of useful information set out in paragraph 15, and hence provides the most useful information to users of financial statements.

### **The recognition of the DRM adjustment in the statement of financial position**

50. As both alternative approaches would result in the DRM adjustment to be recognised in the statement of financial position, in the February 2022 IASB meeting some IASB members asked whether the DRM adjustment would meet the definition of an asset or a liability in the *Conceptual Framework*.
51. The *Conceptual Framework* defines an asset as 'a present economic resource controlled by the entity as a result of past events', and a liability as 'a present obligation of the entity to transfer an economic resource as a result of past events'.<sup>11</sup> Paragraph 5.6 of the *Conceptual Framework* also states that:
- Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance. However, not all items that meet the definition of one of those elements are recognised.
52. As part of our research and analysis, we compared the economic phenomenon of dynamic risk management with scenarios in some other projects in which IASB had considered similar challenges, including the regulatory debit or credit balance that would be recognised by applying the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities*. However, the DRM adjustment is different to a regulatory debit or credit balance which represents a present right to charge customers or obligation to refund customers in future, as a result of having (in effect) under- or over-charged customers in previous periods.

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<sup>11</sup> Paragraph 4.3 and 4.26 of the *Conceptual Framework*.

53. In the case of dynamic risk management, we acknowledge that there is no additional right or obligation associated with the DRM adjustment beyond the rights or obligations already accounted for through the underlying items and the designated derivatives in either of the alternative approaches. As such, we think the recognition of the DRM adjustment as an asset or a liability in the statement of financial position would not necessarily be consistent with the definition of an asset or a liability in the *Conceptual Framework*.
54. However, the *Conceptual Framework* acknowledges that there might be some circumstances where the IASB departs from aspects of the *Conceptual Framework* in order to meet the objective of general purpose of financial reporting. Paragraph SP1.2 and SP1.3 of the *Conceptual Framework* state that:
- SP1.2 The Conceptual Framework is not a Standard. Nothing in the Conceptual Framework overrides any Standard or any requirement in a Standard.
- SP1.3 To meet the objective of general purpose financial reporting, the Board may sometimes specify requirements that depart from aspects of the Conceptual Framework. If the Board does so, it will explain the departure in the Basis for Conclusions on that Standard.
55. In our view, departing from the *Conceptual Framework* on the definition of an asset or a liability may be justified to ensure the mechanics of the DRM model provide useful information to the users of financial statements about entities' dynamic risk management, which is one of the most important and fundamental aspects of a banking business:
- (a) as discussed in paragraphs 45–49, we think that Approach B would generate information that meets the objective of general purpose financial reporting, providing information that is useful to the primary users of financial statements; and
  - (b) the scope of the departure would be limited to specific risk management strategies and activities (ie holistic dynamic risk management, commonly present in limited types of businesses).

## Appendix A—Illustrative Example: Economic phenomenon of dynamic risk management

A1. In this Appendix, we illustrate through an example the economic phenomenon of dynamic risk management.

### Scenario 1: The bank is not hedged

First, we consider a scenario where a bank is exposed to repricing risk due to changes in interest rates and does not undertake any activities to mitigate that repricing risk.

#### Assumptions:

At  $t_0$ , the bank obtained a five-year floating-rate funding of CU1,000 at the prevailing 1-year benchmark interest rate which corresponds to the bank's internal transfer pricing funding rate (ITP)—that is, the funding liability reprices every year. The benchmark spot rate was 4.00% at  $t_0$  (see term structure of interest rates below). With this funding the bank originates a five-year fixed rate loan on-market, in this case this means at a fixed rate of 4.38%.

We have derived the on-market rate based on the five-year swap rate calculated on the provided term structure of interest rates. This assumes the fixed rate is determined using a swap market proxy, not another cash product yield curve. Credit risk spread, liquidity premiums and any other variables in the loan are also disregarded.

#### Term structure of interest rates for the illustration is as follows:

Please note that the rate resets at the start of the period. For example, at the start of  $t_2$  the rate reset from 4.0% to 5.0% and is still 5% at the end of the period for cash flow calculation purposes.

Start of period	t0	t1	t2	t3	t4	t5	
		+1%	-3%	+0%	+0%	+0%	
Maturity Year		Forward Rate					
1		4.00%	5.00%	2.00%	2.00%	2.00%	Issuance of floating liability end of t0 start of t1
2		4.20%	5.20%	2.20%	2.20%	2.20%	
3		4.40%	5.40%	2.40%	2.40%	2.40%	
4		4.60%	5.60%	2.60%	2.60%	2.60%	
5		4.80%	5.80%	2.80%	2.80%	2.80%	
Maturity Year		Swap Rate					
1		4.00%	5.00%	2.00%	2.00%	2.00%	5 year swap rate in t0
2		4.10%	5.10%	2.10%	2.10%	2.10%	
3		4.19%	5.19%	2.20%	2.20%	2.20%	
4		4.29%	5.29%	2.29%	2.29%	2.29%	
5		4.38%	5.38%	2.39%	2.39%	2.39%	
Maturity Year		Zero Rate					
1		4.00%	5.00%	2.00%	2.00%	2.00%	
2		4.10%	5.10%	2.10%	2.10%	2.10%	
3		4.20%	5.20%	2.20%	2.20%	2.20%	
4		4.30%	5.30%	2.30%	2.30%	2.30%	
5		4.40%	5.40%	2.40%	2.40%	2.40%	

### Economic phenomenon

#### Scenario 1 – Not hedged

Period	t0	t1	t2	t3	t4	t5	
	@ 20X0	@ 20X1	@ 20X2	@ 20X3	@ 20X4	@ 20X5	
Fixed Assets	Rec Fixed	4.38%	4.38%	4.38%	4.38%	4.38%	Fixed rate on-market @ 20X0
Floating Liabilities	Rec Benchmark	-4.00%	-5.00%	-2.00%	-2.00%	-2.00%	Floating rate resets based on market
Net cash flows		3.8	-6.2	23.8	23.8	23.8	
<b>Earnings</b>							
Net Interest Income (A/L)		3.8	-6.2	23.8	23.8	23.8	Earnings & economic value volatility
Total		3.8	-6.2	23.8	23.8	23.8	
=cash flow variability							
<b>Economic Value</b>							
Assets FV	1,000.0	968.1	1,062.9	1,044.3	1,023.4	0.0	Repricing risk not hedged
Liabilities FV	-1,000.0	-1,000.0	-1,000.0	-1,000.0	-1,000.0	0.0	
Total	0.0	-31.9	62.9	44.3	23.4	0.0	
=fair value variability							

### Economic analysis

As noted in the example, when looking at the funding liabilities together with the originated assets, the bank is exposed to repricing risk. It is the risk that the prevailing benchmark interest rate resets periodically and therefore results in a gain/loss in present value terms for the entity (we refer to present value terms as economic value based on discounted cash flows). This gain/loss is effectively the present value of the changes to the entity’s net interest income, as the net interest cash flows from the asset and liability will fluctuate when the benchmark interest rate changes. Therefore, when looking at the funding liabilities together with the originated assets, the bank is exposed to cash flow variability and fair value variability at the same time. This is depicted in the illustration above.

**Scenario 2: The bank is fully hedged ie the risk mitigation intention is to completely mitigate repricing risk**

**Assumptions:**

Expanding the example in Scenario 1, the bank also trades a plain vanilla interest rate swap at t<sub>0</sub>, based on the t<sub>0</sub> swap rate for the above term structure of interest rates. This means the bank trades a 5-year swap with a notional of a CU1,000, paying 4.38% fixed and receiving the benchmark interest rate. The spot rate for the benchmark interest rate at inception is 4.00%.

**Scenario 2 – Fully hedged**

Period	t0 @ 20X0	t1 @ 20X1	t2 @ 20X2	t3 @ 20X3	t4 @ 20X4	t5 @ 20X5	
Fixed Assets	Rec Fixed	4.38%	4.38%	4.38%	4.38%	4.38%	Fixed rate on-market @ 20X0
Floating Liabilities	Pay Benchmark	-4.00%	-5.00%	-2.00%	-2.00%	-2.00%	Floating rate resets based on market
IR Swap	Pay 4.38%	-4.38%	-4.38%	-4.38%	-4.38%	-4.38%	Swap traded with on-market rates
IR Swap	Rec Benchmark	4.00%	5.00%	2.00%	2.00%	2.00%	Swap traded with on-market rates
<b>Net cash flows</b>		0.0	0.0	0.0	0.0	0.0	
<b>Earnings</b>							
Net Interest Income (A/L)		3.8	-6.2	23.8	23.8	23.8	Repricing risk fully hedged
Derivatives NII contribution		-3.8	6.2	-23.8	-23.8	-23.8	
<b>Total</b>		0.0	0.0	0.0	0.0	0.0	
-cash flow variability							
<b>Economic Value</b>							
Assets FV	1,000.0	968.1	1,062.9	1,044.3	1,023.4	0.0	} No earnings & economic value volatility
Liabilities FV	-1,000.0	-1,000.0	-1,000.0	-1,000.0	-1,000.0	0.0	
Derivatives FV	0.0	31.9	-62.9	-44.3	-23.4	0.0	
<b>Total</b>	0.0	0.0	0.0	0.0	0.0	0.0	
-fair value variability							

**Economic analysis:**

Based on the traded interest swap all variability in cash flows and fair value has been mitigated. Therefore, the bank’s exposure to the benchmark interest rate risk has completely been mitigated. This is because the entity traded a swap to transfer that risk to another counterparty, in other words to buy ‘protection’ in form of a derivative. In conclusion the entity has fully achieved its risk mitigation intention.

## Appendix B—Illustrative Example: Reflection of the economic phenomenon in the financial statements

### Current DRM model approach

B1. The following example illustrates why recognising the DRM adjustment in OCI as contemplated by the current mechanics of the DRM model only partially achieves faithful representation of the economic phenomenon:

Example - Current DRM model							
Period	@ 20X0	@ 20X1	@ 20X2	@ 20X3	@ 20X4	@ 20X5	
Fixed Assets	Rec Fixed	4.38%	4.38%	4.38%	4.38%	4.38%	Fixed rate on-market @ 20X0
Floating Liabilities	Pay Libor	-4.00%	-5.00%	-2.00%	-2.00%	-2.00%	Floating rate resets based on market
IR Swap	Pay 4.38%	-4.38%	-4.38%	-4.38%	-4.38%	-4.38%	Swap traded with on-market rates
	Rec Libor	4.00%	5.00%	2.00%	2.00%	2.00%	
<b>Net Cash Flows</b>		0.0	0.0	0.0	0.0	0.0	Repricing risk fully hedged
<b>Earnings</b>							
Net Interest Income (A/L)		3.8	-6.2	23.8	23.8	23.8	
Derivatives NII contribution		-3.8	6.2	-23.8	-23.8	-23.8	
<b>Total</b>		0.0	0.0	0.0	0.0	0.0	
<b>Economic Value</b>							
Assets FV	1,000.0	968.1	1,062.9	1,044.3	1,023.4	0.0	
Liabilities FV	-1,000.0	-1,000.0	-1,000.0	-1,000.0	-1,000.0	0.0	
Derivatives FV	0.0	31.9	-62.9	-44.3	-23.4	0.0	
<b>Total</b>	0.0	0.0	0.0	0.0	0.0	0.0	
<b>DRM Core Model: Statement of Profit or Loss and Other Comprehensive Income</b>							
Net Interest Income (A/L)		3.8	-6.2	23.8	23.8	23.8	Net interest income
Derivatives NII contribution		-3.8	6.2	-23.8	-23.8	-23.8	Derivative accrual
OCI		31.9	-94.8	18.6	20.9	23.4	Recognised aligned portion
<b>Total</b>		31.9	-94.8	18.6	20.9	23.4	
<b>DRM Core Model: Statement of Financial Position</b>							
Assets	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0	0.0	Amortised Cost
Liabilities	-1,000.0	-1,000.0	-1,000.0	-1,000.0	-1,000.0	0.0	Amortised Cost
Derivatives	0.0	31.9	-62.9	-44.3	-23.4	0.0	Derivative MtM
<b>Equity Component</b>	0.0	-31.9	62.9	44.3	23.4	0.0	Recognised aligned portion

Economic position based on scenario 2 in Appendix A

Balance in the DRM equity component **does not reflect** the unchanged economic position

## Appendix C—A reminder of the elements and robustness of the DRM model

### *Elements of the DRM model*

- C1. The elements of the DRM model, including the refinements the IASB tentatively decided at its November 2021 meeting are:
- (a) *Current net open risk position* – the interest rate risk position (by time bucket) which is derived from the combination of expected (ie modelled) cash flows from assets, liabilities (including core demand deposits) and eligible future transactions over the period which the entity is managing repricing risk;
  - (b) *Target profile* – 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;
  - (c) *Risk mitigation intention* – the extent to which an entity intends to mitigate the current net open risk position through the use of derivatives;
  - (d) *Designated derivatives* – derivatives traded with external counterparties which are used to execute an entity’s risk management strategy; and
  - (e) *Benchmark derivatives* – the benchmark derivatives represent the risk mitigation intention. It is a mathematical expedient to enable measurement of the risk mitigation intention.

### ***Robustness of the model***<sup>12</sup>

#### *Target profile*

- C2. The target profile (ie risk limits) is required to be directly linked to the entity’s documented risk management strategy. In other words, it is not merely an accounting concept. When entities assess repricing risks across different time buckets when applying the DRM model, these time buckets need to be consistent with the entity’s risk

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<sup>12</sup> These have been discussed in more detail in [Agenda Paper 4A](#) of the November 2021 IASB meeting.

management strategy and the characteristics of the underlying risk positions (ie consistent with how the entity aggregates and manages risk).

- C3. The specification and documentation of the target profile, as one of the qualifying criteria to apply the DRM model, should be done at the initial designation of the hedge. This means 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 DRM model.

*Risk mitigation intention*

- C4. The determination of the risk mitigation intention is subject to certain model constraints. An entity applying the DRM model needs to apply both prospective and retrospective assessments to be able to apply the DRM model. The prospective assessments need to be satisfied at the time the risk mitigation intention is designated, supplemented by the two retrospective assessments at the end of each assessment period.
- C5. When determining their risk mitigation intention, entities are restricted by the following considerations:
- (a) the maximum amount of risk mitigation intention is capped to the current net open risk position, and this maximum amount is not affected by the entity’s target profile (ie risk limits) determined at the inception of the hedge. In addition, for entities that monitor and manage their current net open risk position by maturity time buckets, there would be further discipline that the maximum amount of risk mitigation intention in each maturity time bucket is capped at the current net open risk position within that bucket;
  - (b) the risk mitigation intention needs to transform the current net open risk position to a residual risk position that is within the target profile—this requirement establishes the minimum amount that an entity needs to designate as risk mitigation intention to be consistent with its risk management strategy;
  - (c) the risk mitigation intention needs to be evidenced by real actions taken to mitigate risk (eg the actual derivatives traded in the market). Once it is determined, it would be documented via the construction of the benchmark derivatives, and entities will not be able to amend the risk mitigation intention retrospectively.

- C6. In determining the current net open risk position, an entity allocates risk exposures to time buckets based on the expected repricing dates. This is consistent with the IASB's tentative decisions about using 'behavioural' models to determine the expected repricing of items such as core demand deposits and prepayable loans.