

---

**IASB<sup>®</sup> meeting**

Date	<b>July 2023</b>
Project	<b>Dynamic risk management (DRM)</b>
Topic	<b>Designation of hedged exposures in the current net open risk position</b>
Contacts	Matthias Schueler ( <a href="mailto:mschueler@ifrs.org">mschueler@ifrs.org</a> )
	Zhiqi Ni ( <a href="mailto:zni@ifrs.org">zni@ifrs.org</a> )
	Alev Halit Ongen ( <a href="mailto:alev.halitongen@ifrs.org">alev.halitongen@ifrs.org</a> )
	Riana Wiesner ( <a href="mailto:rwiesner@ifrs.org">rwiesner@ifrs.org</a> )

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<sup>®</sup> Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB<sup>®</sup> *Update*.

---

**Introduction**

1. The current net open risk position (CNOP) represents the net open interest rate risk position (by time bucket) derived from the combination of an entity's financial assets and financial liabilities (including core demand deposits) and eligible future transactions over the period the entity is managing such risk. As the CNOP is the combination of underlying risk exposures, it cannot be directly linked back to the individual underlying financial assets and financial liabilities.
2. Determining the CNOP is an important step in applying the DRM model because the CNOP is the basis for an entity's risk management activities—it defines the 'organic' risk exposures that are dynamically managed for repricing risk due to changes in interest rates. The CNOP is also used as the basis for the DRM performance assessment and capacity assessment.
3. The IASB has already discussed most of the topics relating to the eligibility criteria for the determination of the CNOP (as identified in the July 2022 [project plan](#)), in its

---

November 2022, February 2023 and April 2023 meetings. These relevant tentative decisions are summarised in Agenda Paper 4A of this meeting.

4. One of the eligibility criteria defined as part of the core DRM model, was that items which are already designated in a hedging relationship are not eligible for designation in the CNOP. Another criterion was that financial assets and financial liabilities must be denominated in the same currency to be eligible for designation in the CNOP. This paper focuses specifically on these two requirements thereby specifically taking into account stakeholders' feedback with regards to the designation of items denominated in multiple currencies in the CNOP.
5. This paper is structured as follows:
  - (a) [previous tentative decisions and feedback to date](#);
  - (b) [staff analysis](#);
  - (c) [staff recommendation](#); and
  - (d) [question](#) for the IASB.

## Previous tentative decisions and feedback to date

6. This section summarises why the relevant qualifying criteria were considered as necessary during the previous deliberations, along with feedback on the challenges they may cause when applying the DRM model and how this could result in outcomes that are inconsistent with the objective to better reflect the effects of risk management activities in financial statements.
7. We will focus on two tentative decisions we consider relevant for redeliberation:
  - (a) the restriction not to be able to designate items in the CNOP which already form part of a hedging relationship under IFRS 9; and
  - (b) the requirement to allocate underlying financial assets and financial liabilities denominated in different currencies into separate DRM models.

- 
8. Regarding the restriction in paragraph 7(a), the IASB was, during the development of the core DRM model, concerned about double counting the effects of hedge accounting (see Agenda Paper [4B](#) of the February 2018 IASB meeting). The IASB therefore tentatively concluded in February and April 2018 that items already designated in a hedging relationship should not be eligible for inclusion in the DRM model.
9. The tentative decision related to paragraph 7(b), was also considered by the IASB in its February 2018 meeting, specifically in relation to the designation of portfolios of financial assets and financial liabilities. It formed part of a wider discussion on whether designated portfolios must share similar risk characteristics because different risk characteristics might require different risk mitigating actions. Three examples of such different risk characteristics were mentioned:
- (a) interest rate basis risk;
  - (b) prepayment risk due to changes in interest rates; and
  - (c) interest rate risk of financial assets or financial liabilities denominated in different currencies.
10. With regard to interest rate basis risk we are of the opinion that paragraph 45 of the February 2018 Agenda Paper [4B](#) continues to be relevant—differences in interest rate basis lead to fluctuations in interest income and interest expense over time. However, differences in interest rate basis simply imply a difference in the re-pricing frequency of a financial asset. Interest rate basis is simply another required consideration when managing interest rate risk, much like different maturity dates is a required consideration. In the DRM model the differences in interest rate basis will be reflected through the construction of the benchmark derivatives which are based on the managed risk. As such there is no requirement for different DRM models with regard to interest rate basis risk.
11. Similarly, prepayment risk was given as an example for different risk characteristics in a portfolio of financial assets. With respect to prepayment risk, the DRM model

permits the use of expected cash flows to determine the CNOP to reflect the expected timing and amount of future cash flows where these may be (at least in part) uncertain due to the presence of prepayment options. This means that there is no requirement for different DRM models for financial assets with prepayment features and ones without prepayment features.

12. However, underlying items denominated in different currencies are linked to different economic environments and therefore have different risk characteristics. This means that the nature of the underlying interest rate risk is different and therefore cannot be managed together with one set of hedging instruments referring to a single managed risk as required by an entity's risk management strategy. In fact, when underlying items are denominated in different currencies, foreign currency risk is introduced into the portfolio as an additional risk to interest rate risk. This is why the IASB previously tentatively decided that, at a minimum, underlying financial assets and financial liabilities denominated in different currencies should be allocated to separate DRM models.

### ***Feedback received from stakeholders and IASB members***

13. During the outreach with preparers in 2020, many participants said it is common for them to raise funding or originate loans in currencies other than their functional currency, and as a result they are likely to be exposed to foreign currency risk as well as interest rate risk from these portfolios. In many cases, they would economically manage the foreign currency risk using cross-currency swaps first, and then manage the interest rate risk in their functional currency holistically and dynamically together with other financial assets and financial liabilities denominated in their functional currency.
14. These participants asked whether and how the DRM model may be applied for entities using these funding/lending strategies, where the cross-currency swaps change the underlying interest rate risk exposure from one currency to another currency. This

feedback from preparers has repeatedly been confirmed in further informal outreach sessions.

15. Furthermore, some other preparers also described a risk management strategy of generally swapping every fixed rate asset or liability back to variable rate through the use of a plain vanilla interest rate swaps, before considering their overall holistic interest rate risk position. In executing such a risk management strategy, the entity simplifies its risk management operations because, rather than determining the organic net interest rate risk position from its underlying position (which contains a mixture of fixed and variable positions) first and executing derivatives based on that exposure, it swaps all interest rate risk exposure to variable rate and then consider its total variable position.
16. When discussing other topics as part of developing the DRM model, some IASB members asked the staff to explore the possibility of designating financial assets or financial liabilities in the DRM model after such assets or liabilities have been designated in a general hedging relationship (applying IFRS 9 *Financial instruments* (or IAS 39 *Financial instruments: Recognition and measurement*). For example, whether an entity that designated a financial instrument in a qualifying hedging relationship for foreign currency risk could include the same underlying financial instrument in the DRM model for interest rate risk management purposes.
17. One IASB member also asked whether we could consider requirements similar to the hedging of aggregated exposures under IFRS 9, which allows an entity to achieve its risk management objective using a chain of instruments, and effectively designate the ‘net cash flows’ from a combination of a hedging instrument and a hedged item in a new hedge accounting relationship.

## Staff analysis

18. The objective of the DRM model is to better reflect:

- 
- (a) how interest rate risk management affects amount, timing and uncertainty of cash flows; and
  - (b) the effect of risk management activities on the financial statements
19. We therefore have assessed if the requirements expressed in the topics identified for redeliberation should be maintained going forward or should be revised in order to meet the objective of the DRM model.

***Reflection of economic actions taken by the entity***

20. Requiring separation of financial assets and financial liabilities denominated in different currencies into different DRM models appears to be reasonable (for the reasons explained in paragraph 12 of this paper) and possible at first glance. However, this may not be consistent with the entity's risk management strategy, in particular when large amount of funding is raised in a currency different to the currency in which the assets are generated (ie funding currency does not match asset generation currency). For example, the lack of market liquidity in an entity's local currency often means the entity has to raise funding in a more liquid market such as the US Dollar or the Euro market, despite most of the financial assets are originated in local currency.
21. Although notional alignment is not required under the DRM model, operating two different DRM models due to an accounting restriction (for example one for liabilities in a foreign currency and another for assets in the local currency) would be inconsistent with the entity's risk management strategy (RMS) to manage interest rate risk holistically and how the related risk mitigating activities are carried out. Using designated derivatives to mitigate the interest rate risk and designating the risk mitigation intention for each of these DRM models would most likely be arbitrary. Therefore, it would not achieve the DRM objective as set out in paragraph 18.
22. Entities might also be able to achieve an economic advantage by funding themselves in a foreign currency and may often do so as part of their funding strategy. Therefore, as noted in paragraph BC6.160 of the Basis for Conclusions on IFRS 9, an entity is

sometimes economically required to enter into transactions that result in more than one risk simultaneously, for example, interest rate risk and foreign currency risk. However, an entity may not always intend to manage the two risks simultaneously. Instead, it may economically manage the combined effect of foreign currency funding liabilities and cross-currency swap, together with their local currency interest rate risks from other positions.

23. For example, for a 10-year fixed rate debt denominated in a foreign currency an entity may hedge the foreign currency risk for the entire term of the debt instrument, but require fixed rate exposure in its functional currency only for the short to medium term (say two years) and variable rate exposure in its functional currency or the remaining term to maturity.<sup>1</sup> At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years (if the interest level is such that the entity wants to fix interest rates). In such a situation it is common to enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed rate foreign currency debt into a variable rate domestic currency exposure. This is then overlaid with a two-year interest rate swap that—on the basis of the functional currency—swaps variable rate debt into fixed rate debt. In effect, the fixed rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable rate debt in functional currency for risk management purposes.
24. However, currently such a constructed 10-year variable rate debt exposure is not eligible for designation in the CNOP as the 10-year fixed-to-floating cross-currency interest rate swap does not meet the qualifying criteria for designation in the CNOP. As a result, the DRM model is currently unable to reflect such risk management activities even if they are consistent with an entity's risk management strategy.

---

<sup>1</sup> Refer to paragraph BC6.160 of the Basis for Conclusions on IFRS 9.

---

***The concept of aggregated exposures in IFRS 9 as a possible way of considering different currencies in one DRM model***

25. As part of the deliberations on the hedge accounting requirements in IFRS 9, the IASB discussed the designation of aggregated exposures. The IASB concluded at the time that the fact that an aggregated exposure is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude designation of that aggregated exposure as a hedged item. As a result, paragraph 6.3.4 of IFRS 9 states:

An aggregated exposure that is a combination of an exposure that could qualify as a hedged item in accordance with paragraph 6.3.1 and a derivative may be designated as a hedged item (see paragraphs B6.3.3–B6.3.4). This includes a forecast transaction of an aggregated exposure (ie uncommitted but anticipated future transactions that would give rise to an exposure and a derivative) if that aggregated exposure is highly probable and, once it has occurred and is therefore no longer forecast, is eligible as a hedged item.

26. Under IFRS 9 an entity is allowed to designate as hedged items aggregated exposures that are a combination of an (‘organic’) exposure and a derivative. When designating such a hedged item, an entity assesses whether the aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks).



- 
27. As noted in paragraph BC6.167 of the Basis for Conclusions on IFRS 9, achieving hedge accounting for the first level relationship is not a prerequisite for qualifying for hedge accounting for the second level relationship (ie the one using aggregated exposures as a hedged item).<sup>2</sup>
28. However, in many circumstances not achieving hedge accounting for the first level relationship would make the accounting for the aggregated exposure more complicated and the outcome inferior compared to achieving hedge accounting for the first level relationship. As such, all three illustrative examples provided in IFRS 9 assumed qualifying hedging relationships for both first level and second level relationships.<sup>3</sup>
29. It is, however, important to note the clarification in paragraphs BC6.158– BC6.168 of the Basis for Conclusions on IFRS 9 that the unit of account, even when using a concept of aggregated exposure, is the individual financial instrument. That means that derivatives that form part of an aggregated exposure are always recognised as separate financial assets or financial liabilities and are measured at fair value through profit or loss and accounting for aggregated exposures does not allow ‘synthetic accounting’.
30. In our view, permitting the inclusion of the combined effects from aggregated exposures in the DRM model could help to address the challenges of reflecting an entity’s holistic interest rate management activities and the effect of those activities on the financial statements, in particular when the managed portfolios contain financial assets and financial liabilities denominated in different currencies. However, referring to the concept of aggregated exposures in IFRS 9 we have identified two challenges, being:

---

<sup>2</sup> Consistent with paragraph BC6.167 of the Basis for Conclusion on IFRS 9, first level relationship refers to the relationship between the underlying exposure and the derivative that constitute the aggregated exposure, while the second level relationship refers to the relationship between the aggregated exposure and other derivatives used for risk management.

<sup>3</sup> See Example 16–18 of Illustrative Examples of IFRS 9, in paragraphs IE115–147.

- 
- (a) the underlying position in CNOP must be an ‘organic’ risk position; and
  - (b) the risk of double-counting.

*‘Organic’ risk positions*

- 31. One of the prospective tests in the DRM model is based on the concept of available risk to mitigate. In other words, an entity must be able to demonstrate that it is actually exposed to a non-leveraged or ‘organic’ risk position as a result of its business activities. This is because interest income or expense of an organic position (ie a position measured at amortised cost or fair value through comprehensive income) is calculated using the effective interest method, which is the source of earnings variability in the form of net interest income.
- 32. Derivatives are usually excluded as underlying items because they would introduce leverage into the portfolio. Although they are also a source of variability in economic value to equity or earnings, derivatives do not contribute to the net interest income (NII) calculated by using the effective interest method. Therefore, they are not eligible to be designated as underlying items in the CNOP.
- 33. However, when a derivative is designated in a hedging relationship (applying general hedge accounting requirements) to hedge the interest rate risk of a hedged item, the net cash flows from the derivative and the underlying hedged item transform the net interest income profile of the underlying item economically.

*The risk of double-counting*

- 34. The IASB tentatively decided in [February 2018](#) and [April 2018](#) that items already designated in a hedge accounting relationship are not eligible to be qualifying items for designation in the CNOP under the DRM accounting model because<sup>4</sup>:

---

<sup>4</sup> See paragraph 12 of AP4B for [February 2018](#) IASB meeting, and paragraph 15 of AP4B for [April 2018](#) IASB meeting.

[...] hedged items and hedging instruments already designated in a hedge accounting relationship for interest rate risk should not be eligible for the DRM accounting model. This is because designation of such items under the DRM model would result in deferring gains or losses in Other Comprehensive Income for items already considered in a hedge accounting relationship and, therefore, could result in double counting.

35. Based on the feedback from the 2020 outreach as well as the discussion we have had with stakeholders (see paragraphs 13–17), we understand that when determining the interest rate risk exposures in the CNOP, an entity may consider an item already designated in a qualifying hedge accounting relationship mainly for the following reasons:
- (a) the existing hedge accounting relationship is designated for another risk, such as foreign currency risk or interest rate risk in a foreign currency. In addition, the entity intends to manage the combined effect from the hedged item and hedging instruments in the DRM model for the interest rate risk in its functional currency, together with other financial assets and liabilities of the same currency holistically and dynamically; and
  - (b) the existing hedge accounting relationship is designated for the interest rate risk on an individual/micro basis, and the entity manages the combined effect from the hedged item and hedging instrument with other financial assets and liabilities holistically and dynamically when managing the overall interest rate risk.
36. For the scenario described in paragraph 35(a), the entity effectively manages its business in its functional currency. Consequently, all foreign currency exposures are first converted into functional currency exposures using derivatives on a one-to-one basis (for example, by transacting a cross-currency swap for each foreign currency debt issuance). The resulting combined net open interest rate risk position in its functional currency is then included within the entity's dynamic risk management of

- interest rate risk. In other words, the risks managed under the general hedge accounting model and the DRM model are different. We also think this is consistent with what the IASB had in mind with its previous decision as quoted in paragraph 34.
37. The scenario described in paragraph 35(b) is slightly different. Although, the existing hedge accounting relationship is referring to the same interest rate risk in the entity's functional currency as the one managed under the DRM model, it is in effect mitigating a different aspect of that risk compared to what the DRM model mitigates. This is because in the first level hedging relationship an entity would be managing the variability in cash flows or fair values using general hedge accounting models, which is different from mitigating the repricing risk due to changes in this interest rate under the DRM model.
38. We understand such an arrangement is not rare in risk management practices, because risk management is generally carried out as a chain of actions, as only some risk managers in the treasury function of the entity would have the visibility of an entity's overall holistic interest rate risk position. For example, when an entity purchases fixed rate government bonds as part of its liquidity portfolio, it is common for it to enter into individual interest rate swaps at the same time to mitigate the interest rate risks in each bond and effectively get variable interest income, without considering the entity's overall holistic interest rate risk position. Such interest rate swaps are commonly quoted together with the fixed rate asset, so it is usually easier and cheaper to manage the risk there and then. Therefore, it is the combined effect from the underlying bond and the interest rate swaps (ie the variable rate exposure) that gets transferred into an entity's asset and liability management function to be managed as part of the DRM process.
39. In our view, excluding such hedged exposures in both scenarios when determining an entity's CNOP, in cases when these hedged exposures are economically included and considered as part of an entity's interest rate risk management, may be a departure from the objective of the DRM model, which is to better reflect the effects of risk management activities in the financial statements.

---

*Designating ‘hedged exposures’ as part of the CNOP*

40. As commented by some IASB members during previous discussions in April 2018, in the scenarios described in paragraph 35, the combined effects for the purpose of the DRM model are similar to the IFRS 9 guidance on aggregated exposures.
41. However, given the focus of the DRM model on the ‘protection/benefit’ in the form of reduced variability in both economic value and net interest income, it is important that the items eligible for inclusion in the CNOP are those that would cause variability in net interest income in the first place. We think that this would not necessarily be the case unless the underlying exposure and the derivative that forms the first level relationship are designated in a hedge accounting relationship.
42. This is because without applying hedge accounting for the first level relationship, the combined accounting outcome between the underlying exposures (to which the effective interest method is applied) and the derivative (to be measured at FVPL) would be significantly different to the profit or loss profile of an equivalent financial asset or financial liability measured at amortised cost. In other words, unless hedge accounting is applied, the variability in net interest income or economic value to be mitigated through the application of the DRM model would not exist. Consequently, the DRM adjustment would not mitigate the variability in economic value or net interest income.
43. As mentioned in paragraph 34, the risk of ‘double counting’ was the main reason the IASB tentatively decided to exclude items already designated in an existing hedge accounting relationship. In other words, the intention was that an entity should not be able to hedge the same risk twice and adjust the accounting measurement of either the underlying items or related derivatives twice.
44. However, considering the accounting mechanics for the DRM model, the DRM adjustment represents the extent to which the fair value changes of the *designated derivatives* offset against the fair value changes of the RMI (which is based on the CNOP). At the same time the DRM adjustment mitigates future NII variability

originating from the hedged exposure through its unwind over time. It is therefore important to note that applying the DRM model does not directly change the accounting classification and measurement of either the underlying financial assets and financial liabilities, or the designated derivatives. In other words, the DRM adjustment is separate from any adjustments made due to the first level hedging relationship. For that reason, and our observations in paragraph 37 we are of the view that there is no risk of ‘double counting’ when including items already designated in an existing hedge accounting relationship under IFRS 9.

### Staff recommendation

45. We are of the opinion that the requirement described in paragraph 7(b) of this paper, that at a minimum, underlying financial assets and financial liabilities denominated in different currencies should be allocated to separate DRM models, continues to be relevant.
46. However, for the reasons explained in paragraph 18–44 of this paper, we recommend that an entity is permitted to include hedged exposures for the purpose of determining the CNOP in the DRM model, when doing so is consistent with the entity’s risk management strategy. Such hedged exposures refer to the combination of the underlying exposures as the hedged items and the derivatives as the hedging instruments that are designated in an existing hedge accounting relationship.

### Question for the IASB

#### Question for the IASB

Does the IASB agree with the staff recommendation set out in paragraph 45 – 46 of this paper?