IFRS Accounting

Staff paper

Agenda reference: 4B

IASB® meeting

Date	**September 2024**
Project	**Dynamic Risk Management**
Topic	**Discontinuation of the DRM model**

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Introduction

1. In its June 2018 and September 2018 meetings, the IASB tentatively decided that when a change in risk management strategy requires a change in an entity's target profile, the entity discontinues applying the dynamic risk management (DRM) model, and the accumulated balance recognised in other comprehensive income (OCI) is reclassified to statement of profit or loss over the life of the original target profile.

2. The purpose of this paper is to consider—following the IASB's tentative decisions to further develop the DRM requirements (see Agenda Paper 4 of this meeting for a summary of tentative decisions to date)—when an entity would be required to discontinue (ie terminate) applying the DRM model.

3. This paper is structured as follows:

   (a) staff's recommendations and the question for the IASB;

   (b) a reminder of the IASB's previous tentative decisions on discontinuation;

   (c) development of the DRM model; and

   (d) staff analysis and conclusions.

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Staff's recommendations and the question for the IASB

4. Based on the analysis included in this paper, the staff recommend that:

   (a) a change in an entity's risk management strategy results in discontinuation of the DRM model. A change in risk management strategy refers to a change in the managed interest rate risk or how the entity manages that risk;

   (b) an entity is neither permitted to voluntarily discontinue applying the DRM model nor to voluntarily:

      (i) remove underlying items that were included in determining its current net open risk position when these items continue to meet the qualifying criteria; or

      (ii) de-designate a designated derivative; and

   (c) upon discontinuation of the DRM model, the DRM adjustment is recognised in the statement of profit or loss on either a straight-line basis or another systematic and rational basis over the risk management time horizon, if the underlying items included in the current net open risk position continue to exist and/or future transactions are still expected to occur.

Question for the IASB
1. Do the IASB members agree with the staff's recommendation included in paragraph 4 of this paper?

A reminder of the IASB's previous tentative decisions on discontinuation

5. In its June 2018 meeting, the IASB tentatively decided that if an entity discontinues the DRM model—by making changes to its target profile, ie its risk management objective—and the cash flows from the underlying financial assets and financial liabilities still exist and/or future transactions are still expected to occur, the amount recognised in OCI is reclassified to the statement of profit or loss over the life of the

target profile (ie over the contractual tenor of financial liabilities and core demand deposits).[1]

6. The IASB tentatively decided in September 2018 that when a change in risk management strategy requires a change in the entity's target profile (see also footnote 1 and paragraph 9 of this paper), the accumulated balance recognised in OCI (see paragraph 15 of this paper) should be reclassified to the statement of profit or loss over the life of the target profile that was established prior to the change in risk management strategy.

7. As summarised in the Agenda Paper 4A for the April 2019 meeting, the IASB expressed preliminary views not to allow optional de-designation of financial assets or financial liabilities within the DRM model when the risk management objective remains the same, and the financial assets or financial liabilities continue to meet the qualifying criteria. In addition, the IASB tentatively decided that the DRM model should not allow optional de-designation of a derivative when the risk management objective for that particular derivative remains the same.

8. The IASB also tentatively agreed that financial assets, financial liabilities and future transactions are only de-designated when they no longer meet the qualifying criteria or when they are derecognised from the statement of financial position in accordance with the requirements of IFRS 9 *Financial Instruments,* as also summarised in the Agenda Paper 4A for the April 2019 meeting.

[1] Consistent with the IASB's previous tentative decisions on the target profile as discussed in paragraph 9 of this paper, the specification and documentation of the target profile, as one of the qualifying criteria for applying the DRM model, are done at the inception of the model. This means any changes to an entity's risk management strategy that results in a change to the entity's target profile (ie risk management objective) would result in the discontinuation of the DRM model based on the IASB's previous tentative decisions.

Development of the DRM model

9. For the purposes of the core DRM model that was used for the 2020 outreach, the target profile was described as:

   (a) the *risk management objective* for a given asset profile. At the time, the DRM model considered underlying financial assets and financial liabilities of an entity as two separate elements; and

   (b) a *single outcome* and a key element in the measurement of misalignment in the statement of profit or loss.

10. However, during the 2020 outreach, stakeholders said that entities consider financial assets and financial liabilities in combination when determining the net open risk position from a risk management perspective, and an entity's risk management strategy does not specify a single targeted outcome, but rather a range of acceptable outcomes within risk limits.

11. In response to feedback, as discussed in Agenda Paper 4A of the IASB's November 2021 meeting, the IASB tentatively decided:

    (a) to introduce the concept of a current net open risk position (CNOP), as the net open interest rate repricing risk position (by time bucket) derived from the combination of an entity's financial assets and financial liabilities (including core demand deposits) over the period the entity is managing such risk; and

    (b) to revise the definition of the target profile to be the range (risk limits) within which the CNOP can vary *while still being consistent with an entity's risk management strategy*.

12. In November 2021, the IASB also tentatively decided to introduce the concept of risk mitigation intention (RMI), which represents the extent to which an entity intends to mitigate the interest rate repricing risk exposure of its CNOP through the use of derivatives. That is to say, an entity's RMI *represents its risk mitigation objective* and transforms the CNOP to a residual risk position that is within an entity's target profile (ie risk limits).

13. As discussed in Agenda Paper 4A of the IASB's November 2021 meeting, unlike the general hedge accounting models in IFRS 9, under which the hedging relationships are required to be discontinued when an entity's risk management objective changes, a change in the RMI can occur without affecting the continuation of the DRM model. This is because, at any time, the dynamic nature of the underlying items in CNOP could require a change in an entity's RMI.

14. Following the changes to the DRM model summarised in paragraphs 11–13, a change in target profile would now only refer to a change in risk limits, rather than a change in overall risk management strategy. Stakeholders have therefore asked for clarification on what would constitute a change in risk management strategy and when an entity would be required to discontinue applying the DRM model.

15. Lastly, the IASB tentatively decided that the DRM adjustment is presented as an asset or a liability instead of a balance in OCI (see Agenda Paper 4A of the IASB's May 2022 meeting). Therefore, following a discontinuation, when and how the DRM adjustment is recognised in the statement of profit or loss is required to be clarified.

Staff analysis and conclusions

16. In broad financial risk management terms, a risk management strategy is a structured approach that outlines how an entity will identify, assess, respond to, monitor, and govern risks within a specific category. This is consistent with how this term is used in the context of the general hedge accounting requirements in IFRS 9. Although the IASB has not provided a definition for 'risk management strategy', paragraph B6.5.24 of IFRS 9 states that (emphasis added):

> For the purposes of this Standard, an entity's ***risk management strategy is distinguished from its risk management objectives***. The risk management strategy is established at the highest level at which an entity determines ***how it manages its risk***. Risk management strategies typically ***identify the risks*** to which the entity is exposed and set out ***how the entity responds to them***. A risk management strategy is typically in place for a ***longer period*** and may include

some ***flexibility to react to changes in circumstances that occur while that strategy is in place*** (for example, different interest rate or commodity price levels that result in a different extent of hedging). […]

17. In the staff's view, an entity's risk management strategy is a matter of fact and not merely an assertion made by its management. It is typically observable through the activities that the entity undertakes to achieve its risk management objectives, and the information provided to its senior management and external stakeholders.

18. For the purposes of this paper, references to an entity's 'risk management strategy' relates to an entity's strategy for dynamically managing interest rate repricing risk.

Required discontinuation of the DRM model

19. In considering when an entity discontinues applying the DRM model, in the staff's view, one would need to consider circumstances in which continuing to apply the DRM model would no longer be consistent with the entity's risk management strategy.

20. As the DRM model is intended to be applied when an entity dynamically manages interest rate repricing risk, the staff think it is important to distinguish between changes in *how* an entity manages interest rate repricing risk and changes that *reflect the dynamic nature* of the entity's exposure to interest rate repricing risk. In our view, applying the DRM model should be discontinued only when there is a change in how an entity manages interest rate repricing risk.

21. More specifically, we believe that continuing to apply the DRM model when there has been a change in how an entity manages interest rate repricing risk, would no longer meet the objective of the DRM model. This is because, when an entity changes how it manages interest rate repricing risk, the ongoing effects on the financial statements would be different from what has already been recognised in the financial statements. For example, in such a case, the DRM adjustment recognised in the statement of

financial position would no longer represent the future protection or benefit that the entity expects to achieve under its revised risk management strategy.

22. Changes in how an entity manages repricing risk would include, for example a change in the managed rate, the level at which or the time horizon over which interest rate repricing risk is managed.

23. An entity might need to apply judgement when determining what would constitute a change in its risk management strategy. The following examples illustrate a change in an entity's risk management strategy. The list of examples is not exhaustive:

A change in strategy	Illustrative example
Risk management level	A banking group, following a decision to expand its operations to different jurisdictions, concludes that a 'group-level only' risk management strategy is no longer a fair representation of how it aims to achieve its post-expansion interest rate repricing risk management objectives. Therefore, it decides to change its risk management strategy to include additional jurisdiction-level strategies. The effects of the DRM model based on the pre-expansion 'group-level only' risk management strategy do not provide relevant information to users of financial statements about how the group is managing its exposures to interest rate repricing risk based on the revised risk management level. Therefore, the pre-expansion DRM model has to be discontinued and subsidiaries from each jurisdiction have to start applying the DRM model in their own financial statements, the results of which would then be aggregated at consolidated group level at the

A change in strategy	Illustrative example
	reporting date and further adjusted for the revised group level risk management strategy (if necessary).
Risk management time horizon	A bank might set up a time horizon of 5 years for managing interest rate repricing risk, because this is consistent with the time horizon of its lending strategy. Due to changes in the bank's external environment, it decides to shorten the time horizon of its lending strategy to 3 years. This means the bank will have to achieve its risk management objectives over a 3-year period instead of a 5-year period. The effects of the DRM model with the 5-year time horizon no longer provide relevant information to users of financial statements about how the interest rate repricing risk is being managed based on the revised time horizon. Consequently, a DRM model constructed for a 5-year time horizon will have to be discontinued, and replaced by a DRM model constructed for a 3-year time horizon.
Risk management priority	A bank's risk management strategy has historically been based on prioritising the sensitivity in its net interest income (∆NII) over short-term. However, due to changes in the bank's prudential regulatory environment, the bank now changes its risk management strategy to prioritise sensitivity in economic value of equity (∆EVE) instead.

A change in strategy	Illustrative example
	Consequently, the bank will have to change how it manages its interest rate repricing risk to ensure it achieves its new risk management objectives. The DRM adjustment that was based on prioritising ∆NII over short-term will no longer provide relevant information about revised risk management strategy that prioritises protection over ∆EVE variability. Therefore, the bank will discontinue its DRM model based on ∆NII priority, and commence a new DRM model based on ∆EVE priority.
Managed rate (risk aggregation methodology)[2]	A bank decides to change its managed rate from Sterling Overnight Index Average (SONIA) to the central bank's base rate in conjunction with its revised lending strategy. Consequently, the DRM model based on the previous managed rate is discontinued because it is no longer consistent with the revised interest rate repricing risk the bank is managing, and its effects on the financial statements no longer provide users of financial statements with relevant information about the new managed rate.[3]
Key risk metrics	A bank uses the notional repricing gap in underlying financial instruments as the key risk metric in its risk management strategy, divided into repricing periods

[2] Managed rate refers to the specified interest rate risk an entity manages consistent with its risk management strategy. It is therefore the risk that an entity's risk limits are based on.

[3] In some circumstances, such as the Interest Rate Benchmark reform (IBOR reform), a change in the managed rate that is considered to be on an 'economically equivalent' basis might not result in a change in risk management strategy and discontinuation of the DRM model (see paragraph 5.4.8 of IFRS 9 *Financial Instruments* for examples of changes in a benchmark rate that would be considered 'economically equivalent' under the IBOR reform).

A change in strategy	Illustrative example
	consistent with the risk management time horizon. However, the bank decides to change its key risk metric to a present value per basis point of movement in managed rate (PV01), because it is a better representation of how the bank assesses the performance of its interest rate repricing risk management activities. Consequently, application of the DRM model based on the previous risk metric has to be discontinued because it is no longer consistent with how the bank manages its interest rate repricing risk, and therefore it would not provide relevant information to users of financial statements about the bank's revised risk management strategy.

24. Similar to a change in business model for managing financial assets (as described in paragraph B4.4.1 of IFRS 9), we would expect changes in *how* an entity manages a particular risk to be the result of external or internal factors that are expected to impact the entity's operations and are demonstrable to internal and external stakeholders. Because the risk management strategy refers to a structured approach that sets out how an entity assesses, responds to and monitors risk, changes to this approach are expected to be *very infrequent*.

25. On the other hand, changes that reflect the dynamic nature of an entity's exposure to interest rate repricing risk typically occur more frequently and include changes to the RMI, changes to the risk limits within which the CNOP can vary, changes to the underlying financial assets, financial liabilities or future transactions included in the CNOP or changes to the designated derivatives.

26. As noted in paragraph 13 of this paper, although general hedge accounting relationships are discontinued when an entity's risk management objective changes, a change in the RMI is a fundamental element of the DRM model and reflects the dynamic nature of an entity's risk exposure.

27. Changes that reflect the dynamic nature of an entity's exposure to interest rate repricing risk can be appropriately accommodated in the DRM model through the various elements and measurement requirements. Therefore, these changes do not constitute a change in the risk management strategy that requires the discontinuation of the DRM model.

Voluntary discontinuation

28. Another pertinent question to consider is whether voluntary discontinuation of the DRM model is to be permitted.

29. IFRS 9 prohibits voluntary de-designation of a hedging relationship and the discontinuation of hedge accounting when the risk management objective for a particular hedging relationship remains the same, and all the other qualifying criteria are still met (see paragraph B6.5.23 of IFRS 9 and paragraphs BC6.314–BC6.331 of the Basis for Conclusions on IFRS 9).

30. As noted in paragraph 7 of this paper, the IASB previously decided that voluntary discontinuation of the DRM model is not permitted. The staff continue to think this is appropriate, because it safeguards the DRM model from being applied only in circumstances when favourable accounting outcomes can be achieved.

31. Therefore, in the staff's view, if voluntary discontinuation of the DRM model is not permitted, and an entity would also not be permitted to voluntarily:
    (a) remove underlying items that were included in determining its CNOP when these items continue to meet the qualifying criteria; or
    (b) de-designate a designated derivative.

Accounting for the discontinuation of the DRM model

32. As explained in paragraphs 5 and 6 of this paper, the IASB tentatively decided that when an entity discontinues applying the DRM model, the amount recognised in OCI is reclassified to profit or loss over the life of the target profile. However, following the further development of the DRM model, the DRM adjustment is no longer recognised in OCI, and the life of the target profile no longer represents contractual tenor of an entity's financial liabilities and core demand deposits.

33. The staff nevertheless still agree with the previous tentative decision that the DRM adjustment (now recognised as an asset or liability rather than an OCI balance) continues to be recognised in the statement of profit or loss over the risk management time horizon. This will ensure that entities continue to recognise the effects of previous risk mitigation activities up to the point of discontinuation of the DRM model. In addition, it will also ensure that entities are not changing their risk management strategy simply to achieve a specific accounting outcome that is inconsistent with the objective of the DRM model.

34. In the staff's view, an entity would continue to recognise the DRM adjustment in the statement of profit or loss after the discontinuation of the DRM model on either a straight-line basis or another systematic and rational basis over the risk management time horizon, if the underlying items included in the CNOP continue to exist and/or future transactions are still expected to occur (ie the future net cash flows arising from these items are still expected to occur).

35. If the reason for the discontinuation of the DRM model is a change in risk management time horizon, then the DRM adjustment will continue to be recognised in the statement of profit or loss over the original time horizon. This is consistent with paragraphs 6.5.11(d)(ii) and 6.5.12(a) of IFRS 9 that state, when a cashflow hedge is discontinued, reclassification to profit or loss should occur in the same period during which the hedged expected future cash flows affect profit loss, if those hedged cash flows are still expected to occur.

Redesignation of off-market derivatives

36. When the DRM model is discontinued following a change in risk management strategy, an entity might repurpose and redesignate a designated derivate as a hedging instrument in a new hedge relationship (applying the general hedge accounting requirements in IFRS 9) or as a designated derivative in a new DRM model, provided the relevant qualifying criteria have been met.

37. In such a scenario, the derivative is unlikely to have a zero fair value at the date it is redesignated in the new hedging relationship or DRM model. This is because the market conditions at this date are likely to be different to the market conditions at the date the derivative contract was entered into, ie the derivative has off-market terms on the day of the new hedge relationship or DRM designation.

38. As tentatively agreed by the IASB in July 2023 and discussed in Agenda Paper 4C, off-market derivatives would be eligible to be designated derivatives in a new DRM model when their use is consistent with an entity's risk management strategy. However, only the fair value changes that arise after the initial date of redesignation are considered when measuring the new DRM adjustment, therefore avoiding the potential double-counting of fair value changes in both the discontinued and new DRM models. The fair value gains or losses recognised as part of the previous DRM adjustment before redesignation will continue to be recognised in profit or loss as discussed in paragraphs 33−34 of this paper.

Conclusions

39. Based on the analysis included in this paper, in the staff's view:

    (a) a change in an entity's risk management strategy results in discontinuation of the DRM model. A change in risk management strategy refers to a change in the managed interest rate risk or how the entity manages that risk. In contrast, any other changes in risk management activities that reflect the dynamic nature

of the entity's exposure to interest rate repricing risk does not result in discontinuation of the DRM model;

(b) changes in how an entity manages interest rate repricing risk are expected to be very infrequent and to be the result of external or internal factors that are expected to impact the entity's operations, and are demonstrable to internal and external stakeholders;

(c) an entity is neither permitted to voluntarily discontinue applying the DRM model nor to voluntarily:

  (i) remove underlying items that were included in determining its CNOP when these items continue to meet the qualifying criteria; or

  (ii) de-designate a designated derivative;

(d) upon discontinuation of the DRM model, the DRM adjustment is recognised in the statement of profit or loss on either a straight-line basis or another systematic and rational basis over the risk management time horizon, if the underlying items included in the CNOP continue to exist and/or future transactions are still expected to occur; and

(e) when an entity discontinues its DRM model, it is permitted to repurpose and redesignate derivatives in a new hedge relationship or in a new DRM model, provided the qualifying criteria have been met. However, only the fair value changes that arise after the date of initial redesignation are considered when measuring the new DRM adjustment.