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Dynamic Risk
Management Project

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Executive Summary

The International Accounting Standards Board (“IASB”) has made considerable progress over the last two years with its Dynamic Risk Management (“DRM”) project and is planning to issue an exposure draft in 2025. The objective of this project is to develop an accounting model that will enable users of financial statements to understand the effect of an entity’s dynamic risk management of repricing risk due to changes in interest rates, and to evaluate the effectiveness of those risk management activities. Such risk management practices are predominantly used by banks and building societies.

The proposed DRM model is still a work in progress, but some of its core features, based on the IASB’s tentative decisions to date, are beginning to emerge. The proposed model aims to be closely aligned with current risk management practices by relaxing the eligibility requirements for hedged items (e.g., to include demand deposits) to be designated in a hedge accounting relationships. The proposed DRM model also aims to reduce some of the operational burden currently associated with the portfolio fair value hedging requirements of IAS 39¹ (e.g., addressing the current inability to designate net risk positions). The single model would also apply to hedging combined portfolios with both fixed and floating rate exposures, unlike IAS 39/IFRS 9 which have different hedge accounting requirements for hedging portfolios of fixed rate exposures versus floating rate exposures.

The mechanics of the proposed DRM model framework incorporate principles of both fair value and cash flow hedge accounting. In the proposed model, a DRM adjustment is calculated as the lower of:

- (i) the cumulative change in fair value of a ‘*Benchmark Derivative*’; and
- (ii) the cumulative gain or loss on the ‘*Designated Derivative*’, recognised as an asset or liability on the balance sheet with the corresponding amount recognised in profit and loss.

As part of the next DRM project milestone, the IASB will consider and conclude on other key challenges, e.g. the disclosure requirements for DRM adjustments, hedge documentation, consideration of non-linear derivatives (e.g. options) and off-market derivatives.



1. IAS 39 Financial Instruments: Recognition and Measurement (“IAS 39”) was replaced by IFRS 9 Financial Instruments (“IFRS 9”) for financial reporting periods beginning on/after 1 January 2018. The IFRS 9 hedge accounting framework applies to all hedge accounting relationships, except for portfolio fair value hedges (for which an alternative to the IAS 39 framework does not yet exist).

Introducing the Dynamic Risk Management Project

The DRM has moved on to the standard-setting stage with an exposure draft expected by 2025

Many financial institutions dynamically manage interest rate risk exposures, which frequently change over time, and seek to economically hedge the residual net interest rate risk arising from asset and liability mismatches. Hedge accounting for dynamic portfolios of hedged items is referred to as “portfolio” or “macro” hedging and can currently only be applied in accordance with the requirements of IAS 39.

However, the current requirements are complex and operationally cumbersome to meet, and there are some restrictions with regards to the eligibility of hedged items for hedge accounting. In many situations, hedge accounting cannot be applied for the economic hedge, leading to entities either not applying hedge accounting, or identifying alternative eligible items in their balance sheet for hedge accounting purposes. These limitations make it difficult for organisations to properly reflect their dynamic risk management strategies in their financial reporting.



Status of the DRM project

In recognition of the issues and complexities with applying portfolio hedge accounting under IAS 39, the IASB initiated the DRM project with a discussion paper issued in 2014. However, the discussion paper feedback from market participants on the model proposing the ***Portfolio Revaluation Approach*** identified certain key limitations with the model, which was based on a full revaluation of the hedged portfolio (as opposed to focusing on the portion of the portfolio giving rise to accounting mismatches), that led the IASB to reconsider its approach.

Since then, the IASB has been developing a new DRM model that seeks to address the concerns raised previously. The feedback from outreach programme on the elements of the new model proposal has proven generally positive. The IASB sought to address stakeholder concerns of potential volatility in Other Comprehensive Income (“**OCI**”) which would have a negative impact on capital. Under the DRM, the IASB has opted for a “hybrid” model approach which uses the mechanics of both cash flow and fair value hedge accounting, limiting volatility in profit or loss but without the use of OCI.

The IASB has moved the DRM project to its standard-setting programme and intensified discussions, with tentative decisions, over the proposed model. The IASB aims to issue the exposure draft for the proposed DRM model in 2025. This paper discusses some of the features of the proposed model with some simplified illustrative examples.



Introducing the Dynamic Risk Management Project (cont)

The DRM has moved to the standard-setting stage with an exposure draft expected by 2025

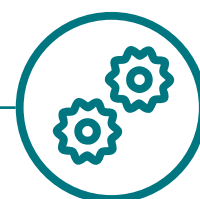
Key issues with IAS 39 portfolio fair value hedge accounting

- The IAS 39 portfolio fair value hedge accounting framework treats an open portfolio of hedged exposures as a series of closed portfolios (i.e., by periodic discontinuation of the hedge accounting relationship for the previous closed portfolio and by designation of a new hedge accounting relationship for a revised closed portfolio). This gives rise to operational complexities, and the IAS 39 requirements are often onerous to apply.
- IAS 39 requires entities to identify eligible assets and/or liabilities and designate them as hedged items on a gross basis to qualify for hedge accounting. However, it is common for risk exposures to be managed on a net basis. The IAS 39 restrictions can result in risk management activities not being faithfully represented in the financial statements.
- The eligibility conditions for hedged items to be designated in a portfolio fair value hedge accounting relationship under IAS 39 are restrictive and do not allow for the designation of core demand deposits or business which has been written but is not contractually committed (e.g. pipeline hedging).

Objectives of the DRM Project

The objective of the DRM is to better reflect an entity's dynamic risk management strategies and activities in the financial statements. As such, the application of the DRM model should provide useful information to enable users of financial statements to understand:

1. The entity's dynamic risk management strategy and how it is applied to manage repricing risk due to changes in interest rates;
2. How the entity's application of dynamic risk management practices may affect the nature, timing and uncertainty of future cash flows; and
3. The effect that dynamic risk management has had on the entity's financial position and financial performance.



Aligning hedge accounting with risk management

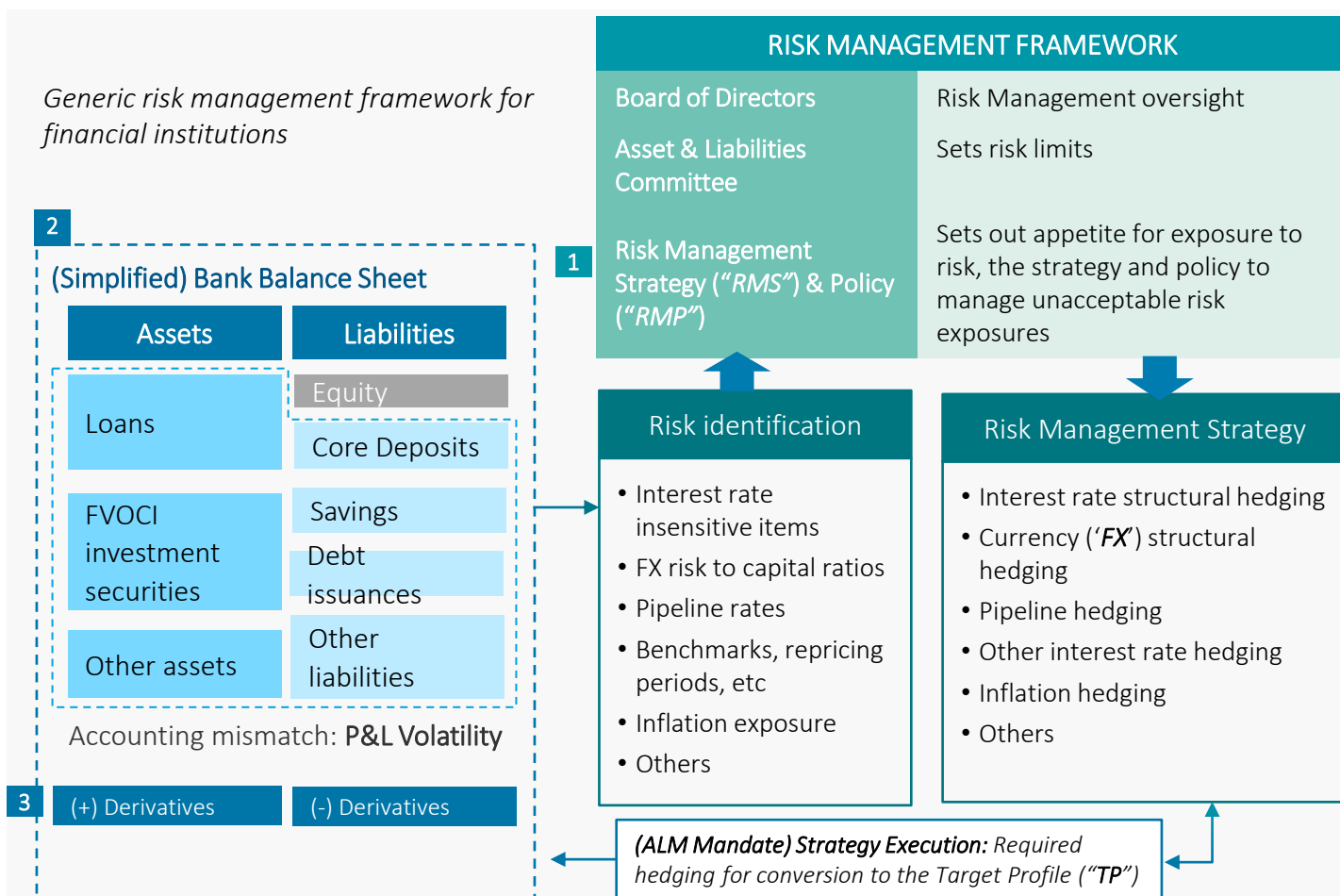
An accounting framework to bridge the gap between interest rate risk management practices and financial reporting

A bank's business model can be described as collecting deposits and issuing debt / equity to fund loans to customers, while also investing excess available cash to increase returns to shareholders. As a result, the bank's earnings are primarily derived from the difference between interest earned on assets and interest paid on liabilities, referred to as "net interest margin" ("NIM"). Given that assets tend to be longer-dated than the liabilities, this exposes the bank to interest rate risk.

A key objective for a bank of managing interest rate risk is to stabilise and optimise NIM. As a general practice to manage the interest rate risk, banks consider their full balance sheet exposure to interest rate risk, including structural balances (e.g., demand deposits and issued equity). Structural balances do not have cash flows with contractually specified timings, hence modelling (i.e. behavioural analysis) is required to match the various asset and liability positions to stabilise NIM. Managing interest rate risk involves frequent adjustments to the position at risk due to changes in market interest rates, the behavioural profile of customers and ongoing commercial activities.

Below is a generic risk management framework illustrating how a bank's balance sheet gives rise to different types of risks. These risks are economically hedged using derivatives in accordance with the bank's risk management strategy.

Risk Management



DRM model accounting framework

The current proposal results in a hybrid accounting framework combining fair value and cash flow hedge accounting principles

The IAS 39 portfolio fair value hedge accounting requirements have limitations regarding the designation of structural balances in interest rate risk management for hedge accounting purposes. The proposed DRM model aims to bridge the gap between risk management practices and the accounting requirements by removing some of these restrictions.

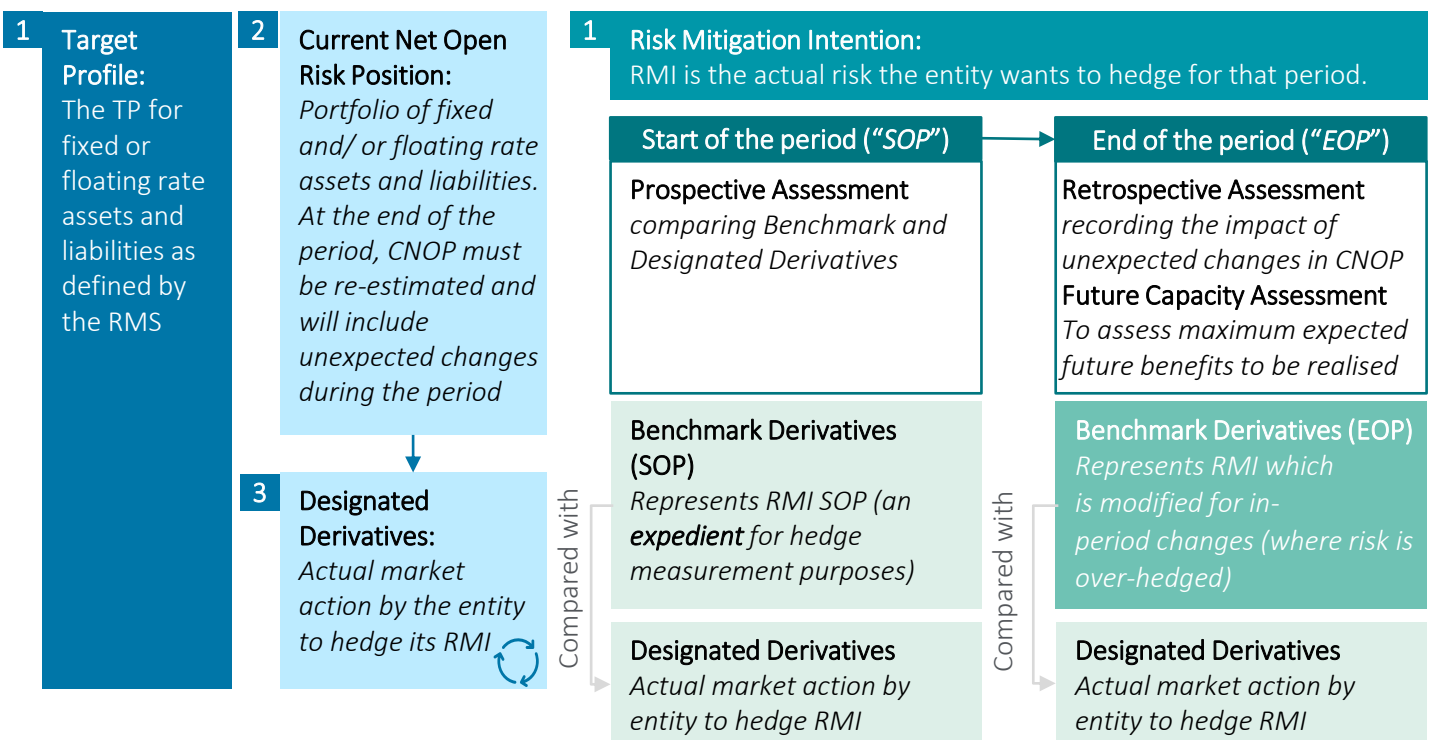
The proposed DRM model draws on many of the characteristics of a bank's risk management activities (e.g. net position hedging) which aims to better align risk management with financial reporting for the industry. In addition, the eligibility, for designation in a hedge accounting relationship, of some of the balances resulting from an entity's core risk management activities has now been tentatively accepted for the new DRM model (refer to p8 for a discussion on eligibility of hedged items).

The proposed framework introduces new concepts, which are defined below. Ultimately, the objective is to compare the TP, defined in the RMS, with the Current Net Open Risk Position ("CNOP") to determine the Risk Mitigation Intention ("RMI"). This determines the exposure hedged and is compared to the actual derivatives executed.

Accounting



Dynamic Risk Management



Retrospective assessment is designed to capture the effect of over-hedging of risk arising from unexpected changes in CNOP.

DRM model accounting framework (cont)

The IASB has set out the initial structure of the DRM model to align to an entity's existing risk management practices

1. Risk Management Strategy and Target Profile

The RMS is established to determine how an entity manages its risk. The RMS should identify the risks to which the entity is exposed and set out how the entity responds to them.

The "**Target Profile**" is defined as the range (risk limits) within which the CNOP can vary while still being consistent with the entity's RMS. The specification and documentation of the TP is one of the qualifying criteria before the DRM model can be applied and should be in place at inception of the hedge.



2. Current Net Open Risk Position

The interest rate risk position (by maturity ("time") buckets) is derived from the combination of expected (i.e., modelled) cash flows from assets, liabilities, and eligible future transactions (i.e., expected reinvestment or refinancing cash flows and other highly probable future transactions) over the period during which the entity is managing repricing risk.

This represents the interest rate risk position of the entity before considering any instruments that are being used for the mitigation of interest rate risk (i.e., Designated Derivatives). The qualifying criteria for designation of financial assets and financial liabilities in the DRM model has been tentatively decided by the IASB².

Based on the methodology used to derive the CNOP and considering the proposed DRM model accounting framework, any hedge accounting and interest rate risk monitoring would be considered on a net position basis, which is consistent with a bank's risk management practices. Considering the eligibility of future transactions in the DRM, an entity would be able to model open portfolios, expected reinvestment or refinancing cash flows and other future transactions subject to meeting the highly probable criteria.



3. Risk Mitigation Intention and Benchmark Derivatives

It has been proposed that the RMI will be defined as the extent to which an entity intends to mitigate the CNOP using derivatives, consistent with its risk management strategy. The RMI needs to be evidenced by an entity's actions taken to mitigate risk (such as derivatives traded in the market with external counterparties, i.e., "**Designated Derivatives**").

The RMI would be determined at the start of the DRM assessment period, documented and represented via the construction of the "**Benchmark Derivatives**", and not subject to amendment retrospectively. The Benchmark Derivatives are theoretical derivatives representing the entity's RMI for hedge measurement purposes.



2. See agenda paper 4A "**Summary of tentative decisions**" of April 2023 IASB meeting for detailed analysis.

<https://www.ifrs.org/content/dam/ifrs/meetings/2023/april/iasb/ap4a-summary-of-tentative-decisions-and-glossary-of-defined-terms.pdf>

Items eligible to be designated in the DRM model

Increased eligibility of hedged items under the DRM model is expected to help align financial reporting with risk management activities

Measurement of the DRM adjustment

1. The Designated Derivatives continue to be measured at fair value in the statement of financial position with gains / losses recognised in profit or loss.
2. The DRM adjustment is recognised in the statement of financial position, as the lower of:
 - 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 Benchmark Derivatives (a proxy for measuring the hedge item).
3. The net gain or loss calculated in accordance with (a), and the DRM adjustment calculated in accordance with (b) would be recognised in profit or loss.

Eligibility of hedged items

The IASB has tentatively decided that the DRM model will allow the inclusion of core demand deposits as hedged items in the CNOP based on an entity's risk management strategy, provided those deposits have a demand feature and are interest rate insensitive.

IAS 39 only allows 'highly probable' forecast transactions to be designated as eligible hedged items in a cash flow hedge accounting relationship, whereas the proposed DRM model has relaxed the eligibility requirements to allow both the inclusion of highly probable future transactions as well as forecast transactions related to the reinvestment or refinancing of balance sheet items which are 'expected to occur, in the CNOP.

Eligibility of hedged items	IAS 39 PFVH ³ model	Proposed DRM model
Fixed rate financial assets or financial liabilities measured at amortised cost	Yes	Yes
Expected reinvestment or refinancing of balance sheet items and other 'highly probable' future transactions (e.g., forecast and pipeline transactions)	No ⁴	Yes
Firm commitments	Yes	Yes
Financial assets measured at FVTOCI	Yes	Yes
Core demand deposits	No	Yes
Equity	No	No

3. Portfolio fair value hedge accounting model

4. Highly probable forecast / future transactions are only eligible for designation in a cash flow hedging relationship under IFRS 9 and IAS 39

Items eligible to be designated in the DRM model (cont)

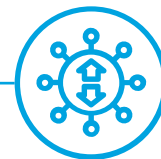
Ongoing deliberations regarding the eligibility of hedged items

The IASB received mixed feedback from various stakeholders on whether equity should be an eligible hedged item in the DRM model. Below is a summary of the feedback received from stakeholders as well as the IASB's rationale for tentatively deciding not⁵ to include equity as an eligible hedged item in the DRM model.



Stakeholders' view on the inclusion of equity:

- Some stakeholders consider that inclusion of equity helps to achieve the objective of the DRM Project to better reflect the impact of an entity's dynamic risk management activities in the financial statements. Allowing the inclusion of equity as a hedged item captures overall interest rate variability more faithfully and avoids the need for proxy hedging.
- Inclusion of equity is similar to the inclusion of core demand deposits that an entity uses to determine the net risk profile of the balance sheet (i.e., both are non-interest-bearing funding instruments with no fixed maturity).



The IASB's view on the inclusion of equity:

- The IASB challenged the view of stakeholders on the inclusion of equity in the DRM model and considered that when equity is used as a source of funding, the impact on the overall interest rate risk exposure is determined by the characteristics of the designated assets (that are funded by equity) instead of the equity which does not give rise to variability in either economic value or NIM. Therefore, in the IASB's tentative view, including equity instruments in the DRM model cannot be justified.
- The IASB also noted that there is a significant difference between including equity in the DRM model compared to including core demand deposits, despite both being non-interest-bearing. This is because, from an economic perspective, the fair value of a portfolio of non-interest-bearing core demand deposits changes when benchmark interest rates change (when customer behaviour is taken into consideration). In contrast, when interest rates change, there may not be a meaningful corresponding change in the fair value of equity.

5. See agenda paper 4A "Managing equity" of November 2022 IASB meeting for detailed analysis. <https://www.ifrs.org/content/dam/ifrs/meetings/2022/november/iasb/ap4a-managing-equity.pdf>

Simplified example: a conceptual understanding

The current proposal results in a hybrid hedge accounting framework with elements of both fair value and cash flow hedge accounting

Below is a simplified example illustrating the mechanics of the proposed DRM model:

- An entity has a £1,200 principal of prepayable fixed rate assets, £1,100 principal of floating rate, term liabilities and £100 of fixed rate liabilities (core demand deposits). The entity has determined the exposure for each year based on the behavioural life of the portfolios maturing in 5 years.
- The entity's RMS is to manage the change in economic value of equity ("*EVE*") due to fair value movements caused by changes in interest rates. The entity's RMI is to fully mitigate its interest rate risk exposure. In short, the entity intends to fully convert its fixed rate exposure to a floating rate exposure.
- To achieve the RMI, the entity enters into an interest rate swap whereby the entity pays a fixed rate of interest and receives a floating rate of interest as presented in the table below.
- At the start of each period, the entity performs a prospective assessment to ensure that the RMI transforms the CNOP to a residual risk position within the target profile and does not lead to an over-hedged position.

Details	20X1	20X2	20X3	20X4	20X5
Current Net Open Risk Position					
Total fixed rate exposure (<i>prepayable assets including core demand deposits</i>)	1,100	1,100	1,100	1,100	1,100
Total floating rate exposure (<i>term liabilities</i>)	(1,100)	(1,100)	(1,100)	(1,100)	(1,100)
Risk Mitigation Intention	Fully mitigate interest rate risk exposure				
Benchmark / (Designated) Derivative	Designates a 5-year, pay-fixed / receive-floating interest rate swap				
Fixed exposures	(1,100)	(1,100)	(1,100)	(1,100)	(1,100)
Floating exposures	1,100	1,100	1,100	1,100	1,100
Management priority	Δ in EVE	Δ in EVE	Δ in EVE	Δ in EVE	Δ in EVE
Prospective Assessment	Pass	Pass	Pass	Pass	Pass

At the end of each period, the entity assesses its net open risk position, considering any unexpected changes in the profile, and compares this against the RMI.

Simplified example: a conceptual understanding (cont)

The current proposal results in a hybrid hedge accounting framework with elements of both fair value and cash flow hedge accounting

Retrospective assessment and unexpected changes

Consider the following scenarios:

Scenario 1: Where the CNOP has changed due to changes in the behavioural expectation of prepayable assets, and the entity expects to receive £400 of cash flows on prepayable assets one year earlier (i.e., at the beginning of 20X5). The effect of unexpected changes on the RMI must be captured where the Designated Derivatives are over-mitigating the risk. In such a case, the entity updates the Benchmark Derivative (e.g. through the construction of an additional Benchmark Derivative) to capture the unexpected changes in CNOP.



Changes in fair values of the Benchmark and Designated Derivatives will be used for the measurement of the DRM adjustment (based on the 'lower-of' test) and, consequently, unexpected changes in the CNOP can create volatility in profit or loss.

Details	20X1	20X2	20X3	20X4	20X5
Current Net Open Risk Position					
Total fixed rate exposure (<i>prepayable assets less fixed rate liabilities</i>)	-	1,100	1,100	1,100	700
Total floating rate exposure (<i>term liabilities</i>)	-	(1,100)	(1,100)	(1,100)	(1,100)
Risk Mitigation Intention					
Fixed exposures	-	1,100	1,100	1,100	1,100
Floating exposures	-	(1,100)	(1,100)	(1,100)	(1,100)
Management Priority	-	Δ in EVE	Δ in EVE	Δ in EVE	Δ in EVE
Retrospective Assessment	-	Pass	Pass	Pass	Fail
Unexpected changes	-	-	-	-	(400)
Updated Benchmark Derivative⁶	-	1,100	1,100	1,100	700

6. Includes additional Benchmark Derivative constructed to capture the effect of unexpected changes in the CNOP.

Simplified example: a conceptual understanding (cont)

The current proposal results in a hybrid hedge accounting framework with elements of both fair value and cash flow hedge accounting



Scenario 2: Where the CNOP has not changed, there would be no misalignment in RMI. There would be no volatility in the profit or loss as the entity has managed to fully mitigate its exposure to interest rate risk (assuming that the terms of the Benchmark Derivatives perfectly mirror those of the Designated Derivatives and there are no other sources of ineffectiveness).

Details	20X1	20X2	20X3	20X4	20X5
Current Net Open Risk Position					
Total fixed rate exposure (<i>prepayable assets less core demand deposits</i>)	-	1,100	1,100	1,100	1,100
Total floating rate exposure (<i>term liabilities</i>)	-	(1,100)	(1,100)	(1,100)	(1,100)
Risk Mitigation Intention		Fully mitigate interest rate risk exposure			
Designated / Benchmark Derivative	-	1,100	1,100	1,100	1,100
Unexpected changes	-	-	-	-	-

In both scenarios, the entity also performs a capacity assessment⁷ to ensure that the DRM adjustment is not recognised at an amount higher than the expected benefit of reduced variability to be realised in future (i.e., that any over-hedging is reflected in profit or loss). Any excess of the DRM adjustment over the fair value of an entity's CNOP is recognised in profit or loss during the period of the assessment.

7. See agenda paper 4B "Performance assessment and unexpected changes", February 2023 IASB meeting for further explanation.
<https://www.ifrs.org/content/dam/ifrs/meetings/2023/february/iasb/ap4b-drm-performance-assessment-and-unexpected-changes.pdf>

What's next for the IASB?

Next steps for development of the DRM model

Next Steps

In April 2023, the IASB set out items to be considered further in order to complete the development of the proposed DRM model, together with a potential order of future discussions for the next stage of the DRM Project. These are as follows:

- Eligible hedged items for determining the CNOP
- Inclusion of non-linear derivatives (e.g. interest rate options) and off-market derivatives
- Performance assessment and subsequent unwinding of the DRM adjustment
- Discontinuation events for the DRM model
- Presentation and disclosure requirements. Areas of focus would be:
 - Presentation of DRM adjustments in the statement of financial position and subsequent release to profit or loss;
 - Describe qualitatively and quantitatively the RMS and the entity's ability to achieve it; and
 - Understand the impact of an entity's risk management actions on its current and future economic resources
- Transition and effective date.

Latest meeting decisions were made – July 2023

During its July 2023 meeting, the IASB tentatively decided that:

- Non-linear derivatives, except for net written options, are eligible as Designated Derivatives in the DRM model.
- Off-market derivatives (for example derivatives that have a non-zero fair value at the time of the designation in a hedging relationship) are eligible as Designated Derivatives in the DRM model.
- Different currencies should be allocated to separate DRM models.
- An entity is permitted to include aggregate exposures (combination of hedged items and hedging instruments that are designated in a hedge accounting relationship when applying IFRS 9) in the CNOP if doing so it is consistent with the entity's risk management strategy

The timing of when some of the remaining items above will be discussed is currently uncertain and the IASB may need to conduct further outreach or research activities before proceeding. Furthermore, due to the interactions between these items, the IASB envisages that there may be a need to assess the linkage of the decisions between these items as the project progresses.

What's next for your organisation?

Key pre-implementation activities



What's next for your organisation?

Transition to the DRM framework will require significant changes to established portfolio hedging processes, controls and related models. Those changes will be far-reaching and will create impacts for your organisation beyond the accounting / financial reporting function.

On models and systems particularly, whatever the chosen response, e.g., build new models, purchase new off-the-shelf DRM products or in-house developed systems, the time taken to select and implement those systems is likely to be significant, particularly when considering the evaluation, design, implementation and testing of any solutions implemented. In addition, the data requirements to identify the CNOP and any unexpected changes are likely to be extensive and dependent on multiple upstream systems

A clear and robust governance framework with the right level of oversight and experience will be fundamental for the successful implementation of the DRM framework. This will draw from various stakeholders & functions – such as Risk, Finance, Front-office, Financial Reporting, Treasury, IT etc.

In the short term, entities should be evaluating the proposals made by the IASB for internal discussion, as well as engaging with other market participants to ensure that the proposals in the exposure draft are suitable for application while there is still time to influence decisions being made.

For larger institutions, while the exposure draft will be issued in 2025 with an additional transition period, 2024 will be a critical year to begin mobilising a team to establish the governance of the transition program, with some key activities expected to be (this list is not exhaustive):

- i. understand current portfolio hedging processes across geographies and functions;
- ii. build a stakeholder map and an initial plan;
- iii. consider recruitment strategy for a complex technical area of the accounting/reporting framework; and
- iv. identify transition program risks.

Without doubt, such significant changes present technical and operational complexities that will need to be navigated carefully, however, the potential advantages (reduced volatility in profit or loss and release of capital) are a great incentive to start as early as possible.

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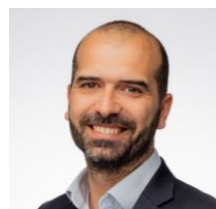
Aisling Kavanagh

Partner
Treasury Assurance
+44 20 7303 4663
akavanagh@deloitte.co.uk



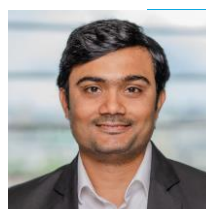
Alex Armstrong

Director
Treasury Assurance
+44 7535 883835
alarmstrong@deloitte.co.uk



Vitor Gomes

Director
Treasury Assurance
+44 7716 080713
vhgomes@deloitte.co.uk



Piyush Jhanwar

Manager
Treasury Assurance
+44 7557 253831
pjhanwar@deloitte.co.uk



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