

# Preparing for the Dynamic Risk Management Accounting Model (Updated August 2025)

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## PURPOSE OF THIS UPDATE

This is an update to a May 2024 paper, as further tentative decisions have been made by the International Accounting Standards Board (IASB) since publication. This paper revises the May 2024 version, with changes in black line for ease of review. It includes insights and observations on all key tentative decisions to date ahead of the publication of the exposure draft in the fourth quarter of 2025.

## INTRODUCTION

The IASB has a project underway to develop a new model to account for dynamic risk management (DRM) activities under International Financial Reporting Standards (IFRS). It is widely expected that banks will need to apply this model, which could replace existing macro-hedge accounting models within IFRS. ~~The IASB will also explore whether the DRM model could be applied to other risk types at a future date.~~

The DRM model will be applicable to entities that meet the following criteria:

- Exposed to interest rate repricing risk;
- Have a dynamic risk management strategy that has a dual risk mitigation objective (stabilization of net interest income (NII) and the economic value of equity (EVE));
- Have an established and systematic process to determine risk and risk exposure; and
- Have access to liquid markets.

There is currently uncertainty over whether the DRM model would apply to different industries/risks. In this regard, the IASB has decided to gather more information from insurers about their risk management strategies. The DRM model, which is principles based and optional in nature, could potentially be applied to all those entities that meet the criteria.

This whitepaper sets out ISDA's preliminary observations on the tentative decisions made by the IASB to date. These observations are based on the current understanding of the model and interpretations of ongoing discussions, but they do not represent a formal industry view, which will not be possible until the IASB publishes ~~a discussion paper, an the exposure draft or a set of deliberations, which is expected in the fourth quarter of 2025.~~

The paper outlines the challenges posed by the existing IFRS in accounting for how portfolios of interest rate risk are managed, and how the key components of the DRM model could address those challenges. This is achieved by providing preliminary observations on the principles of the model, areas to be addressed before the model is finalized and an outline of the key operational challenges.

The paper is most relevant for banks and other financial institutions that conduct DRM activities reported under the macro-hedging models in IFRS and for those using the EU-endorsed version of International Accounting Standard 39 (IAS 39), also known as carve-out fair value hedge (COFVH) accounting. It is also relevant for users of financial statements that need to understand the challenges and outcomes of the DRM model and how these will affect their assessment of the financial statements and associated forecasts. In addition, it is relevant for entities that apply other accounting frameworks, such as US Generally Accepted Accounting Principles (US GAAP), and are interested in understanding how developments in the DRM model will affect reporting by their peers.

ISDA has a global membership and is uniquely positioned to provide a perspective on the DRM model that reflects the IASB's global constituency. ISDA appreciates the IASB's progress so far in developing the DRM model and shares its commitment to the successful completion of the project.

## EXECUTIVE SUMMARY

While it is complex and still evolving, the DRM model has the potential to make significant progress in better aligning accounting with actual risk management and contributing to greater stability in NII and/or economic value, as well as leading to more meaningful communication with investors and regulators in respect of interest rate risk management and the accounting outcomes that result from these activities.

The main objective of this paper is to stimulate discussion on the current DRM deliberations across ISDA's global membership while providing constructive feedback to the IASB on the proposals; discuss the tentative decisions made by the IASB ahead of the exposure draft expected in the fourth quarter of 2025 and the follow-up field testing in order to identify areas where the principles-based nature of the future model requires entities to exercise significant judgment and to outline preliminary observations on areas of operational complexity. The field test may be difficult to perform and have reduced relevance if significant issues identified from the IASB's initial discussions are not addressed in the exposure draft.

The IASB initiated the DRM project to address shortcomings in the hedge accounting requirements in IAS 39 and IFRS 9. These are based on the construct that hedge accounting should report the consequences of hedging individual items or closed portfolios of items on a gross basis. This is not aligned with the way risk managers in financial institutions hedge risks, most notably interest rate risk. This is hedged on a net basis and encompasses a combination of fixed and floating rate exposures, which ultimately represent an economic exposure within an open portfolio of fungible items.

This paper explores the key components of the DRM model and sets out preliminary observations on how those components could represent commonly used risk management strategies. These include net interest margin (NIM) stabilization/optimization, sensitivity of NIM, modelled equity and EVE, among others.

The DRM model relies on several key elements that represent the key components of a risk management strategy for an open portfolio. These elements are supplemented by specific accounting constructs that are designed to report the consequences of those elements within the IFRS financial statements.

The key elements are:

- Risk management strategy: Covering all aspects of how entities identify and respond to the risks to which they are exposed.
- Target profile: Covering the profile entities aim to achieve as a result of applying their risk management strategy. This is governed by strict risk limits that can vary within a range, provided they are consistent with the risk management strategy.
- Current net open risk position (CNOP): Representing the net exposure that is subject to risk management activities. It includes eligible financial assets, eligible financial liabilities, and future transactions/items.
- Risk mitigation intention (RMI): The extent to which an entity intends to hedge its CNOP and the level of adherence to the target profile. This represents the hedged net exposure and is represented by the benchmark derivatives, which are a mathematical expedient to represent the hedged exposures. The RMI is evidenced by the designated derivatives.

- **Accounting representation:** This includes the accounting requirements designed to represent the outcome of risk management in financial statements. It encompasses the recognition and ongoing assessment of the DRM model adjustment, as well as the reporting of the performance of designated hedges, including hedge ineffectiveness.
- **Discontinuation (termination):** A change in an entity's risk management strategy results in discontinuation of the DRM model. Voluntarily discontinuation is not permitted.

There is support for the IASB's objective to develop a model that will provide a principles-based approach and can be applied to hedges of open portfolios of interest rate risk managed on a dynamic basis.

There are some areas banks will need to consider carefully as they assess how the model would be applied:

- The DRM model is not fully aligned with risk management practices. As a result, solutions will need to be found where the model cannot accommodate certain strategies, most notably equity. This highlights the need for consideration of proxy hedging and how this interacts with the design and boundaries of the model.
- Certain components of risk management strategies, which have been subject to tentative IASB decisions, require careful consideration. Most notably, these include the non-linear exposures, such as loan commitments and pipeline trades, which stem from the fact that risk managers look at behavioral patterns and often use bottom layers to establish the volumes of transactions to be included in the risk management view. Where the DRM model cannot accommodate such strategies, this will result in misalignment with the risk management view. Other areas include, but are not limited to, additional tier-one (AT1) issuances, foreign currency denominated aggregated exposures (specifically for entities applying IAS 39) and risk components.
- The principles-based nature of the DRM model requires entities to exercise significant judgment, which is necessary because the model aims to provide an entity-specific view. Key judgments will include, but are not limited to, incorporation of equity in the CNOP, modelling of core deposits, and non-linear exposures.
- The DRM model will also bring significant operational challenges, most notably the establishment of a robust governance process involving key functions such as treasury, risk and finance, as well as significant changes to processes and systems. The existence of taxonomy-based tools, such as the Common Domain Model (CDM), may prove useful for tracking and substantiating the effects of the DRM model as part of a robust control framework.
- There are significant parts of the DRM model ~~that are yet to be fully considered, or where further clarification and guidance with support from is anticipated in the industry is required the exposure draft~~. These mainly include the eligibility of certain items, such as equity, pipeline trades and AT1s, ~~discontinuation or accounting representation. how these will be incorporated into the DRM model and how the DRM adjustment is recognized in profit and loss over time~~. In addition, the modelling of the behavior of core demand deposits will need to be considered, including how lifecycle events such as changes in volumes and the price sensitivity (beta convexity) of core deposits (including the ones where entities have discretion in relation to their remuneration) would be incorporated into the model, ~~accounting mechanics (including discontinuation), presentation and disclosure~~.

In March 2024, ISDA carried out a survey to support the development of this paper. The results, which are presented later in the paper, highlight the wide range of awareness and understanding of this project across jurisdictions. While there is general agreement on the key topics and areas of concern, there has been greater engagement from European banks due to the extensive use of macro hedging in the region.

## OUTLINE

The IASB is currently developing an accounting approach to be applied to risk management activities that follow dynamic processes in managing portfolios of interest rate risk. The board plans to consider other risks and entities in due course<sup>1</sup>.

Adoption of the DRM model would entail moving away from traditional hedge accounting approaches that designate individual hedging instruments against specifically identified hedged items. Instead, the model can be applied to an entity's risk management strategy that manages open portfolios of risk, establishes an acceptable risk range within which exposures can vary, and aims to provide better information about the effects on financial performance of such risk management strategies to investors and other users of financial statements.

The model is expected to provide an entity-specific view of those activities, which is derived from a globally consistent, principles-based approach that aims to reduce the diversity of existing accounting practices. An exposure draft is expected in ~~2025~~ the fourth quarter of 2025<sup>2</sup>, with an effective date not expected before ~~2028~~ 2029.

This paper explains the status of the project and sets out common observations from ISDA's membership on certain elements of the model. The observations cover a representative sample of risk management strategies and approaches for interest rate risk management in the banking book (IRRBB), as follows:

- Net interest margin (NIM) stabilization;
- NIM optimization within risk limits;
- Sensitivity of NIM;
- Earnings at risk;
- Management of interest rate risk in excess cash/residual assets (used as a proxy to represent own equity);
- Modeled equity; and
- EVE.

The paper also notes that shortcomings in the portfolio fair value hedge accounting model in IAS 39 have been subject to specific jurisdictional overlays when the standard was endorsed. The most relevant one is the COFVH in the EU, which has been a widely accepted accounting practice in certain European jurisdictions for nearly 20 years.

ISDA's mission to foster safe and efficient derivatives markets is consistent with the IASB's objective for IFRS to provide a globally consistent language for the financial position and performance of reporting entities.

<sup>1</sup> Dynamic Risk Management: Project Direction, May 2022, [www.ifrs.org/content/dam/ifrs/meetings/2022/may/iasb/ap4b-project-direction.pdf](http://www.ifrs.org/content/dam/ifrs/meetings/2022/may/iasb/ap4b-project-direction.pdf)  
International Financial Reporting Standards (IFRS) Staff Paper, Paragraph 24 states: "As the DRM model is further developed, one of the areas for consideration would be to determine whether the model is suitable to be applied to risks other than interest rate risk or by entities other than banks."

<sup>2</sup> IFRS Accounting Work Plan, March 2025, [www.ifrs.org/content/dam/ifrs/meetings/2025/march/iasb/ap8-work-plan-update.pdf](http://www.ifrs.org/content/dam/ifrs/meetings/2025/march/iasb/ap8-work-plan-update.pdf). Paragraph 9 states that the exposure draft is expected to be published in the fourth quarter of 2025

ISDA's members operate a range of different practices for interest rate risk management, so the issues being addressed by the DRM model are very relevant. ISDA can therefore provide the IASB with a unique and constructive perspective on the benefits and challenges when these are assessed against the principles of the DRM model.

To this end, ISDA established a working group comprising several large banks that report under IFRS from jurisdictions around the world and gathered their views on key principles and areas of challenge, both from a conceptual and operational perspective. The paper also considered the views of the wider ISDA membership affected by the proposal.

In addition, ISDA developed a survey covering the key aspects of the DRM to gather a wider view of the key issues. The results of the survey are summarized later in the paper and are available in full on the ISDA website.

## CHALLENGES WITH THE CURRENT IFRS HEDGING FRAMEWORK

The DRM project has been initiated to address the shortcomings of existing hedge accounting models under IFRS and resulting practices. Most notably, these models have not been designed to deal with dynamic hedging of open portfolios, which means ongoing changes to the risk position are required. This creates challenges for reporting entities as they have had to rely on 'proxy' positions to report the results of activities conducted by risk managers.

The key issues identified are:

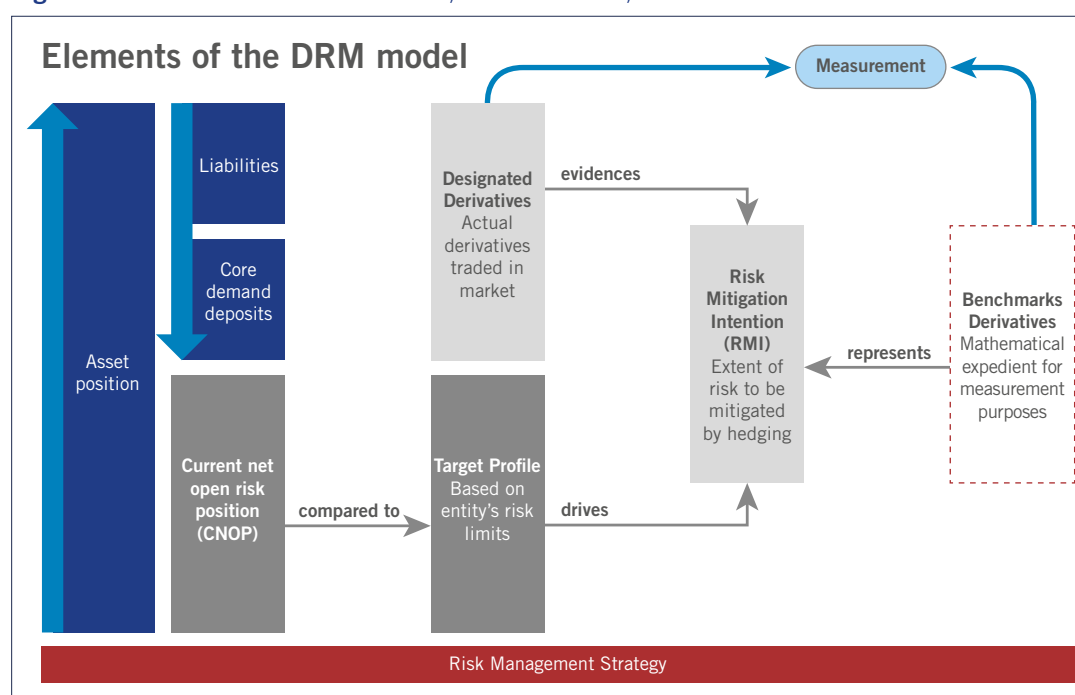
1. Traditional hedge accounting requirements are designed for 'closed portfolios', where specific hedging instruments are linked to designated hedged items for a set period of time. This approach often doesn't align with banks' actual risk management activities as these entities deal with portfolios of interest rate risk, which are dynamically managed with regular changes to the risk position of fungible items. The available hedge accounting approaches do not reflect actual risk management practices, which creates the need for 'proxy hedging' or jurisdiction-specific overlays such as the COFVH. As a result, derivatives are designated as hedges of proxy items, because the actual items dynamically monitored for risk management are not eligible under IFRS to be designated in hedge accounting relationships. These include core demand deposits, issued equity and sub-reference rate items on a risk components basis. Tracking proxy hedge accounting relationships and amortizing hedge adjustments is excessively complex and operationally challenging and ultimately gives a distorted view of the effects of the risk management activities on entities' financial performance. In addition, this creates bespoke system developments, processes and controls, which are difficult to leverage for any purpose other than accounting.
2. Banks often manage interest rate risk on a net basis, meaning they manage the net risk arising from a group of financial assets and liabilities, which provides a natural hedge. However, hedge accounting under IFRS relies on designation on a gross basis and variable and fixed rate positions need to be designated separately under different requirements. This is inconsistent with risk management, as these risks are often managed together through a combined risk position. Financial statements therefore do not accurately reflect risk management and there is a difference between the accounting framework and the risk management reality.
3. Many banks' customers maintain demand deposit accounts for an extended duration. Banks' risk managers often view a portion of this demand deposit portfolio, deemed stable and insensitive to movements in interest rates, as a fixed interest rate liability represented through a replicating portfolio for risk management purposes. However, because the fair value of demand deposits is required to be kept constant at the amount that could be required to be repaid, hedge accounting is not permitted (unless the relief provided by the jurisdiction-specific overlays is applied).
4. Some banks see their excess cash and/or excess floating rate financial assets as a proxy for equity stable 'funding', which is hedged using proxy exposures, similar to what is done for core demand deposits. This is because designating a residual element such as equity is not currently permitted under IFRS, leading reporting entities to create artificial constructs to convey the economics of their risk management activities in financial statements.



## PRINCIPLES AND PRELIMINARY OBSERVATIONS

ISDA supports the IASB's intention to develop a principles-based model that can be applied by any entity managing open portfolios of interest rate risk. It is critical that the model should enable the closest possible representation of risk management activities to avoid significant shortcomings.

**Figure 1:** Overview of the DRM model, IASB webcast, October 2022<sup>3</sup>



The objective of the DRM model is to better reflect the interest rate risk management strategy applied by an entity in its financial reporting. This is achieved with a set of elements that deal with the accounting mismatch between on-balance-sheet exposures and future transactions resulting in such exposures (reported at amortized cost or fair value through other comprehensive income) and derivatives (reported at fair value). The DRM elements in Figure 1 are designed to capture the key decisions and activities made by risk managers and report their financial effects under a consistent financial reporting framework.

Observations on the model can be classified as follows:

- Areas for further consideration clarification are those issues where ISDA believes further research, deliberation or additional guidance from the IASB or the banks may be required and is anticipated as part of the exposure draft.
- Areas of judgment are those areas where ISDA considers the tentative decisions provide, subject to the wording in the exposure draft, an adequate basis for entities to exercise judgment and apply the principles of the model to their risk management strategy.
- Operational complexities provide a preliminary outline of the operational challenges entities will face when assessing the principles of the DRM model. This is not intended to be exhaustive and will be further developed in future papers and with the results of field testing.

<sup>3</sup> Webcast series: Dynamic Risk Management, IFRS, [www.ifrs.org/projects/work-plan/dynamic-risk-management/webcast-series-dynamic-risk-management](http://www.ifrs.org/projects/work-plan/dynamic-risk-management/webcast-series-dynamic-risk-management)

## 1. Risk Management Strategy

The starting point for the DRM model is the entity's risk management strategy, which covers all aspects of how risk is identified and how an entity responds to this risk. It documents the approach and assumptions used to determine each of the other key elements.

The risk management strategy, which should be kept consistent throughout the application of the DRM model, determines:

- i. The process to approve and amend risk management strategy;
- ii. Risk management levels and scope;
- iii. Risk metrics used;
- iv. Range of acceptable risk limits (ie, the target profile);
- v. Risk aggregation method and risk management time horizon;
- vi. Methodologies to estimate expected cashflows (eg, on core demand deposits);
- vii. Reporting to senior management; and
- viii. Process to change risk management systems, processes and controls.

Banks have different overall goals for how they manage their portfolios of interest rate risk. Some focus on stabilizing the NIM over time; others seek to stabilize the EVE or earnings at risk. Regardless of the priority, banks will often use similar financial instruments – for example, interest rate swaps, as well as other linear and non-linear derivatives instruments, such as options, to achieve their risk management objectives.

ISDA recognizes that the underlying principle of the DRM model is anchored in the entity's risk management strategy. However, DRM is not completely aligned with the risk management strategy of reporting entities and the way risk management techniques are applied. The principles-based nature of the model accommodates different risk management strategies, which is a welcome feature, given the diversity of risk management practices among financial institutions.

### Areas for Further Consideration

The model proposes that ~~changes a change in the risk management strategy, should meaning a change in the managed interest rate risk or how the entity manages that risk, would lead to the discontinuation of the application of the DRM model for a specified portfolio. It is currently unclear the specific instances when discontinuation should take place~~ IASB staff have clarified that any change in the risk management strategy would need to be substantial enough to be interpreted as a fundamental shift in the entity's overall risk management approach. The change therefore needs to be material for the entity as a whole and how they should be applied. For example, ISDA considers that changes to made at by the chief operating decision maker (CODM).

Under the DRM model, arising from the it is not permitted to voluntarily discontinue applying the model nor to voluntarily:

~~acquisition of new information, such as behavior data, should not discontinue the application of the DRM model. This contrasts with a material change to the entity's risk management strategy, which should require the discontinuation of the DRM model as a matter of principle. The concept of material change needs to be linked to the key principles. This can be achieved through illustrative examples. In addition, it needs to be clarified whether the outcome of a discontinuation event leads to the immediate acceleration of the DRM adjustment through profit or loss or amortization over a defined period of time.~~

The period over which the DRM adjustment is amortized should be carefully considered and preferably covered by application guidance. This will be relevant when there are changes to the CNOP because the position follows its expected course (duration) with regard to ongoing adjustments to the open risk position. This also interacts with the general discontinuation provisions:

The IASB's current tentative decision is that the application of the DRM model would be optional. This aligns with the current application of IFRS 9 and IAS 39 hedge accounting, with the former continuing to be applicable once the DRM model is established. ISDA supports an optional application as this accommodates the ongoing differences between the DRM model and an entity's risk management strategy, as well as differences between risk management practices and US GAAP.

- Remove underlying items that were included in determining its CNOP when these items continue to meet the qualifying criteria; or
- De-designate a designated derivative.

Upon discontinuation of the DRM model, the DRM adjustment is recognized 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.

### Areas of Judgment

The examples provided by the IASB in its board papers provide helpful clarification on the various scenarios that could trigger discontinuation of the model. These examples are expected to be incorporated as part of the exposure draft. However, judgement might be needed to assess what adjustments constitute a change in risk management strategy that would lead to discontinuation versus those that reflect the dynamic nature of the risk management strategy – for example, changes in risk management intention, risk limits within the target profile and underlying items or designated derivatives.

- In setting the risk management strategy, entities establish an overall framework within which detailed risk management operates. An entity will set its risk management objectives, risks to be hedged and risk limits. Determining how risk management objectives should be set and how they interact with the entity's risk management strategy depends on its overall approach to risk management. This is a positive element of the DRM model as it provides inherent flexibility to reflect different risk management approaches. However, judgment will be required if the DRM model excludes exposures that are integral to the risk management strategy and objectives. This links to scenarios in which entities may need to consider proxy hedging and whether the DRM model has sufficient flexibility to accommodate it (eg, equity, AT1s and non-linear exposures).
- The DRM model will result in the reporting of financial information that is specific to the individual entity or group. This is useful because it provides a view on the performance of the risk management strategy, but it makes comparison between entities more challenging, as they have significant scope to apply their own judgment to implementation. This also requires users to consider the facts and circumstances of each specific entity, notably the differences in risk management approaches.

- Notwithstanding the tentative decisions on future transactions and demand deposits and their associated set of qualifying criteria, the definition of core demand deposits, pipeline trades and loan commitments in the DRM model should be aligned with the definition used for risk management modelling purposes. How non-linear exposures, most notably loan commitments and pipeline trades, are assessed, modelled and included as hedged exposures within risk management strategies needs to be understood. This will affect the eligibility criteria for them to be included within the scope of the DRM model. Some of these exposures are considered for expected credit loss (ECL) purposes under IFRS 9, so it is inconsistent to exclude them from the DRM model. These exposures should be considered as integral to the DRM cycle when this is defined as part of the RMI and target profile.

### Operational Complexities

- Establishing robust governance over risk management processes that cut across functions will be complex. This will present similar challenges, if not bigger, to those that arose when the ECL methodologies were implemented upon adoption of IFRS 9. This required new interactions between credit risk, financial reporting and client-facing functions in order to provide the data that was needed. These processes are complex and difficult to put in place and have continued to evolve since IFRS 9 became effective in 2018. It is expected that implementation of the DRM model will present similar challenges at initial adoption and processes will continue to evolve once the DRM model is applied. Key areas of operational challenge include, but are not limited to, intragroup pooling of risk, volumes of transactions under the DRM program and ongoing monitoring of the effectiveness of the program.
- Implementing the DRM model has the potential to require some adaptation to the roles and responsibilities of existing teams. The model functions and responsibilities will need to be assigned, for example between business, risk management, treasury (including IRRBB), and accounting functions. Consideration should also be given to control and governance aspects, most notably the role of the three lines of defense model.
- When assessing the alignment between the risk management strategy and the DRM model, entities will need to carefully review their existing risk management processes and determine where they align with the model and where they don't. This will require a comprehensive review of all of the systems, processes, controls and management reporting, with consideration for how data is transferred between different entities and functions and if this data meets the accounting requirements. This will be a complex exercise, requiring a comprehensive review of existing processes that are then amended and enhanced as necessary. Where misalignment is identified, solutions must be found, and this will increase the complexity of the model itself and implementation. This is a direct consequence of the proxy hedge accounting model, which is detached from the real exposures and relevant information reported to senior management. A degree of bridging is therefore required to ensure differences between risk management and the DRM model are properly understood.

## 2. Target Profile

The target profile is intended to represent a range of risk exposures, defined within risk limits, which identifies the level of risk an entity is willing to tolerate, as detailed in its risk management strategy. Interest rate risk, which aligns with the entity's risk management strategy, qualifies as the managed risk, as approved by relevant internal governance, for the DRM model's purposes.

The target profile may be set for each period or, in the case of EVE, for an indefinite period of time, provided the entity remains a going concern. If an entity evaluates repricing risks and sets risk limits according to interest rate or nominal amount sensitivities across different time buckets, these should be reflected in its target risk profile. This risk profile may vary for different time buckets.

If the CNOP is outside of the target profile, risk mitigation actions are required.

The principles-based nature of the target profile enables it to be different depending on the risk management strategy the entity follows. For example, an entity following a net interest margin-based approach may have buckets that focus on ensuring a stable net interest margin for each time period and these may be standardized across multiple time periods. Alternatively, if an entity is following a risk management approach that focusses on sensitivity by reference to present value, the time buckets may have a different target profile for each time bucket. This is defined by sensitivity to present value changes due to interest rate movements (also known as a sensitivity to the present value change due to an interest rate change of one basis point, or PV01).

This is an area that should remain principles-based to allow entities to exercise judgment and ensure their specific circumstances are adequately reflected in the model.

The implementation of the DRM model will make clearer the accounting consequences of risk management activities. This may have implications for the way risk management activities are reported to senior management, as management information and accounting will be more aligned. However, since the DRM model does not result in a full alignment to risk management practice, differences between management and accounting views need to be controlled and reconciled as potentially different outcomes may arise following implementation of the DRM model.

### Areas for Further Consideration Clarification

- It is not clear from the IASB's tentative decisions whether there should be a single target profile or whether there could be multiple target profiles depending on the risk characteristics of the items being hedged. This should depend on an entity's risk management strategy, the risks being hedged and the associated risk limits. Failure to do so may create artificial outcomes (eg, artificial accounting discontinuation/rebalancing).
- When setting the target profile, entities will need to distinguish between those risk exposures that can be included within the DRM model and those that cannot. This may lead to defining risk limits for DRM that are different from those used for actual risk management. The DRM model boundary is discussed further in the next section, focusing on the CNOP. This is likely to have various knock-on effects that will need to be fully identified and considered. Every difference between accounting and risk management practice will require entities to identify suitable solutions. One example could be the need to consider the inclusion, at initial recognition, of financial instruments at fair value through profit and loss (FVPL), which are outside the model and therefore excluded from the CNOP and would require refinement of the target profile.

### Areas of Judgment

- Entities using standardized time buckets for risk management purposes will have the flexibility to apply judgment to determine the time buckets that align with their risk management strategy. It is expected that banks will often split their portfolios of interest rate risk into time buckets that are one month long for short- and medium-term maturities (for example, up to five years) and larger time buckets for very long-dated instruments. However, this should be aligned to risk management and the relevant risk characteristics of the items being hedged.
- Risk management strategy will evolve over time in response to changing business conditions. Entities will need to distinguish between changes to the risk management strategy and changes to risk management objectives, as each could have different consequences under the DRM model. For example, a change to the risk management strategy could require the DRM model to be discontinued, whereas a change to the risk management objective may result in an update to the RMI.
- Applying the DRM model will require new information to be generated internally for the purpose of informing the ~~chief operating decision maker (CODM)~~ CODM. Entities will need to decide how to amend and enhance existing reporting processes upon application of the DRM model.

### 3. Current Net Open Risk Position

The IASB's DRM model requires entities to determine what financial assets and liabilities will be managed within the model's scope. These are encapsulated in the CNOP, which characterizes the interest rate risk position, sorted by time bucket, and reflects projected cashflows from assets, liabilities and eligible future transactions.

The qualifying criteria for including financial instruments within the CNOP include:

- i. Must be financial assets/liabilities measured at amortized cost, or debt instruments measured at fair value through other comprehensive income (FVOCI) under IFRS 9;
- ii. Credit risk should not dominate changes in expected future cashflows;
- iii. Future transactions must be highly probable unless they are refinancing or reinvesting existing financial assets/liabilities, in which case they must be expected to occur;
- iv. Future transactions must result in financial assets/liabilities classified and subsequently measured at amortized cost or debt instruments at FVOCI under IFRS 9;
- v. Items previously designated in a hedge accounting relationship under IAS 39 or IFRS 9 can be included in the CNOP as hedged exposures (ie, the combined position of hedged item and hedging instrument coming from the existing hedge accounting relationship) if it aligns with the entity's risk management strategy;
- vi. Items must be managed on a portfolio basis for interest rate risk management purposes;
- vii. Derivatives may not be included in the CNOP (unless part of a hedge accounting relationship included in the DRM perimeter as a hedged exposure) or an entity's own equity. Financial assets classified as FVPL, even if considered part of the 'banking book' from a risk management standpoint, do not qualify for inclusion.

#### Areas for Further Consideration Clarification

- Whether and how foreign currency-denominated aggregated exposures can be included in the CNOP is an important issue, particularly for entities applying IAS 39 hedge accounting, as this is not available for designation. This relates to instruments such as minimum requirements for own funds eligible liabilities, subordinated liabilities and other debt securities in issue that are denominated in a foreign currency different to the functional currency of the issuer. For international banks, it is common to issue these types of debt instruments into overseas markets and to hedge the associated interest rate risk on a combined basis (ie, considering the effect of the FX element as an aggregated exposure back to the functional currency of the entity). The DRM model appears to be based on instruments denominated in the functional currency and it is not clear whether aggregated exposures, as understood in the context of the IFRS 9 hedging requirements, can be included in the model when not having been designated in a qualifying hedge accounting relationship for interest rate risk.
- For risk management purposes, many entities model what they refer to as their 'fixed rate equity risk', which can be understood as the exposure to interest rate risk arising from cash or other residual assets. This is represented as an open portfolio of interest rate risk, where equity is modelled as a fixed rate source of stable funding. They may also wish to hedge the risks associated with AT1 instruments that are classified as equity for accounting purposes. The IASB has confirmed equity cannot be included in the CNOP but has indicated that entities may include floating rate assets as a proxy to equity. While ISDA welcomes the decision that the notional values of assets and liabilities within the CNOP do not have to be equal, further discussion is needed to identify the boundaries for the use of proxy hedging in the DRM model, especially on the risks associated with AT1 instruments.



- Demand deposits can be included within the DRM model and, as a result, the modelling of behavioral expectations will be subject to additional scrutiny, in addition to the current analysis performed by supervisors for the purpose of IRRBB. The behavioral models will need to be capable of supporting the level of scrutiny associated with financial reporting. Similar considerations will apply for other forecasts, such as those for repricing expectations across portfolios, loan commitments, pipeline trades and residual cash. Banks will already have model governance in place where they are used for risk management processes, but this may need to evolve to support and be compliant with the DRM model.
- The definitions associated with the designation of demand deposits are aligned with risk management. More specifically, they include non-rate sensitive demand deposits (eg, non-interest-bearing current accounts, the non-sensitive portion of interest-bearing current accounts, as well as demand deposits subject to discretionary remuneration, which are managed using a replicating portfolio approach). However, the application guidance needs to capture, through examples, some of the critical aspects associated with the management and modelling behavior of demand deposits. For example, how lifecycle events such as changes in volumes and price sensitivity of core demand deposits (ie, deposit beta convexity) would be incorporated in the model. Risk components are widely used by risk managers as a hedging strategy. The IFRS requirements for them to be separately identifiable and reliably measurable (SIRM) are well established and well understood. ISDA acknowledges the tentative decision on managed risk, but because this concept and the concept of SIRM have not been compared against each other to date, the DRM model would benefit from guidance to ensure the existing discipline of identifying them remains intact. It should also consider the way risk managers look at hedgeable risks, most notably through a replicating portfolio approach to designation, and how this relates to the current tentative decision. Given that in some jurisdictions there will be multiple benchmarks, it would need to be determined how the model would work with a single benchmark per entity or currency.
- ISDA acknowledges the IASB's tentative decision on future transactions, which differentiates those transactions that are entered into for refinancing or reinvestment purposes from those that are not. It is not clear whether so-called 'pipeline transactions', such as fixed rate mortgage approvals within the scope of IFRS 9 ECL and derecognition (ie, when the mortgage is approved but not yet drawn down and on-balance sheet and other transactions that are forecasted but not yet completed), will be eligible for inclusion within the model. This stems from the fact that risk managers look at behavioral patterns and often use bottom layers to establish the volume of transactions to be included in the risk management view. It is unclear how risk management practice would be aligned with the developed criteria in respect of highly probable transactions. Inclusion of such balances would lead to misalignment with risk management and reduce the need for proxy hedging solutions for the interest rate risk that arises on these exposures.
- For loan commitments and the relationship with pipeline risk, the inherent uncertainty associated with these exposures introduces non-linear interest rate risk that cannot be directly hedged with vanilla interest rate swaps. Allowing the inclusion of non-linear derivatives (eg, swaptions) would provide a means to hedge this risk. It is not yet clear whether the IASB intends for this approach to be followed, so some clarification would be beneficial. Risk managers may use non-linear derivatives to hedge all orders of risk and the transformation of a non-linear exposure into a linear one is not followed, given the level of optionality and uncertainty to which entities are exposed.
- Banks are also experienced in applying a bottom layer approach to manage the risks arising from potential prepayments (future drawdowns), which are inherent to non-linear exposures. This involves identifying different layers of the portfolio for pre-payment risk and focusing the resulting risk management on particular layers. It is not clear whether the IASB would expect this approach to be accommodated by the model, so further discussion on this issue would be beneficial.



It is expected that lifecycle events that impact the CNOP, such as changes in modelled deposit volume, will affect the DRM model. It would be helpful to better understand the IASB's expectation for the type of events that would lead to the discontinuation of the model versus those that would just be a change to the CNOP.

### Areas of Judgment

- The topic of proxy hedging will require entities to apply judgment to reflect suitable items, such as floating rate assets, cash deposits and future transactions (reinvestments) as proxies to hedge 'fixed rate modelled' equity risk. Entities may need to create a behavioral profile for these assets to ensure they are suitable to be considered proxies for the fixed rate equity exposure.
- While the DRM model is intended to reflect an entity's risk management strategy, if the constraints of the accounting framework give rise to differences, such as the incorporation of equity by proxy, the complexity of the model will increase. As a result, there will be various differences between the risk management view and what can be included in the CNOP, otherwise referred to as the boundaries of the DRM model. Entities will need to apply judgment to what they include in the model and how they structure transactions and exposures to ensure they are either inside or outside the boundary of the model. This will also create the unintended consequence that risk limits based on the risk management view will be disconnected from the target profile based on the CNOP. This will require a proxy element to address this difference, or the model outcomes will be disconnected from risk management.
- Entities will need to apply their judgment to decide how to reflect items in the CNOP. There will be some instances of natural hedging within the CNOP, such as where floating rate financial assets and floating rate financial liabilities of the same tenor offset to create a stable net interest margin. In other cases, where entities divide the interest rate risk by time bucket, they may arrive at a net residual risk position that is subject to risk mitigation techniques. The entity may choose to identify behavioral characteristics of the risks within a time bucket, which it could represent as a non-linear instrument, or it may follow a bottom-layer approach to identify a portion of the total risk that they consider has a high level of certainty to manifest as forecast. How an entity views the CNOP is highly judgmental and will always represent an entity-specific view.
- The ability to directly include banks' core demand deposits in the DRM model would be a significant improvement on existing approaches to account for open portfolios of interest rate risk. Nevertheless, for added clarity, it should be clear that demand deposits subject to discretionary remuneration by banks and managed through a replicating portfolio for risk management purposes are also included in the model. The behavior of demand deposits can be a significant consideration for risk management. Entities will need to apply their judgment in modelling the behavioral profile of core demand deposits included in the DRM model.

The expectations associated with pipeline risk and prepayment risk will be subject to the entity's forecasting process to identify the risk that is included in the CNOP. These forecasts will directly affect all aspects of the DRM model.

### Operational Complexities

Changes to systems will need to capture the different elements of the CNOP. The system solution will likely use existing risk management systems to the extent possible, but some adjustment and customization to meet the specific requirements of DRM is expected.

## 4. Risk Mitigation Intention and Benchmark Derivatives

### Risk Mitigation Intention

In each period, entities must establish an RMI, outlining the extent to which they intend to use derivatives to offset the CNOP to adhere to the target profile. An RMI can still be established even when the CNOP is already within the target profile.

In practice, the RMI needs to be evidenced by actual derivatives traded in the market, which align to the entity's risk management practices. The RMI would be calculated in a manner consistent with the entity's actual risk management practices and there can be prospective adjustments to the RMI over time.

The RMI is constrained by the following factors:

- It cannot exceed the CNOP determined for each time bucket;
- It transforms the CNOP so the target risk profile is achieved (this requirement establishes the minimum amount the entity must designate as its RMI to be consistent with its risk management strategy);
- It is evidenced by real actions taken to mitigate risk – ie, the designated derivatives traded in the market;
- The RMI is supported by a prospective assessment, which is aimed at evaluating whether it mitigates the risk and transforms the residual risk to meet the target profile.

The RMI cannot be based on internal derivatives traded with an internal risk transfer desk without being traceable to external derivatives, similar to the current accounting framework.

For standalone financial statements prepared by legal entities within a group, derivatives transactions between subsidiaries can be recognized upon application of the DRM model at the group level if they are externally transacted.

### Benchmark Derivatives

To be able to measure the effects of the DRM model, the RMI is represented by benchmark derivatives (ie, a mathematical expedient to enable measurement of the RMI).

Benchmark derivatives can be based on the actual derivatives used for risk mitigation, but they may not be identical, as the benchmark rate, tenor, maturity and volume needed to align the RMI are bound by the CNOP and the target profile.

The concept of a benchmark derivative aligns with the principles in IFRS 9 regarding hypothetical derivatives. Benchmark derivatives must therefore be calibrated to the current market rates of the risk being managed when first included in the DRM model, resulting in an initial fair value of zero. Subsequently, benchmark derivatives are not reset for every period, but new benchmark derivatives are added to those carried forward from the previous period at the start of any period. This is done to increase or reduce the risk mitigation in accordance with the current RMI.

Despite not being subject to a tentative decision by the IASB, it is expected that any managed risk identified must be reliably measurable, which means being linked to a benchmark interest rate

with a liquid market that allows for the construction of the term structure of interest rates. As the benchmark derivative needs to be based on the managed risk, it will not necessarily be the same as the interest rate basis present in the CNOP, which could contain financial instruments linked to more than one benchmark.

The principle behind the benchmark derivative concept is well established and understood from cashflow hedge accounting. This inclusion is aligned with the principles and intended purpose of the DRM model.

### Areas for Further Consideration Clarification

The IASB has indicated that entities may wish to create market consistent benchmark derivatives to minimize the difference to the designated derivatives. This covers both differences in the managed risk and differences in tenor if an adjusted market-based benchmark derivative is used. It would be helpful to understand what this means in practice, since in some instances it may not be possible for a benchmark derivative to be market consistent. For example, if the RMI identifies new risk arising in a nine-year time bucket, there may not be a market derivative available to be a designated derivative. This could also be the case if the interest rate curve were illiquid at the nine-year point, with the nearest liquid point being at ten years. In addition, in the context of standardized time buckets where these do not have a specific tenor associated with them, there may not be a market derivative available.

### Areas of Judgment

- Entities will need to apply judgment to ensure appropriate differences are reflected in the benchmark derivative compared to any corresponding designated derivative. This is necessary to ensure any ineffectiveness is recognized and not erroneously captured as part of the DRM adjustment.
- In response to changes to the CNOP, entities will need to adjust the benchmark derivatives as the RMI develops. They will also need to update the designated derivatives, which may lead to a mismatch between the changes to the benchmark derivatives and the run-off of the designated derivatives. Entities will need to track this difference to be able to properly explain changes to the DRM adjustment.
- Entities may need to represent some risks that arise from the RMI as non-linear benchmark derivatives. This could include reflecting the inherent uncertainty associated with pipeline risk (eg, using swaptions) and prepayment risk (eg, through the use of swaptions and other interest rate options). Entities will need to apply judgment to construct non-linear benchmark derivatives that replicate the characteristics of the CNOP and the RMI.
- ~~Despite not being subject to a tentative decision by the IASB, when~~ When performing the prospective and retrospective assessment, entities will need to apply judgment to determine how to make the assessment. Various alternative approaches could be applied, including an assessment that focuses on expectations for conformity with the target profile (as supported by risk limits) ~~or ; changes in the underlying net position or, alternatively,~~ a statistical assessment that uses data from the historical performance and behavior of exposures in the CNOP.
- The prospective and retrospective tests should link, to the greatest extent possible, to the entity's actual risk management practice. For example, the frequency with which risk managers rebalance hedges may correspond to the frequency at which the retrospective and prospective assessments are performed. This aligns the DRM model with the entity's risk management practices and leverages, or builds on, existing systems and processes.

### Operational Complexities

- The current data model will need to be expanded to accommodate different valuations for the benchmark derivatives. For this, it will be necessary to determine the placement of the benchmark derivatives in appropriate systems for their measurement and tracking. This could include in front-office trading systems, risk management systems, finance systems or a dedicated hedge accounting system. The choice will depend on factors including available capacity, who has responsibility and how this aligns with DRM-related responsibilities.
- For the DRM model to accurately reflect the risk management strategy, it would ideally be run as frequently as the risk management process revises the entity's hedging position. This may require the DRM model to be run with a daily frequency, with corresponding updates to the DRM adjustment. This is particularly relevant if the designated derivative is traded within the assessment period (rather than at the start as in the May 2023 IASB illustrative examples), but the benchmark derivative is deemed to have been traded at the beginning of the assessment period. Entities will need to apply judgment to define whether the benchmark derivative is based on market rates at the start of the period or when the designated derivative is traded. This issue requires clarification.
- This level of frequency could present a significant operational challenge.

## 5. Designated Derivatives

Entities enter into designated derivatives with external counterparties to manage risks in line with their RMI and its target profile. These derivatives commonly include swaps, basis swaps and forward rate agreements. Non-linear derivatives such as interest rate options (excluding net written options) and swaptions may also be incorporated into the model, provided their use is consistent with the entity's risk management strategy.

Off-market derivatives are also eligible as designated derivatives in the DRM model, provided such a designation is in line with the entity's risk management strategy and faithfully represents the entity's risk management activities, and only fair value changes of the designated derivatives after the date of the designation are considered as part of the measurement of the DRM adjustment.

The designated derivatives will have a relationship to the CNOP – to reduce interest rate risk – that is similar to the IFRS 9 requirement for hedge accounting.

The designated derivatives must be adjusted at the beginning of the DRM period to reflect the entity's risk management objectives and other eligibility criteria of the DRM model. A derivative would not be de-designated if the RMI remained the same compared to the start of the DRM period, but new and/or offsetting derivatives may need to be booked to achieve the desired RMI.

It is expected that the 'credit risk must not dominate' restriction will be applied to all the designated derivatives as for the assets and liabilities. This restriction helps to maintain a conservative approach in dealing with financial risks.

In line with IFRS 9 and IAS 39, the DRM model applies the concept of designated derivatives, which provide a direct and disciplined relationship between externally transacted derivatives, the RMI and the DRM adjustment. The combination of the designated derivatives with the documented risk management strategy provides a strong foundation for the DRM model.

### Areas of Judgment

- Entities engaging in dynamic risk management will have to consider how the benchmark derivatives, which represent the risk(s) being hedged, relate to the derivatives they wish to designate. This translates into a flow of potentially up to daily designations, which will cater for mismatches between benchmark and designated derivatives as well as consequential misalignment or hedge ineffectiveness. This will likely be a meaningful change to the current process where entities designate at specific points in time within a pre-defined accounting period, often a calendar month.
- The length of the DRM period will need to be set by an entity depending on its risk management approach. It is possible that complex banks may wish to set the DRM period to a daily basis. Less complex entities may be comfortable setting the DRM period on a weekly, monthly or even quarterly basis.

### Operational Complexities

- The frequency with which an entity designates and de-designates derivatives will affect the operational challenge of implementing the DRM model. The frequency of changes to the RMI will also drive the volume of designations and de-designations. This will likely be linked to the tenor of the benchmark derivatives.

- The requirements to ensure the designated derivatives are external are expected to be similar to the general hedge accounting requirements, where qualifying hedge accounting instruments should be external to the reporting entity. Operationally, it is expected that similar practices will be used to demonstrate externalization as are already used under general micro or macro hedging. If this is not in line with the IASB's intention, it will add significant operational complexity to the model.
- An additional layer of complexity will need to be considered as non-zero fair value derivatives – ie, late hedges – will need to be tracked and the misalignment created by the non-zero fair value changes upon designation will need to be recognized in the statement of profit or loss. This is because any gains or losses relating to those excess cashflows on initial designation cannot be considered when determining the protection/benefit to the net interest income provided by the DRM adjustment. These cashflows should continue to be recognized as net trading income, similar to those from any other derivative. Consequently, an entity should exclude the accrual impact of these off-market elements when recognizing the DRM adjustment in profit or loss.

## 6. Retrospective Assessment and Unexpected Changes

At the beginning of a period, the entity must consider the RMI that satisfies the prospective assessment to meet the following criteria:

- The cumulative amount of risk cannot exceed the CNOP for each time bucket;
- It transforms the CNOP so that the target risk profile is achieved;
- It is evidenced by the designated derivatives.

The prospective assessment ensures the RMI only mitigates the entity's organic risk as captured in the CNOP and helps to establish the target profile.

During the DRM period, there may be unexpected changes to the CNOP. At the end of the DRM period, an assessment is required to calculate unexpected changes in the CNOP since inception (ie, excluding new business of the period), which led to over-mitigation of risk.

The retrospective assessment is still a risk assessment, which is different to the retrospective assessment under IAS 39 and assesses changes in the fair value of the hedged item versus the hedging instrument. In the case of the DRM model, if a situation of over-mitigation of risk is assessed, the RMI has to be adjusted accordingly and additional benchmark derivatives are needed to reflect this. Hence, the IASB should clarify how different the DRM retrospective assessment is when compared to current IAS 39/IFRS 9 requirements.

The capacity test is an assessment of whether the entity has the capacity to realize the expected benefits of the DRM adjustment. It deals with unexpected changes in the CNOP due, for instance, to unexpected prepayments or rollovers, impairment, sales of assets or buy-back of liabilities. The test prevents DRM adjustments from being stranded on the balance sheet after the assets or liabilities that gave rise to them have been derecognized. This has a close relationship with the retrospective assessment and designation criteria to be within the CNOP, particularly when equity is involved. ~~It should be subject to further consideration and additional guidance to ensure consistency in application.~~

### Areas for Further Consideration

~~How the capacity test will operate warrants further consideration.~~

The capacity test considers the maximum future economic benefit of the CNOP based on its present value and compares this to the carrying amount of the DRM adjustment on the balance sheet at the measurement date.

If a capacity shortfall in the DRM adjustment is identified, then this must be recognized in profit or loss. The unwinding of that shortfall in future periods is recognized on a systematic and rational basis over the risk management time horizon. In the absence of a systematic and rational basis, the shortfall is recognized on a straight-line basis. The reversal of capacity shortfalls previously recognized in profit or loss is not permitted.

The capacity test is intended to operate as a backstop that is akin to an impairment test of the DRM adjustment – put another way, it confirms the recoverability of the DRM adjustment. This works in conjunction with end-of-assessment-period activities, which include the retrospective test and the prospective test, with consequential adjustments to the designated hedges if these are outside an entity's risk limits. Adjustments to designated hedges will have a direct effect on the DRM adjustments, with consequential recognition in profit or loss due to unexpected changes to the CNOP. These changes result in misalignment due to imperfect hedging when unexpected changes occur – ie, changes to the forecasted cashflows.

As a result, the capacity test does not work in isolation and is expected to be triggered only when there is an event or indicator that the DRM adjustment may not be recoverable.

### Areas for Further Consideration Clarification

~~How the capacity test will operate warrants further consideration. We anticipate that the exposure draft will include illustrative examples outlining how the capacity may be carried out by entities. This could include how it would be applied for an NII-based approach, since the comparison of fair values of the CNOP and the DRM adjustment has the potential to be out of alignment. This has a direct impact on the discontinuation provisions of the DRM model, which are to be further discussed by the IASB. This interaction should be considered with the discontinuation provisions and the period of amortization of the DRM adjustment.~~

### Areas of Judgment

~~Tailoring the capacity test to the particular risk management approach being followed may be necessary to adapt the capacity test to portfolios where a residual 'accrual' profile exists (eg, residual cash and residual financial assets):~~

~~However, it is essential to note that the capacity test considers the CNOP in its entirety. This may have potential unintended consequences.~~

The capacity test compares the maximum future economic benefit of the CNOP (where alignment of notional is based on the fair value change of the fixed rate exposures in the CNOP, represented by another hypothetical derivative, as described in paragraph A5 of the June 2024 IASB staff paper) to the DRM adjustment (which is based on the lower of the benchmark derivative and the designated derivative).

Given the complexity of the capacity test and its relationship with end-of-cycle activities, entities should consider both of these elements in the field testing and provide appropriate feedback to the IASB in response to the exposure draft. This is necessary to ensure the benefit of comprehensively field testing the model is realized.

### Operational Complexities

The capacity test requires detailed transaction-level data for the underlying fixed-rate exposures in the CNOP. The example suggests that additional hypothetical derivatives will need to be represented (in addition to the benchmark derivatives) to measure the maximum economic benefit of the CNOP.

Current capacity and persistency tests, which include retrospective review of available and utilized capacity, will need to be reviewed to accommodate the requirements of the DRM model. This includes their design, associated governance and reporting to the CODM. This will affect systems, processes and controls and will require significant changes as the capacity test will be a key component of the prospective and retrospective assessment.

## **7. Accounting Representation**

The mechanics of the DRM model require that the amount recognized for the protection benefit, which results from the entity's risk management strategy, is carried in the statement of financial position at an appropriate value and released to the profit or loss as the corresponding exposure in the CNOP affects the income statement.

The designated derivatives (those traded in the market to mitigate the entities' risk and achieve the RMI) are recognized at FVPL. This follows the normal approach required by IFRS, which also applies to the items within the CNOP.

At the end of each DRM period, the entity calculates the cumulative gains and losses on the designated derivatives and changes in the RMI, which are attributed to the repricing risk represented by the benchmark derivatives.

The DRM adjustment is recognized in the statement of financial position, with an offset to profit or loss, measured as the lower of, in absolute amounts:

- a) The cumulative gain or loss on the designated derivatives from the inception of the DRM model; or
- b) The cumulative change in the fair value of the RMI attributable to repricing risk from inception of the DRM model (ie, the benchmark derivatives identified so far, including the ones set to track the effects of unexpected changes in the CNOP).

The aligned portion is the lower of, in absolute amounts, (a) and (b). This is recognized in the statement of financial position as the DRM adjustment.

The 'lower of' test quantifies the extent to which the risk management activities of the entity, as represented by the DRM model, have resulted in a protection benefit for the entity.

The misaligned portion relates to changes in the fair value of designated derivatives that exceed the aligned portion. This is recognized in profit or loss and aims to mimic hedge ineffectiveness in the current IFRS hedge accounting models.



The DRM adjustment is reclassified to the income statement through NII over time to offset the variability arising from the underlying risk positions.

The DRM adjustment provides a mechanism to show the economic effect of the entity's risk management strategy as reflected in the DRM model. The lower of test, as the basis for the DRM adjustment, is similar to the existing cashflow hedge accounting requirements.

The recognition of an asset or liability for the DRM adjustment is a departure from the IFRS conceptual framework. The IASB believes the approach is justified because of the useful information provided by the DRM adjustment.

#### Areas for Further Consideration

- The IASB has agreed the principles for the DRM adjustment. If there are specific expectations for how it should be calculated and released, more detailed guidance should be provided in the exposure draft. One area where further guidance would be helpful would be with respect to the amortization basis for the release of the DRM adjustment and what is the required reference point. Current decisions seem to indicate this is the benchmark for derivatives and how they unwind over the maturity of the CNOP. This should be specifically stated to ensure consistent application.
- The IASB could helpfully give more clarity on the dividing line between unexpected changes to the CNOP that result in the DRM adjustment being revised and changes to the risk management strategy that result in the discontinuation of the DRM model. It would also be helpful to provide further guidance on the detailed provisions that would apply when a discontinuation of the DRM model occurs.

#### Areas of Judgment

The basic principle behind the timing for when the DRM adjustment should be recognized in profit or loss is reasonably clear. Entities will need to apply judgment to determine an appropriate method to align the release of the adjustment with when the volatility from the interest rate risk within the CNOP affects the income statement. This may include considering the behavioral period that relates to when items in the CNOP are expected to affect the income statement.

#### Operational Complexities

- The frequency of changes to the designated derivatives and lifecycle events affecting the CNOP will result in revisions to the DRM adjustment. The level of operational complexity presented by calculating and maintaining the DRM adjustment will depend on many factors associated with how the entity runs the DRM model. These include the length of the DRM period, the frequency of changes to the RMI resulting in designation and de-designation of the derivatives, and the number of designated derivatives.
- The calculation and release of the DRM adjustment, including the amount that should affect NII, will need to track the clean prices of the designated benchmark derivatives, which serve as elements of the lower of test. The proposal to include all past derivatives cashflows to perform this calculation would cause unnecessary effort because it does not differentiate between clean and dirty prices (realized cashflows).

## PRESENTATION AND DISCLOSURE

~~The~~ To present and disclose the outcomes of the DRM model, the IASB has made the following tentative decisions on the presentation of the effects of DRM adjustment, with a focus on disclosure requirements that would assist users to:

- The DRM adjustment, as a net amount in a separate line item in the statement of financial position at the end of the reporting period;
- The unwinding of the DRM adjustment recognized during the reporting period as a net amount in a separate line item in the statement of profit or loss; and
- Any misalignment (between the net gains or losses from designated derivatives and the DRM adjustment) recognized during the reporting period, together with the fair value gains or losses from other derivatives.

The IASB has adopted an all-encompassing model for discloses that disregards the existing requirements of IRRBB and Pillar 3. An entity is required to provide information that enables users of financial statements to understand:

- Understand and evaluate the merits of the The entity's interest rate risk management strategy and how it is used to manage repricing risk;
- Evaluate The effect of the entity's performance on achieving the stated interest rate risk management strategy; activities on the amount, timing and uncertainty of its future cashflows; and
- Understand the The effect of an the entity's interest rate risk management actions on its current and future economic resources<sup>3</sup> activities on the statement of financial position and statement of profit or loss.

For each of these principles, the IASB has tentatively agreed on further guidance that enables entities to meet these disclosure objectives.

When deciding what disclosures to provide, the following should be taken into account:

- They provide relevant incremental information to users of the financial statements;
- Disclosures should provide an entity-specific view, allow entities to exercise judgment, and consider existing disclosure requirements that are applicable to the various components of the DRM model;
- They provide useful information on the effects of the DRM model (or its underlying components) on the financial position and financial performance of the reporting entity. They should avoid disclosure overload and unnecessary overlap between different sets of disclosures required for different purposes or by different regulators;
- Disclosures should strike an adequate balance between usefulness of information, incremental benefit, cost and commercially sensitive disclosure.

<sup>3</sup>Dynamic Risk Management, Optional Application and Areas of Focus for Disclosure, July 2019, IFRS, [www.ifrs.org/content/dam/ifrs/meetings/2019/july/iasb/ap4d-drm.pdf](http://www.ifrs.org/content/dam/ifrs/meetings/2019/july/iasb/ap4d-drm.pdf)

### Areas for Further Consideration Clarification

- During 2024, the IASB is likely to welcome input on what the disclosures should include. Entities that expect to apply the DRM model, most notably the ones where preliminary assessments have been undertaken, could gather useful suggestions from their financial reporting and investor relations functions on what disclosures they expect to be most useful to users of the accounts.
- Risk management is extensively disclosed not only within the initial section of the annual report and accounts, but also as part of the Pillar 3 disclosures for regulatory purposes. These include detailed disclosure of the risk management approach to IRRBB and EVE and already allow users to form their view on the adequacy of those and the effect on their forecasts.
- In developing the disclosures, the DRM model can offer several significant benefits in relation to improved internal and external information on how entities manage their open portfolios of interest rate risk. This, however, should not come at the expense of disclosure overload or artificial disclosure created for accounting purposes. An alignment between reporting of DRM model outcomes and risk management should be at the forefront of the goal of the disclosure model. ISDA encourages the IASB to conduct outreach with its global constituency to understand current disclosures, additional information already requested by users, and the costs and benefits of the proposed disclosure model.
- In certain jurisdictions such as the UK, users already request a significant amount of additional information on structural hedging positions. Understanding those requests and how they interplay with the needs of users should be assessed as part of field testing so that the end-state disclosures are meaningful while keeping a reasonable cost-benefit balance for preparers.
- Some aspects of the DRM model will be proprietary and commercially sensitive. Disclosures on the entity's risk limits, levels of PV01 sensitivity, or forecasting expectations, have the potential to compromise the entity's commercial position.
- The disclosures should aid transparency for external reporting. This is the ultimate goal of any disclosure framework, which aims to report the outcomes of an accounting model, conveying the results of certain risk management activities in the financial statements. This also strengthens the communication between preparers, users and regulators.

### Operational Complexities

The new disclosures will present the need for additional information to be gathered and aggregated. New systems, processes and controls will form part of an entity's implementation plan. Given the lead times banks face to implement changes to their risk management and financial reporting systems, entities will need to develop the outline of a technology plan to deliver the new disclosures.

Even though the IASB has allowed cross-referencing to other disclosures, this raises auditability issues. This is because cross-referencing to notes to the financial statements from regulatory documents is often not possible without a significant increase in the audit scope and a corresponding increase in the cost and complexity of the audit.

## FURTHER CONSIDERATIONS

### Jurisdiction-Specific Overlays: EU, IAS 39

Certain jurisdictions within the EU have adopted specific overlays that were introduced upon endorsement of IAS 39, which led to the establishment of prevailing accounting practices. These jurisdictions will face distinct challenges, stemming from the way in which the relief provided by those overlays will be considered in the DRM model and how proxy hedging will be considered in the DRM model. These have been widely used as tools to include and report the effects of interest rate risk management within the scope of hedge accounting.

The ultimate goal of the IASB should be to align DRM with risk management to the greatest extent possible. Some of the observations outlined in this paper use concepts that served as a basis for the carve-out, most notably the fungibility of items within an open portfolio, the use of a bottom layer approach for measuring effectiveness, and the possibility of hedging demand deposits and sub-LIBOR exposures.

While DRM is a distinct model, some of these COFVH concepts contribute positively to the alignment between accounting and risk management and should, to the extent possible, be considered in the IASB's future deliberations.

### Field Testing

For the field test to be successful, stakeholders need to be comfortable with the key principles of the model as described in the exposure draft. It is therefore important that concerns raised by stakeholders during the earlier stages of the model's development, such as those concerning the capacity test, are addressed in the exposure draft.

There could be are distinct benefits associated with running field testing of the DRM model before the exposure draft is published. This includes considering: i) how the conceptual accounting principles of the model work in practice; and ii) the prudential and operational implications. The insights obtained will be beneficial for different stakeholders, such as regulators, standard setters and other interested parties.

The IASB has set a 240-day comment period for the exposure draft. This extended comment period is deemed necessary due to the complexity of the DRM model and the need for thorough stakeholder input, including the results of field testing. Banks will need to make their best efforts to ensure sufficient resource is available following publication of the exposure draft and commencement of the field test to analyze the exposure draft and make comments and recommendations to the IASB as part of the comment process. The ongoing industry discussions with the IASB are crucial to the development of the model, and this dialogue should continue during the comment period to ensure feedback is provided on a timely basis and is as comprehensive as possible.

At the time of the publication of this paper, no formal plans for a field test had been announced by the IASB or any other organization. ISDA recommends field testing, as this would provide a good opportunity for suggestions and observations that could improve the proposed DRM model. It should be easier for the IASB to incorporate these points prior to the publication of the exposure draft and before its views have been crystallized.

The format of any field test will need to be determined. This would include operational considerations for participants to test the model and key items to be assessed. It would also comprise an assessment of the conceptual basis of the model to identify how the principles of the DRM model align with entities' actual risk management practices. With its global membership, ISDA would be well placed to support this process.

## Transition

Given the complexity, scale and effect of the proposals, the transition arrangements will be critical.

The model should leverage existing risk management practices, processes and controls. A comprehensive review of existing accounting practices must be carried out to identify key areas where transition relief is required. This will not reduce the complexity and costs of implementation.

To ensure the smooth transition of pre-existing hedge relationships to the DRM model, the IASB has tentatively decided that:

- An entity should be required to apply the DRM model prospectively and be permitted to apply it early, together with the required disclosure.
- An entity making the transition from hedging relationships in accordance with IFRS 9 Financial Instruments should be permitted to discontinue its existing hedging relationships on the date of initial application, which is the beginning of the annual reporting period in which the entity first applies the proposed requirements. The entity would then be required to designate the underlying financial assets and financial liabilities in a DRM model at that date.
- An entity making the transition from hedging relationships in accordance with IAS 39 Financial Instruments: Recognition and Measurement should be required to apply paragraphs 6.5.10 and 6.5.12 of IFRS 9 to the hedge adjustments related to those relationships.
- An entity making the transition to the DRM model should be permitted to prospectively revoke (at the date of initial application) the designation of financial assets or financial liabilities under the fair value option in IFRS 9. The entity would then be required to designate those financial assets and financial liabilities in a DRM relationship at that date.
- An entity making the transition to the DRM model is not required to provide the disclosures described in paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.
- An entity making the transition to the DRM model should be required to provide specific transition disclosures in the financial statements about the effects of:
  - Making the transition to the DRM model; and
  - Revoking financial assets or financial liabilities previously designated under the fair value option in IFRS 9.

Given the scale of the transition and the widespread use of IAS 39 hedge accounting provisions, entities would need to consider whether a phased transition to IFRS 9 is appropriate, as well as the implication of IAS 39 being withdrawn. This will affect banks significantly as IAS 39 includes a specific provision for fair value hedge accounting for a portfolio of interest rate risk (macro fair value hedge), which is not included in IFRS 9.

The requirements in IFRS 9 also differ from those of IAS 39, such as the specific provisions for voluntary de-designation and re-designation, which are widely used in current hedge accounting for open portfolios of interest rate risk under IAS 39. However, IFRS 9 does not allow for this, and it is not expected the DRM will either.

## Survey Results

In March 2024, ISDA carried out a survey of its members to understand their views on the current stage of development of the DRM model. Many of the largest banks that currently report under IFRS were invited to participate.

The results show a concentration of respondents in Europe, consistent with the widespread use of macro hedging approaches in the region. Entities that are heavy users of macro hedging approaches in IAS 39 and IFRS 9 showed greater familiarity with the potential consequences of the model in its current form.

The survey also revealed that a material number of entities are still developing their thinking and are therefore moderately familiar with such consequences, which are expected to evolve towards a greater level of familiarity as the development of the model progresses.

Treasury and accounting policy functions are the key stakeholders engaged in assessing the model. Some entities have also engaged risk managers. This is an area that is expected to evolve as the development of the model moves towards finalization.

The survey results can be found here: [www.isda.org/2024/05/28/survey-the-iasbs-proposed-drm-model](https://www.isda.org/2024/05/28/survey-the-iasbs-proposed-drm-model).

In September 2024, ISDA carried out a member survey to obtain views on the development of the DRM model. In particular, the survey sought to understand the accounting and regulatory treatment of AT1 financial instruments and contribute this information to the development of the IASB's DRM model.

The survey shows that:

- For balance sheet classification under IFRS, the majority of respondents classify their AT1s as equity;
- The majority of respondents include their AT1s for IRRBB as equivalent to financial liabilities, indicating that AT1s are an integral part of respondents' interest rate risk exposure;
- There is strong desire for the inclusion of AT1s in the current net open position as they are integral to risk management strategies, with evidence from inclusion in IRRBB risk metrics (eg, economic value of equity) and the banking risk management framework, indicating that a lack of inclusion could conflict with the objectives of the DRM model.

The survey results can be found here: [www.isda.org/2024/09/27/isda-publishes-results-of-survey-on-at1-treatment-in-drm-model/](https://www.isda.org/2024/09/27/isda-publishes-results-of-survey-on-at1-treatment-in-drm-model/).

## Taxonomy-Based Solution

The effects of the DRM will need to be subject to ongoing monitoring and tracking in a way that supports substantiation for the purpose of banks' internal controls and external reporting.

The CDM, an open-source data standard for financial products, trades and lifecycle events<sup>4</sup>, could help banks to meet these requirements. The CDM is inherently flexible and could be used to track, substantiate and report the effects of the DRM model on banks' financial statements.

<sup>4</sup> Common Domain Model, ISDA Solutions InfoHub, [www.isda.org/cdm](https://www.isda.org/cdm)

### Potential Relevance of the CDM

Regulators are expected to start to adapt their requirements for banks' reporting after the IASB's exposure draft on DRM has been published next year. Once the development of the DRM model is finished and the final accounting standard has been published, regulators will have finalized their own requirements.

To the extent that banks are already familiar with the CDM because they have been applying it, their experience can be used to address the future reporting and compliance needs associated with DRM.

### How CDM Could Support Accounting Requirements

For external reporting, the DRM model will require the presentation and disclosure of overall positions on an aggregated basis. For control and substantiation purposes, it will be necessary to have a process in place for the tracking of individual derivatives and exposures that are part of the DRM model.

The tracking ability the CDM provides could be used to satisfy the needs of regulatory reporting of derivatives positions, as well as supporting the substantiation of the DRM adjustment, RMI and the other elements of the model.

### Risks the CDM Could Mitigate

In the absence of suitable tracking or substantiation tools, there is an increased risk the DRM model outputs will be seen as coming from a black box, resulting in greater concern and scrutiny from regulators and auditors. A standardized model such as the CDM has the potential to reduce the perceived audit risk and increase the level and quality of compliance achieved by banks.

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## ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In

addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the association's website: [www.isda.org](http://www.isda.org). Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).