Dynamic Risk Management

The Phase-Out of IAS 39 Portfolio Hedge Accounting Is Approaching

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01. Introduction

With the introduction of IFRS 9 “Financial Instruments” on 1 January 2018, the accounting rules for financial instruments — including hedge accounting — were fundamentally revised. However, one area was excluded from the new requirements: portfolio hedge accounting.

Although the IASB had been working since 2013 on an update to portfolio hedge accounting as part of the so-called “portfolio revaluation approach”, widespread criticism of the 2014 discussion paper and several unresolved technical issues meant that no final guidance was included in IFRS 9.

As a result, the existing IAS 39 provisions for portfolio (macro) hedging may continue to be applied for the time being. This option also extends to micro and group hedges where relevant. In addition, the EU-specific carve-out, which permits bottom-layer hedging, remains applicable under EU-endorsed IFRS.

DRM Core Model and Transition into a Standard-Setting Project
Since the publication of the “Core Model” in July 2019, the IASB has been working intensively on developing a new approach to portfolio hedge accounting under the project titled “Dynamic Risk Management (DRM)”. The initiative was elevated to a standard-setting project in July 2022.

With the release of the agenda paper on transition upon initial application (AP4A, 10/24)[1], it has become clear that the DRM model is intended to be incorporated into IFRS 9. While the implementation timeline has not yet been finalized, first-time application — and the resulting replacement of IAS 39 — could occur by 2030.

Planned Publication of the DRM Exposure Draft
The IASB’s project on Dynamic Risk Management (DRM) has now reached an advanced stage. In October 2024, the IASB decided to proceed with the balloting of an Exposure Draft, the publication of which is expected in Q4 2025 (AP4B, 10/24).

Interest Rate Management as a Central Aspect of Hedge Accounting
With the DRM project, the IASB aims to achieve a more realistic representation of risk management activities within financial reporting (AP4C, para. 1, 06/24). The DRM approach is therefore derived from the risk management strategy of the respective institution, resulting in different perspectives depending on the primary interest rate risk management view applied (EVE vs. NII perspective). In all cases, the key metrics — Current Net Open Position (CNOP) and Risk Mitigation Intention (RMI) — must be determined consistently with the entity’s risk management framework (AP4A, paras. 10–26, 11/21). This, in turn, raises architectural considerations for a system-based implementation of DRM processes.

The closer alignment with the entity’s risk management strategy, as mentioned earlier, also entails certain limitations — for instance, the elimination of voluntary and period-specific (de-)designations. While under IAS 39 strategic derivative positions may currently be included in portfolio hedge accounting — a practice that is applied in practice depending on prevailing market expectations — such a flexible interpretation will not readily be possible under the DRM model.

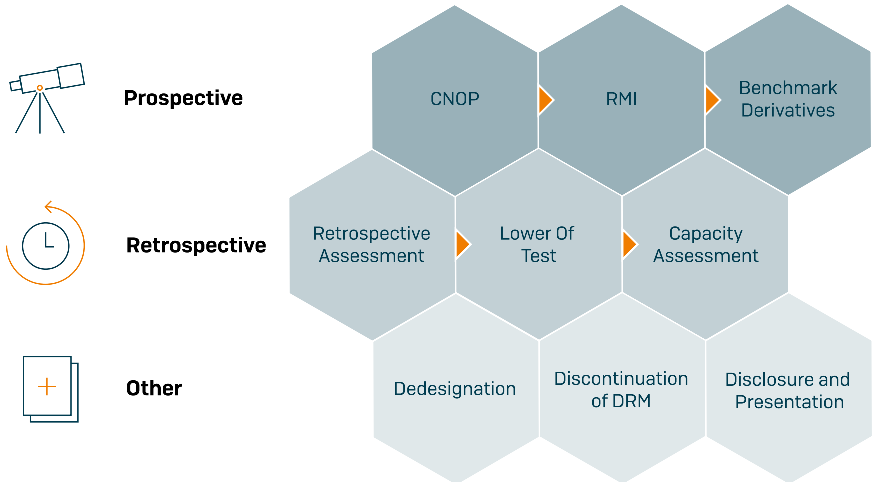
1 The agenda papers concerning the DRM topic may be accessed via the IASB website, where they are arranged by meeting.

02. Elements and Standard Process of DRM

2.1 The Regular DRM Process

The future DRM process represents an interaction between the treasury's risk management activities and the accounting perspective within financial reporting. The Risk Management Strategy (RMS) provides the decisive framework for the DRM, as it defines how the entity manages its (interest rate) risks (AP4B, paras. 16 – 18, 09/24).[2] Key components of risk management — such as governance structures, the managed interest rate, the primary risk metric applied for management purposes, and the risk limits relevant to DRM — are determined by the RMS.

The following section briefly outlines the core elements of the regular DRM process.



2.1.1 Prospective Steps at the Beginning of the Hedging Period

The following procedures are to be performed as part of the regular DRM process at the beginning of each hedging period (cf. AP4 Cover Note, 10/24).

Determination of the Current Net Open Risk Position (CNOP)
Depending on the entity's primary risk management approach (EVE or NII) and the respective risk metric applied, the net risk position of the underlying portfolios is determined for each time bucket. This may, for instance, take the form of a PV01 profile (under the EVE perspective) or may be based on repricing cash flows (under the NII perspective). In principle, all non-derivative positions relevant to interest rate risk management — that is, assets and liabilities including demand deposits — are to be considered. Behavioral modelling techniques consistent with those used in interest rate risk management, such as deposit modelling or prepayment assumptions, may likewise be applied.

2 Initially, the IASB's focus in the context of DRM lies on the interest rate risk management of banks. Nevertheless, DRM is intended, in the longer term, to become part of IFRS 9, which is not designed to be industry-specific (AP4, para, .5, 10/24).

However, several exclusion criteria apply when determining the CNOP: in particular, positions measured at FVPL, equity instruments and exposures whose cash flows are dominated by credit risk must not be included in the CNOP calculation (AP4A, para. 9, 02/23).

Determination of the Risk Mitigation Intention (RMI)
The Risk Mitigation Intention (RMI) represents the portion of the CNOP that the entity intends to mitigate by using derivatives. The basis for the RMI is formed by the designated derivatives, which generally constitute a subset of the external derivatives used for interest rate risk management. Internal derivatives and certain types of (net written) options are excluded from this scope (AP4C, paras. 12–17, 07/23).

In alignment with the determination of the CNOP, a risk profile — separated by time buckets — is first established in accordance with the entity's primary risk management approach (NII or EVE). The RMI is then determined in compliance with the following principles (see also AP4B, paras. 25–33, 04/23):

Rules for the determination of the CNOP

- RMI ≤ CNOP – No over-hedging is permitted; the RMI may only include risk positions that reduce the exposure identified in the CNOP.
- CNOP – RMI ≤ risk limits – The net risk position must, within the defined tolerance range, align with the target profile[3] as established under the entity's risk management strategy.

Once the RMI has been initially established, subsequent amendments are, as a rule, not permissible (AP4A, para. 46c, 11/21). An exception applies only in circumstances where changes in the CNOP would otherwise result in the failure of the retrospective assessments (see Section 2.1.2).

Construction of Benchmark Derivatives
Once the RMI has been determined, it must be evidenced through the construction of so-called benchmark derivatives (AP4B, paras. 34–37, 04/23). This procedure is intended to ensure that the RMI is measured independently of the derivatives actually designated for hedging purposes.

Benchmark derivatives are synthetic instruments that conceptually replicate an entity's Risk Mitigation Intention (RMI). Their properties must exclusively capture the characteristics of the RMI as determined by the risk metric set out in the entity's risk management strategy, rather than those of the derivatives that were designated for hedging. The benchmark derivatives are defined with respect to the managed risk and the reference rate pertinent to the underlying interest rate exposure identified in the risk management framework. At inception they are calibrated to prevailing market interest rates for the managed risk to ensure a fair value of zero at inception.

3 With the introduction of the concept requiring entities to manage the CNOP within defined limits, the DRM framework distinguishes between the notions of Target Profile and Risk Mitigation Intention (AP4A, paras. 10–16, 11/21). The Target Profile represents the corridor of net risk positions permitted under the entity's risk management strategy for each time bucket, measured in the respective risk metric and taking into account the applicable risk limits.

2.1.2 Retrospective Steps at the End of the Hedging Period

The following steps must necessarily be performed at the end of the hedging period:

Retrospective Assessment
To assess the impact of unexpected changes in the CNOP during the preceding period — for instance, those resulting from unanticipated prepayments — a retrospective test is performed (AP4A, paras. 30–38, 11/21). The purpose of this test is to determine whether, and to what extent, the bank has successfully mitigated its interest rate risk and achieved the intended target profile despite such unforeseen developments. If, in the retrospective assessment, the bank is found to have over-hedged, the RMI must be adjusted retrospectively, and additional benchmark derivatives must be recognised accordingly.

Lower of Test
The DRM adjustment for the respective completed period is determined using the so-called Lower of Test (AP4A, paras. 41–49, 04/22). In this test, the cumulative present value changes of the designated derivatives are compared with those of the benchmark derivatives; the lower of the two values is subsequently recognised as the DRM adjustment. The Lower of Test is applied on a cumulative basis and is also performed for realised interest income. This approach ensures that not only the volatility of the present value is mitigated, but that variability in net interest income (NII) is also reduced.

Capacity Assessment
The consideration of unforeseen changes in the CNOP during a hedging period constitutes a complex and widely debated issue that is not fully captured by the retrospective assessment. To avoid extensive CNOP tracking and the ongoing monitoring of unexpected variations, the DRM project introduced — initially in February 2023 and in more detail in June 2024 — the concept of a Capacity Assessment (AP4A, 06/2024). The objective of this approach is to account for the effects arising from unexpected changes in the risk position, thereby ensuring that the recognised DRM adjustment remains consistent with the expected hedging effects on the CNOP

According to the current state of deliberations, no automatic adjustment of the DRM adjustment from prior periods is intended when the underlying exposures partially cease to exist due to prepayments. To ensure that the recognised DRM adjustment remains aligned with the risk of the CNOP, a Capacity Assessment is to be performed. Its goal is to determine whether the DRM adjustment exceeds the economic value of the current CNOP and would therefore no longer be consistent with the expected risk mitigation effect. In such cases, a corresponding portion of the DRM adjustment shall be derecognised through profit or loss. Moreover, a shortfall identified in the Capacity Assessment poses additional challenges for the subsequent Lower of Test, as it must be ensured that the test outcome is not subsequently reversed. Such reversals could otherwise lead to an inappropriate smoothing of net interest income (NII), thereby compromising the faithful representation of risk mitigation results within the DRM framework.

However, the current deliberations regarding the Capacity Assessment leave open several conceptual and practical questions. For instance, in cases where deliberately open risk positions are maintained in accordance with the Target Profile, situations may arise in which the DRM adjustment exceeds the fair value of the CNOP— an outcome for which a partial derecognition of the DRM adjustment would likely not be consistent with the underlying objectives of the DRM model. Moreover, both the European Banking Federation (EBF) and the European Central Bank (ECB) have raised critical questions to the IASB, particularly concerning the conceptual consistency between the DRM framework and the ICAAP guidelines.

Consequently, substantial revisions to the Capacity Assessment are anticipated in the forthcoming Exposure Draft, relative to the approach debated thus far.

2.2 Further DRM Process Steps

Beyond the regular core process of the DRM, there are additional procedural requirements to be considered.

De-designation / Discontinuation of DRM
As the DRM framework is aligned with the entity's risk management strategy, it must be discontinued and re-established whenever that strategy undergoes material modifications. In contrast to the portfolio hedge accounting model under IAS 39, voluntary de-designation or termination of the DRM relationship is not envisaged (AP4B, para. 39, 09/24).

Disclosures in the IFRS Notes
As noted at the outset, a principal objective of the DRM framework is to achieve a higher degree of transparency in the representation of an entity's risk management activities within its financial statements (AP4C, para. 1, 06/24). Accordingly, the application of the DRM model entails the disclosure of additional information, including, inter alia, maturity profiles and average interest rates of the designated derivatives, a breakdown of the components of the CNOP, as well as details pertaining to the Capacity Assessment (AP4A, paras. 16–50, 09/24).

03. Transition / First-time Adoption

Although the effective date of initial application has not yet been determined, detailed proposals regarding the transition and first-time adoption requirements of the DRM framework have already been developed

Discontinuation of Hedge Accounting under IAS 39
While the application of the DRM framework is currently expected to be voluntary rather than mandatory, the introduction of the DRM will preclude the continued use of existing IAS 39 hedge accounting relationships (AP4A, para. 18, 10/24). This restriction applies to both portfolio hedges and micro hedges. In such cases, a de-designation in accordance with the requirements of IAS 39 / IFRS 9 must be carried out at the date of initial application of the DRM (AP4A, paras. 20–22, 10/24).

Micro Hedge Positions under IFRS 9
For positions previously designated in micro hedge relationships under IFRS 9, entities are granted a one-time option at the date of initial application of the DRM to perform a de-designation and include the affected positions within the scope of the DRM framework (AP4A, para. 26, 10/24).

Fair Value Option
For positions previously measured under the Fair Value Option, entities are likewise granted a one-time option at the date of initial application to reclassify such positions to include them within the scope of the DRM framework (AP4A, paras. 30–34, 10/24).

04. Conclusions

The introduction of the DRM framework constitutes a paradigm shift in hedge accounting, presenting banks with a wide range of challenges, but also with significant opportunities.

Strong Interlinkage between Risk Management and Accounting
The strong orientation of the DRM framework toward the risk management process and the overall risk management strategy results in a substantially closer integration between interest rate risk management and hedge accounting. This development places banks in a position where both the risk strategy and the operational risk management processes must be reviewed to ensure an optimal design of the DRM framework. At the same time, this integration offers opportunities to streamline banking processes and to leverage associated synergies.

For an effective incorporation of the DRM within the system architecture, merely adapting existing portfolio hedge accounting systems will, in many cases, not be sufficient. Instead, each process step of the DRM should be examined individually to determine whether and how integration with the bank's risk management systems can be achieved within the broader architectural framework.

Interaction with Other Systems
Potential implications are not limited a priori to the risk management and hedge accounting systems; the involvement of trading systems—particularly for the generation and data maintenance of benchmark derivatives—may also prove beneficial. Given the significant impact of the Lower of Test and, potentially, the Capacity Assessment on booking logic, notable effects are expected within the sub-ledger architecture.

Traditionally, standard booking processes for interest income and fair value results on derivatives have often been operationally decoupled from hedge accounting entries, which are subsequently recorded "on top," for instance, through reclassifications between fair value and hedge accounting results. The introduction of the Lower of Test, however, establishes new dependencies between standard accounting processes and hedge accounting entries, thereby posing substantial challenges for the end-to-end implementation of the DRM framewor

Strategic Considerations for IT Architecture and Transition
For the reasons outlined above, the implementation of the DRM framework is likely to be accompanied by cross-functional architectural decisions within many banks. Given the associated lead times, an early-stage analysis is advisable in order to ensure an efficient implementation and sustainable operation of the DRM in the future. From a technical perspective, several fundamental decisions must also be made in preparation for the DRM—among them the use of transition reliefs, the treatment of group structures, and the determination of hedge period durations.

Practical Testing and Preliminary Impact Assessment
In order to identify potential issues and to test possible solutions under realistic conditions, the performance of simulation-based calculations is advisable. Such pilot runs under near-real conditions enable a thorough analysis of potential gaps while also facilitating active and targeted engagement with the IASB during the designated 240-day comment period (AP4B, para. 1b, 10/24).

DRM-Glossary

Benchmark Derivates	Synthetic derivatives used to assess the effectiveness of interest rate risk management. They represent the entity's Risk Mitigation Intention (RMI) and are initially calibrated to achieve a fair value of zero.
Capacity Assessment	A DRM process step designed to ensure that the economic stabilisation effects reflected in the DRM adjustment continue to be supported by the underlying Current Net Open Position (CNOP). If the DRM adjustment exceeds the fair value of the CNOP, the excess amount must be immediately derecognised through profit or loss.
Current Net Open Risk Position (CNOP)	The net interest rate risk position, disaggregated by time buckets, that arises from the eligible assets and liabilities of an entity over the designated interest rate risk management horizon. The allocation to time buckets is based on the repricing dates of the underlying positions, considering both contractual and modelled cash flows.
Designated Derivates	Hedging derivatives traded with external counterparties for the purpose of managing the interest rate risk exposure arising from the Current Net Open Position (CNOP). Within the DRM framework, these instruments are used, among other purposes, to demonstrate the entity's Risk Mitigation Intention (RMI).
DRM-Adjustment	A balance sheet component generated through the application of the Lower of Test in the DRM model. From an economic perspective, it reflects the cumulative fair value changes of the designated derivatives that are deferred from immediate profit or loss recognition, thereby portraying the stabilising effect of risk mitigation within the financial statements.
Economic Value of Equity (EVE)	In the context of the DRM framework, this term refers to the fair value of the banking book. One of the objectives of applying the DRM model is to substantiate and explain portions of EVE volatility in the balance sheet that arise from risk management activities.
Lower-Of-Test	A test that compares the designated derivatives with the benchmark derivatives in terms of cumulative fair value changes on the one hand and realised interest profiles on the other. The lower of the two amounts is recognised as the DRM Adjustment.
Net Interest Income (NII)	In the context of the DRM framework, this term refers to the interest income of the banking book. One of the objectives of applying the DRM model is to substantiate and explain portions of NII volatility in the balance sheet that arise from risk management activities.
Retrospective Assessment	A process step performed at the end of each DRM period that retrospectively identifies potential over-hedges, considering unexpected changes in the Current Net Open Position (CNOP) that occurred during the preceding period.
Risk Mitigation Intention (RMI)	The extent to which an institution seeks to reduce its open interest rate risk exposure using hedging derivatives. For valuation purposes, this intention is represented by the Benchmark Derivatives.
Risk Management Strategy (RMS)	In the context of the DRM framework, this term refers to the overarching strategy for managing the interest rate risk of the banking book. It provides the central input for the specific design and implementation of the DRM model.
Target Profile	The intended interest rate risk position that is expected to result from applying the Risk Mitigation Intention (RMI) to the Current Net Open Position (CNOP). It is defined by risk limits that must be consistent with those established under the Risk Management Strategy (RMS).

Contact

We invite you to engage in a non-binding discussion on potential implementation pathways for your institution. Our team can provide support in designing a preliminary DRM study to address the outlined considerations in a timely and structured manner.

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