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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.  
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

### **INFORMATION FOR OBSERVERS**

**Board Meeting:** 20 May 2008, London

**Project:** *IAS 39 Financial Instruments: Recognition and Measurement, Exposures Qualifying for Hedge Accounting (ED)*

**Subject:** **Designation of inflation risk in particular situations (Agenda paper 10A)**

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### **INTRODUCTION**

1. This paper addresses the designation of inflation risk in particular situations. This paper sets out:
  - a) the background
  - b) the staff's recommendation
  - c) an analysis of the issue, including consideration of comments by respondents to the ED.

### **BACKGROUND**

2. Markets exist in some jurisdictions for inflation-linked cash and derivative financial instruments. There are many users of such instruments. For example, some governments and regulated utilities have issued inflation-linked debt to investors such as pension funds with inflation-linked liabilities. Other market participants trade and use inflation-linked derivatives. Reasons for using such instruments include economically hedging assets and

liabilities (or revenues or costs) that are specifically linked to inflation<sup>1</sup>, to diversify interest rate risk by creating exposure to changes in real (as opposed to nominal) interest rates, and to protect against a low inflation environment.

3. In November 2005 the IFRIC received a submission asking whether it was possible under IAS 39 to designate as a hedged item the inflation risk associated with a fixed rate financial liability. The IFRIC was unable to reach a decision on this issue and referred the issue to the Board.
4. The Board discussed this issue as part of the deliberations that resulted in the publication of the ED. Inflation risk was not specified as an eligible risk in paragraph 80Y of the ED. However, if inflation was (a) a contractually specified cash flow, and (b) if it was a contractually specified cash flow, the remaining cash flows of the instrument would not be a residual amount, paragraph 80Y(e) of the ED permitted designation of the inflation component.
5. The Board believed that this decision reflected its original intentions that only risks and cash flows that were separately identifiable and measurable should be eligible for designation. The Board also believed that this decision reflected existing practice and this was largely confirmed by respondents to the ED.

## **STAFF RECOMMENDATION**

6. The staff recommends:
  - a) retaining the approach taken in the ED with regards to this issue
  - b) moving paragraph 80Y(e) of the ED to the application guidance of IAS 39
  - c) some minor drafting changes to clarify that paragraph, and
  - d) re-emphasising the principles underlying eligible risks and portions for hedge accounting in the Basis for Conclusions (BC).

## **STAFF ANALYSIS**

7. Paragraph 80Y(e) of the ED states that:

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<sup>1</sup> This paper does not address cash flow hedge accounting for forecast transactions, including forecast sales. Cash flow hedge accounting is available for forecast transactions if the requirements of IAS 39 are met, and such transactions were not the subject of the submission to the IFRIC and are not addressed in this paper.

*Subject to the restrictions in paragraph 79, a financial instrument may be designated as a hedged item with respect to all of its risks. Subject to the restrictions in paragraph 79, a financial instrument may also be designated as a hedged item for one or more of the following risks:*

...

*e) the risks associated with the contractually specified cash flows of a recognised financial instrument. For example, an entity may hold a financial asset that pays interest at inflation plus 3 per cent. Assuming that the entity is not required to account for the inflation embedded derivative separately, the entity is permitted to designate as a hedged item changes in the cash flows of the financial asset attributable to changes in inflation. This is because inflation is a contractually specified cash flow of the financial asset. However, an entity holding a fixed rate financial asset is not permitted to designate as a hedged item changes in its fair value attributable to changes in inflation. This is because either the inflation component is not a contractually specified cash flow or, if inflation is a contractually specified cash flow, the remaining component would be a residual.*

8. Some respondents to the ED argued that IAS 39 should permit the designation of inflation risk, because inflation is similar to an interest rate index (LIBOR, for example), and IAS 39 explicitly allows such indices to be designated as portions of cash flows.
9. Some respondents also suggested drafting changes to clarify paragraph 80Y(e).

### **The issue**

10. A small number of respondents argued that inflation risk that is not contractually specified should qualify for designation as a hedged risk or portion. Such respondents stated that the expected inflation rate curve can be viewed as a type of interest rate because, similar to interest rates, expected inflation rates for different periods are quoted and traded in the market.
11. Respondents provided an example of a fixed rate bond issued by an entity and turned into the equivalent of an inflation-linked liability by entering into an inflation swap. It was argued that to reflect the true commercial reality, the inflation component of the fixed rate debt should be eligible for designation as the hedged item because the fixed rate on the liability is effectively made up of an inflation indexed component plus a real rate of interest. The ED would not permit such a designation.

## Staff comments

12. The hedge accounting model in IAS 39 is based on a principle of offset. That is, the hedge is expected to be, and does, achieve largely offsetting changes in fair value or cash flows between the designated hedged item and hedging instrument. In situations that the entire exposure to change in fair values or variability in future cash flows is designated, it is relatively straightforward to judge whether or not such a threshold will be and has been achieved. In situations that something other than the entire exposure to change in fair values or variability in future cash flows is designated (a 'partial hedge', when only specific risks or particular portions of cash flows are designated), such a judgement is not so straightforward.
13. Paragraph 88 of IAS 39 sets out the conditions to be met for a hedging relationship to qualify for hedge accounting.
14. Paragraph 88(d) states that the effectiveness of the hedge can be reliably measured if hedge accounting is used. This is a critical requirement underpinning the principle of offset, and imposes discipline on the availability and application of hedge accounting.
15. Paragraph 81 of IAS 39 discusses the designation of financial items as hedged items. Paragraph 81 allows the designation of partial hedges *provided that effectiveness can be measured*. It gives an example of the interest rate portion of an interest-bearing asset or liability being eligible for designation because it is identifiable and separately measurable.
16. Paragraph 82 of IAS 39 discusses the designation of non-financial items as hedged items. That paragraph limits the situations that something other than the entire exposure to change in fair values or variability in future cash flows of a non-financial item can be designated, because of the *difficulty of isolating and measuring* the appropriate portion of the cash flows or fair value changes attributable to specific risks. This confirms the requirements of IAS 39 that relate to hedged financial items and the requirement that effectiveness can be reliably measured. Paragraph AG100 of IAS 39 also provides further insight into the types of eligible hedged items, stating that changes in the price of an ingredient or component of a non-financial item generally do not have a *predictable*,

*separately measurable* effect on the price of the item that is comparable to the effect of a change in market interest rates on the price of a bond.

17. All of these paragraphs in IAS 39 emphasize the requirement that the designated hedged item must be an identifiable risk or cash flow, must be reliably and separately measurable, and must have a predictable effect on the entire exposure to change in fair values or variability in future cash flows.
18. The staff believes that IAS 39 sets a high threshold to be attained before an entity is permitted to designate something other than the entire exposure to change in fair values or variability in future cash flows. In the staff's view, such a high threshold is appropriate. If this were not the case, the hedge accounting model in IAS 39 would impose no discipline over the types of relationships that qualify for hedge accounting, or over the measurement of effectiveness and the recognition in profit or loss of any ineffectiveness.
19. So, let us apply the requirements of IAS 39 to interest-bearing financial assets and liabilities. For most such instruments there is an observable, '*predictable and separately measurable*' relationship between a change in market interest rates and the fair value or cash flows of the financial asset or liability; when pricing such items at issuance or in secondary markets, market participants will normally start with the relevant interest rate swap curve or the relevant government curve. The staff believes that such factors mean that, in most situations, the requirements and thresholds set out above can be achieved to allow the designation of a market interest rate as the hedged risk or portion of a bond.
20. The staff believes that market interest rates are different from inflation risk. Expected inflation is traded in some markets, like expected interest rates. There is certainly a relationship between expected inflation, expected nominal interest rates and hence the fair value of a bond. The theoretical relationship between inflation and nominal interest rates is captured in the so-called Fisher equation. However, this theoretical relationship can break-down, with arbitrage opportunities arising if calculated nominal rates (calculated using the Fisher equation) significantly exceed observed market nominal interest rates.

21. The question, however, for this paper is whether the requirements and thresholds set out previously can be met to enable the designation of an inflation risk or portion for a financial asset or liability that carries a market-based nominal interest rate.
22. The staff does not believe this to be the case, for the following reasons:
- a) there is no clear relationship between the inflation index (which is calculated using many financial and non-financial inputs from across the whole economy) and the inflation risk a specific fixed rate bond is subject to.
  - b) market participants do not generally base pricing and investment decisions for fixed rate bonds on the expected inflation curve, whereas they clearly do base such decisions on the market interest rate benchmarks.
  - c) there is no observable effect on the fair value or expected cash flows of a fixed rate bond if and when expected inflation rates change.
23. The staff also believes that permitting the designation of inflation for a financial asset or liability that carries a market-based interest will significantly loosen the IAS 39 hedge accounting model in terms of items eligible for designation and the calculation of effectiveness and recognition of ineffectiveness. For example, would exposure in changes in the price of oil (an input into any inflation calculation) be eligible for designation as a partial hedge of a fixed rate bond? It might be argued that changes in oil price expectations change inflation expectations which change interest rate expectations which change the fair values of fixed-rate bonds.
24. Now let us consider the situation that an inflation index is a *contractually specified cash flow*, and the remaining cash flows are simply not whatever amount is required to reach a predetermined total cash flow (that is, the remaining cash flows are not a residual amount). An example is a financial asset that pays interest at realised inflation plus three per cent. In such a situation there is a readily identifiable inflation component that is capable of being separately measurable. Market participants will consider expected inflation in pricing and investment decisions for such an instrument. Furthermore, changes in expected inflation will have an observable effect on the entire fair value or expected future cash flows of the instrument.

25. The staff believes that the requirements and thresholds set out in IAS 39 and this paper can be met for this inflation risk component, and so hedge accounting would be available if all the other requirements of IAS 39 are met. This conclusion is consistent with the proposals set out in the ED.
26. In summary, the staff therefore recommends retaining the approach taken in the ED with regard to inflation.

### **Clarity of paragraph 80Y(e)**

27. A number of respondents expressed concerns about the wording of paragraph 80Y(e). In particular, some respondents believe that it is unclear what a '*residual*' component means in the last part of that paragraph.
28. Moreover, a small number of respondents believe that the wording '*risks associated with contractually specified cash flows*' is inappropriate. These respondents noted that it is unclear whether '*associated*' means that the contractually specified cash flows are exposed to a particular risk (and that this risk has a measurable effect on the contractually specified cash flows) or whether '*associated*' means that the specified cash flows must be independent from any other cash flows of the financial instrument. Respondents proposed clarification of the wording.
29. The staff agrees with respondents that the term '*residual*' in paragraph 80Y(e) is not sufficiently clear and will address this issue in redrafting.
30. However, the staff does not believe that the wording '*risks associated with contractually specified cash flows*' is inappropriate. The staff considers that '*associated*' means that the contractually specified cash flows are exposed to a particular risk (and that this risk has a measurable effect on the contractually specified cash flows) **and** that the specified cash flows must be independent from any other cash flows of the financial instrument.

### **Questions for the Board**

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| Does the Board agree with the staff recommendation as set out in paragraph 6? |
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If not, what does the Board wish to do, and why?