Project	**Financial Instruments (Replacement of IAS 39)—Hedge accounting**
Topic	**Hedged items—guidance on determining eligible risk components**

Introduction

1. This paper is one in the series that addresses the designation of a *risk component* as the hedged item. This paper addresses how and what guidance on determining risk components that are eligible for designation as a hedged item should be provided in the final requirements (eligible risk components).

2. The staff recommendations and questions to the Board are included in agenda paper 3C.

Staff analysis

Approach to identifying risk components

Criteria-based approach

3. The staff note that there was overwhelmingly supportive feedback for using a *criteria-based* approach.

4. The staff consider that there is no viable alternative to using a criteria-based approach to identifying eligible risk components because of the large variety of markets and hence circumstances in which hedging takes place.[1] This

[1] See agenda paper 3A for more background.

ramification is amplified for the IASB as an *international* standard setter. It is impossible to analyse and provide specific guidance on all markets and circumstances (in fact, it can only be done for a small number). Also, markets evolve and circumstances change[2]—specific guidance that directly prescribes the outcome would need to be continuously updated in response to changes.

5. Hence, any attempt to provide specific guidance for each particular situation would inevitably result in an *arbitrary list* of situations with eligible risk components while all situations not on the list would be precluded from designating risk components as hedged items. The feedback emphasised that the bias against some types of risk components under IAS 39 *Financial Instruments: Recognition and Measurement* was arbitrary and conceptually not justifiable, and that the new hedge accounting model should avoid similar deficiencies. In contrast, the use of criteria would enable requirements for determining eligible risk components to be the same for financial and non-financial items—this was also a common theme in the feedback.

The criteria to be used

6. The feedback on the Exposure Draft *Hedge Accounting* (ED) generally supported using the proposed criteria, ie that a risk component must be separately identifiable and reliably measureable to qualify for designation as a hedged item. No alternative criteria were suggested. (The commentators' suggestions relate to guidance on applying those criteria.)

7. The staff consider that the criteria proposed in the ED would also have the advantage of being already well established under IFRSs (having been used for financial items in IAS 39)—a fact also pointed out by some commentators. Hence, developing a single, consistent approach to identifying eligible risk components is mainly about extending the application of those criteria from financial to non-financial items.

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[2] See agenda paper 3A for an example—paragraph 34(c).

Guidance to be provided for the application of the criteria

Extent and level of detail

8. The main requests arising from the feedback relate to *how* guidance should be provided in the final requirements. There were two conflicting views:

   (a) Many commentators requested that the final requirements provide more guidance or clarifications, and this request relates almost solely to *non-contractually* specified risk components of *non-financial* items.

   (b) However, a number of commentators opposed doing so because in their view providing more guidance tends to result in rule-based standard setting.

9. Staff note that it is difficult to strike a balance for the extent and type of guidance:

   (a) On the hand the staff agrees that too much guidance or guidance that is too detailed has a tendency to result in rules and ultimately undermines rather than reinforces the application of criteria or principles.[3]

   (b) On the other hand, too little guidance or guidance that is too high level results in uncertainty about how to apply the criteria or that they are not being applied appropriately.

Type of guidance

10. Using *criteria* means useful and effective application guidance should explain *how* the criteria are applied rather than simply giving outcomes for a number of different situations. Hence, the focus of guidance must be on explaining *how to analyse* a given set of facts and circumstances to be able to conclude that a risk component is eligible for designation as a hedged item (instead of trying to

[3] The application guidance on embedded derivatives is a an example of rules-based standard setting by way of providing examples.

provide guidance for a variety of industries or fact patterns). During outreach the staff found that this was the most effective way of explaining the proposal.

Most relevant areas for guidance

11. The staff note that for *contractually specified* risk components there was general agreement that these components should be eligible *irrespective of* whether they relate to a financial or non-financial item (ie a gas oil price link in a natural gas contract is no different from a LIBOR link in variable rate debt). The only issue raised in the feedback was a request for clarification on negative spreads in commodity markets (this issue is the equivalent of the 'sub-LIBOR' issue—see the section 'Negative spreads' further below).

12. People have few problems with contractual price links or indexations. Such exposures are *concrete* and hence easy to understand and verify.

13. Also, the risk components approach and the criteria proposed in the ED have been applied to *financial* hedged items for many years now so there is experience and established practice whereas other than for foreign exchange (FX) risk that was not allowed for *non-financial* hedged items. Hence, people are—quite naturally—less familiar and comfortable with evaluating non-financial hedged items for the purpose of hedge accounting.

14. Hence, the staff consider that guidance for the final requirements should demonstrate the analysis required to conclude that a *non-contractually specified* risk component is eligible for designation as a hedged item.

15. Also, in order to address the requests by commentators and demonstrate the requirements for situations that are new under the proposals in the ED, examples of *non-financial items* should be chosen. However, including an example of a non-contractual risk component of a *financial* item would also be beneficial to:

    (a) demonstrate that there is no difference (any more) between financial and non-financial hedged items; and

    (b) make use of the established practice that IFRS users are familiar with to achieve an easier transition to the new requirements.

Clarifications

16. Before moving on to examples that could be used to demonstrate the application of the criteria, the main requests and suggestions for clarifications from the feedback are analysed. These can be broadly grouped as follows:

    (a) relevance of the 'market aspect';

    (b) availability of prices;

    (c) correlation between the hedged risk component and the entire item; and

    (d) negative spreads.

    In addition to those main requests for clarification there were also some other requests for 'clarifications' that reflect misunderstandings of the intended notion of risk components.

Relevance of the 'market aspect'

17. Some commentators wanted clarification about what can be broadly summarised as the relevance of the 'market aspect' in determining eligible risk components. They referred to this aspect in different ways, for example:

    (a) whether 'common market practice' would be relevant; or

    (b) whether a risk component would be eligible if it was a known cost component and knowledgeable and willing buyers and sellers would be expected to explicitly consider it in determining the price of the entire item or if there was an indicative price list.

18. The staff consider that the market aspect is highly relevant. As set out in the ED[4] and demonstrated in agenda paper 3A, the *analysis of the market structure is crucial for determining eligible risk components*.

19. When referring to the market aspect it is important to keep in mind what the criteria are that must be fulfilled to qualify as an eligible risk component: the

[4] See ED.B14.

risk component must be separately identifiable and reliably measurable. Hence, the criteria do not just relate to a measurement aspect but also to the separate identifiability of a component. The latter is a unit of account question and hence has a different purpose than just determining a value. Arguably, determining the unit of account is the more important and difficult task than subsequently determining the value of that unit of account once established.

20. Therefore, the staff consider that notions such as a knowledgeable and willing buyer or seller or a market participant would be *unsuitable* as a reference point. They would not appropriately reflect the aspect of separate identifiability:

    (a) Many parties that transact in a market do not need to consider risk components because it is *not relevant* for them. For example, gas oil is traded on the commodity exchanges and hence directly available. If an entity simply wants to trade gas oil or a gas oil futures contract because it needs gas oil, wants to sell gas oil or it is an investor that wants to take a position in gas oil the entity does *not* have to consider whether crude oil is a risk component of gas oil or whether gas oil is a risk component of jet fuel. Those considerations apply *only* in the context of hedge when an entity uses a strategy based on risk components. However, not all parties transacting in the market are hedgers (and even the hedgers are not all using risk components—that depends again on their respective hedging strategies).

    (b) If parties transact in items that are not directly available in a liquid market then there is a danger that factors that influence the ultimate transaction price but that are not separately identifiable will be mistaken as an eligible risk component. For example, risks such as prepayment risk, inflation risk and credit risk are all factors that would be taken into account when pricing a transaction for which those factors are relevant. Hence, using a knowledgeable and willing buyer or seller or a similar notion as a reference point would imply that those factors are eligible risk components and the separate identifiability aspect of the criteria would in substance be undermined.

21. The staff consider that the correct analogy to the notion of a knowledgeable and willing buyer or seller would be something like a 'knowledgeable and willing *hedger*' in order to accurately reflect the purpose of determining eligible risk components and the applicable criteria. However, the staff consider that such a notion would also be *unsuitable* as a reference point:

    (a) Hedging strategies are *entity-specific*. Hence, it is unclear how a 'knowledgeable and willing *hedger*' could be determined. Moreover, using such a notion would defeat the purpose of giving information about *the entity's* risk management and hedging strategy. Instead, the financial reporting information would reflect the hedging strategy of *someone else* (the 'knowledgeable and willing hedger'—however determined—reflecting its risk preferences etc). The staff consider if the objective is to benchmark an entity's actual hedging strategy against a 'standard hedger' or a 'super hedger' this is completely different from the objective of the ED—and such a hedge accounting model would have to make hedge accounting mandatory to start with.

    (b) Using the notion of a 'knowledgeable and willing hedger' might have unintended consequences regarding the measurement and recognition of hedge ineffectiveness. For many customary types of hedging hedgers—including the knowledgeable and willing—judge hedge effectiveness by the best hedging instrument that is available. For example, they consider that a credit default swap (CDS) that matches the name and maturity of their credit exposure is perfectly effective for hedging the credit risk. Similarly, for hedges of the interest rate risk of prepayable debt instruments or hedges of inflation risk of fixed rate debt instruments hedgers typically consider an interest rate swap and an inflation derivative, respectively, as perfectly effective in hedging those risks. This approach to measuring hedge ineffectiveness would not be intended so the staff consider that using the notion of a 'knowledgeable and willing hedger' might create ambiguity.

22. The staff note that agenda paper 3A demonstrates that the analysis of the *market structure* is effective as a complement of the risk components criteria proposed in the ED in order to apply those criteria to concrete facts and circumstances. Hence, the staff consider that the market structure is a suitable reference point for determining eligible risk components (ie it is effective and consistent with the criteria proposed in the ED).

Availability of prices

23. Some commentators wanted clarification about what can be broadly summarised as the availability of prices in active markets. For example, they wondered whether the eligibility of risk components for designation as hedged items would depend on:

    (a) whether a forward market exists for the hedged component or;

    (b) whether the risk component is actively traded.

24. The staff consider that as for the issue discussed in the previous section[5], the existence of an active forward or spot market would focus on the reliable measurement aspect of the criteria but would not appropriately reflect the aspect of separate identifiability. Hence, the staff consider it would also create the danger of having the unintended consequence of undermining the proper identification of the unit of account before assessing its measurability (eg directly jumping to the measurement using forward prices thereby skipping the first step of determining whether that component is separately identifiable within the hedged item).

25. Also, the staff note that one common reason for hedging only a risk component is that there is a more liquid market for the component than for the entire item. Hence, the hedging instrument that hedges the component is typically liquid which means there are liquid forward or/and spot markets and therefore the existence of a liquid market (by itself) not a good indicator for distinguishing

[5] See section 'Relevance of the 'market aspect''.

eligible risk components from other components. Instead, this creates a danger that when using a hedging instrument that is traded in an active market that fact is *automatically* considered to support a conclusion that the risk component is separately identifiable and reliably measurable (ie encourages jumping to the conclusion).

26. Conversely, if an entity uses a highly customised (or 'bespoke') hedging instrument that is tailored to a specific risk exposure there might not be a liquid market. The question is why the eligibility of risk components should be ruled out in such a situation because the reason for customising the hedging instrument is often to achieve an exact match with the particular risk exposure instead of using eg a standard derivative that does not fit the hedged exposure as accurately. This could result in the perfectly negotiated hedge ending up not qualifying for a hedging relationship on a risks components basis while a hedging instrument that has an inferior fit (but is traded in a liquid market) achieves hedge accounting on a risk components basis. The hedge ineffectiveness for the better hedge might then be presented as less effective for hedge accounting purposes (see the section 'The effect of risk components' in agenda paper 3A). That would not result in useful information (in fact it would be misleading).

27. Overall, the staff consider that the existence of an active forward or spot market for the risk component is neither a prerequisite for the eligibility of a risk component nor (in and of itself) conclusive that a risk component is eligible. Hence, the staff consider that it is not a suitable reference point in terms of an additional or stand-alone criterion.

28. However, the staff note that the existence of a liquid market can be an *important factor* in analysing the *market structure*. As illustrated in AP 3A, this aspect is one that can be part of the relevant facts and circumstances that have to be considered in analysing the market structure.

Correlation between the hedged risk component and the entire item

29. Some commentators wanted clarification about whether (positive) correlation between the hedged risk component and the entire item would be required for eligible risk components.

30. The staff note that the relevant correlation is *not* between the risk component and the entire item. In effect, this would require that the value of the risk component and the entire item could only move in the same direction (in 'tandem') but not in opposite directions. Such a requirement would defeat the whole purpose of designating risk components. This is explained in agenda paper 3A.[6]

31. The relevant relationship is between the risk component and the hedging instrument. The hedge effectiveness assessment relates to the type of relationship that must exist between those items in order to qualify for hedge accounting. Depending on the circumstances, that could involve a quantitative assessment, eg using statistical correlation analysis, to determine whether there is a systematic economic relationship that gives rise to offset.

32. Hence, the staff consider that correlation is an aspect that relates to the hedge effectiveness assessment rather than to determining eligible risk components. The decision about whether a risk component is eligible must be made before the hedge effectiveness assessment because it determines what is compared with the hedging instrument.

Negative spreads

33. Some commentators wanted clarification about the ramifications of negative spreads. For example, they wondered what the ramifications for eligible risk components are if a spread is negative.

34. The staff note that the ramifications of negative spreads relate to two different aspects:

[6] See agenda paper 3A (section 'The effect of risk components').

(a) determining *whether* a risk component is eligible; and

(b) *how* the hedging relationship can be designated (including consequences for measuring and recognising hedge ineffectiveness).

35. The staff note that the commodity price risk exposure of a particular entity can be equal to the benchmark or at a premium (positive spread over the benchmark) or a discount (negative spread to the benchmark). The existence of a negative spread as such does not affect whether a risk component is eligible—irrespective of whether it is positive or negative.

36. For example, a power supply agreement includes an oil price link to a specific type of crude oil from a particular local oil field. That type of crude oil trades at a discount to the relevant benchmark crude oil for the area[7]. The fact that the crude oil exposure from the power supply agreement trades at a discount does not affect the assessment that it is separately identifiable. As long as the change in the value of the amounts payable under the crude oil price link are reliably measureable their variability is an eligible risk component.

37. Instead, a negative spread affects how the hedging relationship can be designated. This is similar to the 'sub-LIBOR' issue that the Board already discussed in its redeliberations of the ED.[8] This issue also applies to commodity hedges. For example, an entity sells a specific type of crude oil from a particular oil field. That crude oil is priced off the relevant benchmark crude oil and sold under a contract using a contractual pricing formula of 'benchmark minus 10 US dollars (USD)' per barrel with a floor of 15 USD. While the entity can designate as the hedged item the variability in its cash flows from oil sales under the sales contract based on the benchmark crude oil price it *cannot* designate a component that is equal to the *full* change in the benchmark crude oil price. Instead, it can designate as the hedged item the entire cash flow variability under

[7] Assume that the oil is not priced off the benchmark by a contractual formula that fixes the discount as a currency amount or a percentage and that it is not a separately identifiable component of the benchmark crude oil.
[8] See agenda paper 9 of the April 2011 IASB meeting.

the sales contract that is attributable to the change in the benchmark crude oil price.

38. As long as the benchmark crude oil price does not decline below 25 USD the oil price exposure can be offset by a crude oil futures contract on the benchmark crude oil. However, when the benchmark crude oil price declines below 25 USD hedge ineffectiveness arises. The crude oil sales have reached the floor and hence the price does not further decline whereas the crude oil futures contract continues to change in value in response to further declines of the benchmark crude oil price.

39. The staff consider that the Board's tentative decision on the 'sub-LIBOR' issue has clarified how the hedge accounting requirements apply in such situations. However, because under IAS 39 the issue applied only to financial items the staff consider it might be useful to expand the 'sub-LIBOR' example in the ED[9] by including an example of a commodity hedge.

Other requests for 'clarifications' that reflect misunderstandings of the notion of risk components

40. The requests for 'clarifications' that reflect misunderstandings of the notion of risk components are addressed in agenda paper 3A. Those relate to:

    (a) In order for non-contractually specified risk components to be eligible the sum of the values of all components must equal the value of the whole item.[10]

    (b) The hedging instrument can be inferred as the risk component.[11]

    (c) The relevance of the market structure for the determination of eligible risk components is unclear.[12]

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[9] See ED.B24-26.
[10] See agenda paper 3A, section 'The sum of the independent values of all components must equal the total value of the entire item'.
[11] See agenda paper 3A, section 'Designating risk components means no hedge ineffectiveness arises'.
[12] See agenda paper 3A (as a whole).

(d) (Whether) The mere physical presence of an ingredient would be sufficient to conclude it is a risk component.[13]

Examples for demonstrating the application of the criteria

41. The staff note that selecting the 'right' examples requires judgement. As explained earlier in this paper, it is impossible to analyse and provide specific guidance on all markets and circumstances.[14]

42. The section 'Guidance to be provided for the application of the criteria' sets out general considerations for selecting the guidance—essentially, using examples that illustrate how to apply the criteria (rather than only the outcome, ie whether there is an eligible risk component).

Examples provided as part of the feedback

43. The staff have considered the examples and suggestions for examples that some provided as part of their comment letters. They can be broadly grouped by industry as follows:

(a) Metals: contracts with indexations to aluminium and copper (LME price plus conversion charge) as well as aluminium and copper products.

(b) Energy: benchmark crude oil components for different geographical regions, natural gas contracts with price links (noting that the example in the ED[15] is relevant), natural gas prices and liquefied natural gas (LNG).

(c) Electricity: price indexation in power supply contracts, grid transportation charges.

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[13] See agenda paper 3A, section ''Overlap' of risk components of a commodity exposure'.
[14] See paragraphs 4-5.
[15] See ED.B15(a).

(d) Agriculture: commodity price risk of coffee, cocoa and soybeans; in particular, coffee was suggested as an example that should be used in order to not only provide examples of the energy industry (ie oil and gas).

(e) Financial services: interest rate and mortality in insurance liabilities, inflation related products, different LIBOR term structures.

Suitable examples for guidance in the final standard

44. Against the background of the general considerations for selecting the guidance and the examples provided as part of the comment letters the staff consider the most suitable examples are those set out in the following paragraphs.

45. **Commodity price risk related to coffee purchases**. The staff's rationale is:

(a) The example could be based on an example included in an earlier agenda paper.[16] That example has several advantages:

(i) It illustrates both a situation with a contractual price link as well as one where there is no contractual price link (a forecast transaction). The benefit of that example is that it illustrates the interaction between the two situations (ie the ramifications of having a contractual price link in some situations and forecast transactions in other situations).

(ii) It illustrates how criteria can be applied in the context of principal-to-principal transactions (instead of standard hedges in major commodity markets).

(iii) It has been tested and worked very well during the staff outreach.

(b) It would address feedback that requested an example be included that is outside the energy sector—agriculture is a good contrast (better than

[16] See agenda paper 3 of the 27 October 2010 IASB meeting.

electricity or metals) and hedges of coffee price risk were explicitly suggested (giving some assurance regarding its relevance).

46. **Price risk related to jet fuel purchases**. The staff's rationale is:

    (a) The example was included in the ED. It has been a key element of the debate of risk components and been tested by exposure and during the outreach.

    (b) It is a good complement to coffee price risk example. It provides a good contrast because it relates to the crude oil market, which is the most important commodity market with a wide ripple effect for the economy.

    (c) The example can be expanded using the analysis in agenda paper 3A, which would illustrate the relevance of the market structure, in particular the following aspects:

        (i) different geographical benchmarks (WTI versus Brent);

        (ii) different benchmarks regarding raw materials versus refined products (ie different stages in the value or production chain—crude oil versus gas oil);

        (iii) how physical ingredients relate to pricing components (including corroborating factors such as the derivatives market structure for the related commodity).[17]

47. **The fair value interest rate risk of a fixed rate bond**. The staff's rationale is:

    (a) This is the most prominent example for non-contractually specified risk components in *financial* hedged items. Hence, IFRS users are familiar with it from practice under IAS 39. However, the example could be based on the short discussion in agenda paper 3A[18] to illustrate *why* the interest rate risk component is eligible (whereas under IAS 39 the focus has been the outcome, ie *that* it is eligible).

[17] See agenda paper 3A, section ''Overlap' of risk components of a commodity exposure'.
[18] See agenda paper 3A, paragraph 29(a).

(b) It is a good comparison to the other examples that relate to non-financial hedged items, which would be helpful for the overall design of the guidance (as explained earlier in this paper[19]). In particular, using this straightforward example would provide an 'entry point' for IFRS users with the lowest possible barrier while the other examples then step up the sophistication of the analysis.

48. The staff also consider that the example in the ED regarding the contractually specified risk components in a natural gas contract should be retained (but that no expansion of that example is needed). The example was confirmed as useful in the feedback and contractually linked risk components in a long term supply contract were more generally raised as common examples that are relevant for a wide range of industries.

Application of the criteria to specific situations

49. Many commentators also requested that the final requirements not specifically and explicitly preclude designating risk components as hedged items for:

(a) inflation risk (if non-contractually specified for financial items);

(b) credit risk;

(c) prepayment risk;

(d) situations in which the cash flows of the component exceed those of the item as a whole (commonly referred to as the 'sub-LIBOR' issue); some commentators raised this issue in the particular context of commodity hedging (eg a commodity trading at a discount to the commodity benchmark such as Brent 'minus 5 USD').

[19] See paragraph 15.

Inflation risk

50. The staff note that the ED includes a specific restriction that prohibits designating risk components for inflation risk. This applies only to *non-contractually* specified inflation risk components of *financial* items.[20] This is a carry-over from IAS 39. Following a discussion at the IFRIC[21], in July 2008 the IASB amended IAS 39 to include this specific prohibition regarding inflation risk. Hence, this particular issue has already some 'history' under IFRSs.

51. For financial instruments that include an indexation to inflation (ie the instrument includes *contractually specified* payments that vary with an inflation index) that inflation related cash flow variability *can* be designated as a risk component.[22] Those debt instruments with variable payments linked to inflation are commonly referred to as 'inflation-linked bonds'.

52. The ED did not extend that specific restriction regarding eligible inflation risk components to non-financial hedged items. The reference to 'financial' was intentional rather than an oversight as suggested by some. The reason is that there are industries in which payments are linked to inflation because of *price regulation*. However, because that link arises from *regulation* it is a link based on law but one that is in formal legal terms 'non-contractual' even though it can have the same effect that contractual price links have in other situations. In the context of public law (as used by governments), regulation is an alternative to using contracts for creating legal consequences. However, sometimes contracts under public law are used instead of regulation (eg because of flexibility). Hence, the legal distinction between regulation and contracts is sometimes not meaningful for accounting purposes (both create enforceable rights and obligations under law). An example is the utility industry, which in some jurisdictions is regulated in a way that links the sale price of electricity (for

[20] See ED.B18.
[21] Now the IFRS Interpretations Committee.
[22] This applies as long as other cash flows of the instrument are not affected by the inflation component—see ED.B18.

particular customer groups) to inflation. In those circumstances the effect of regulation can be economically equivalent to contractually agreed pricing formulas.

53. The issue that commentators raised is that IAS 39 used an outright prohibition for designating inflation risk components in fixed rate debt instruments and the ED proposed retaining that approach. That leaves no room for the possibility that in some situations there might be might be circumstances that could support identifying a risk component other than making assumptions based on high level economic theory. For example, some entities issue inflation-linked bonds *and* fixed nominal rate debt. This means that when for example the two types of debt are issued at the same time and with the same maturity and seniority, inflation indexation is the differentiator of those two instruments and the inflation risk component (or break even inflation rates—'BEIRs') is commonly determined as the difference between the yield to maturity on the inflation-linked bonds and the fixed nominal rate debt.

54. However, this still leaves the following issues:

    (a) different liquidity for the two types of instruments can affect their values (and would not have been eliminated under the above approach);

    (b) if the maturities (or seniority) do no exactly coincide, credit risk is a factor that cannot be eliminated (and hence separated from inflation);

    (c) after origination, if the bonds are not both actively traded, it would not be possible to determine the inflation component by comparing the fair values of the instruments.[23]

55. An alternative approach to identifying inflation risk would be using one in analogy to the risk free interest rate component. Risk free interest rate components are determined on the basis of the risk-free zero coupon term

[23] Even that involves some challenges such as the issue of adjustments for seasonality of inflation—see paragraph 59(a) below.

structure of interest. This requires a sufficient number of risk free financial instruments to construct such a curve.

56. Inflation markets have developed fast over recent years and there are an increasing number of governments that issue inflation-linked debt in addition to fixed nominal rate debt. As pointed out in a publication of the working paper series issued by the European Central Bank:[24]

> From a monetary policy perspective, this is a welcome development, as the emergence of a well-developed inflation-linked bond market offers new possibilities for disentangling the information embodied in nominal bond yields.

57. For example, for the Euro area the increase in the issuance of inflation-linked bonds has created the possibility of estimating a term structure of zero-coupon real rates. For other currency areas that might have already been the case and for some it might not yet be feasible—it depends on the number and term structure of the available inflation-linked debt in a debt market.

58. *If* for a given currency a term structure of zero-coupon real rates can be determined then the inflation risk component could be determined similarly to how a risk free (nominal) interest rate component can be determined, ie by discounting the cash flows of the *hedged* debt instrument using the term structure of zero-coupon real rates. Considerations for this approach are:

    (a) A sufficiently liquid market of inflation-linked bonds has to be available to be able to construct a term structure of zero-coupon real rates. This means that for the respective currency inflation is a relevant factor that is considered by the debt markets.[25]

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[24] See Working Paper Series No. 830 / November 2007 'The Term Structure of Euro Area Break-Even Inflation Rates—The Impact of Seasonality'.

[25] This is not a foregone conclusion. For example, Germany traditionally did not issue any inflation-linked bonds (and even prohibited inflation indexation in contracts generally unless an exemption was obtained from the central bank). Only in 2006 Germany started issuing inflation-linked bonds. Hence, in areas in which no inflation-linked bonds are issued that allow constructing a term structure of zero-coupon real rates inflation risk components would *not* be eligible for designation as hedged items under this approach.

(b) The approach would *prevent* the terms and conditions of the particular inflation hedging instrument that an entity uses being simply imputed by projecting terms and conditions of the hedging instrument onto the hedged nominal interest debt (which the proposals in the ED do not allow).

59. However, a term structure of zero-coupon real rates is difficult to determine because of some key characteristics of inflation-linked bonds that require adjustments to data—for example:

(a) Seasonal factors that affect price indices require adjustments for inflation seasonality.

(b) Indexation lags resulting from operational aspects of debt servicing for inflation-linked bonds (because of the time lag regarding the release of price index information by statistics offices). Hence, the derived interest curves are not 'purely' forward looking. This can only be adjusted for by estimating a real time forecast for inflation (for the period of the time lag).

(c) Inflation-linked bonds typically have a deflation floor on the principal (ie the principal is repaid at par even if there was deflation instead of inflation—this creates distortions if there were *on average* deflation over the entire life of the instrument).

60. The staff consider that there is a trade-off between:

(a) An outright prohibition on inflation risk components in fixed nominal rate debt, which means the general criteria cannot be applied. Hence, even if inflation risk were separately identifiable and reliably measurable in a particular situation it would still not be an eligible risk component.

(b) Sending the wrong signal to those who would conclude that by removing the outright prohibition inflation risk would more generally be an eligible risk component—even if not supported by the market

structure and not independently determined for the hedged item. Given the 'history' that this issue already has under IFRSs,[26] a change in the requirements could be misunderstood as the Board 'rubber stamping' the use of inflation risk components for hedge accounting.

61. Hence, the staff consider the crux is that for this particular issue it is hard to ignore the previous somewhat unfortunate history. The staff are also aware of many examples of analysis that the staff would not agree with that people are likely to try to apply to justify designating inflation components. These factors mean that if the Board were to move away from an outright restriction it will need to be extremely careful with the wording and/or examples used so as to prevent inappropriate application. On the other hand the staff believe that there are circumstances in some markets when inflation could be separately identified and reliably measured today (albeit with effort). In addition, markets evolve quickly and perpetuating the outright ban might become more and more open to legitimate criticism (ie over time the trade-off will shift).

62. The staff consider this leaves at least the following alternatives for the Board in respect of inflation risk:

    (a) **Alternative 1**: Retain the restriction as set out in the ED.

    (b) **Alternative 2**: Eliminate the restriction in the ED.

    (c) **Alternative 3**: Eliminate the restriction in the ED but add a 'caution' or 'rebuttable presumption' regarding non-contractually specified inflation risk components of financial items.

    (d) **Alternative 4**: Change the outright prohibition in the ED by including an example of a situation in which an inflation risk component is eligible for designation as a risk component and an example of a situation in which inflation risk is not an eligible risk component.

[26] See paragraph 50.

63. The related staff recommendation and question to the Board is included in agenda paper 3C.

Credit risk

64. Credit risk is comprehensively addressed in a separate agenda paper that considers various alternatives including designating risk components as hedged items—see agenda paper 5.

Prepayment risk

65. Prepayment risk has already been addressed by the Board during the redeliberations of the ED. See agenda paper 5 of the 27 April 2011 IASB meeting.

'Sub-LIBOR' issue

66. The 'sub-LIBOR' issue has already been addressed by the Board during the redeliberations of the ED. See agenda paper 9 of the April 2011 IASB meeting. How that issue applies to non-financial items has been addressed earlier in this paper (see paragraphs 37-39).

Appendix A

A1. Extracts of agenda paper 3 of the 27 October 2010 IASB meeting for Example 1 illustrating the analysis of the market structure for commodity price risk related to coffee purchases:

[…]

Example 1

Facts

22. Entity B is a manufacturer of coffee products that requires specific qualities of coffee. Its risk management strategy is to hedge its exposure to the variability in the coffee price as follows:

    (a) Entity B hedges its future coffee purchases based on its production forecast. Hedging starts up to 15 months before delivery for part of the forecast purchase volume and Entity B then increases the coverage volume over time (as the delivery date approaches).

    (b) Entity B uses two different types of contracts to manage its coffee price risk:

        (i) exchange traded *coffee futures* (these are accounted for as financial instruments); and

        (ii) *coffee supply contracts* for Arabica coffee from Colombia to a specific manufacturing site (coffee supply contract). These contracts price a tonne of coffee based on the exchange traded coffee future price plus a fixed price differential plus a variable logistics services charge. The coffee supply contracts are executory contracts under which Entity B takes actual delivery of coffee (ie they are not accounted for as financial instruments).

    (c) For deliveries that relate to current harvest Entity B can fix the price differential between the actual coffee quality purchased (Arabica coffee

from Columbia) and the benchmark quality that is the underlying of the exchange traded future by entering into the coffee supply contracts. However, for deliveries that relate to the next harvest the coffee supply contracts are not yet available so that the price differential cannot be fixed.

(d) Entity B hedges the benchmark quality component of its coffee price risk using exchange traded coffee futures. These futures hedge the benchmark quality component for deliveries that relate to current harvest as well as to the next harvest.

23. For the deliveries that relate to current harvest Entity B has a contractually specified risk component once it has entered into a coffee supply contract. In accordance with the Board's tentative decision on contractually specified risk components, Entity B from that moment can use a coffee future as the hedging instrument for the benchmark coffee price risk component under the coffee supply contract.

24. For the deliveries that relate to the next harvest Entity B also uses the same coffee futures as hedging instruments—but there is not yet a *contractually specified* benchmark coffee price risk component (because Entity B has not yet signed a coffee supply contract). This raises the question whether Entity B should determine the hedged item as:

(a) the entire variability in the cash flows for its forecast actual purchases of Arabica coffee from Columbia (ie including changes in the variable logistics costs and in the price differential to the benchmark quality that will only be fixed after the next harvest); or

(b) the benchmark coffee price risk component (as in the situations after entering into the coffee supply contracts).

Staff analysis

25. The staff view of the situation is that Entity B is exposed to different risks:

(a) Coffee price risk reflecting the benchmark quality (as represented by the coffee futures). This is the risk that Entity B hedges once entering into the coffee futures.

(b) Coffee price risk reflecting the spread (price differential) between the benchmark quality under (a) and the actual quality purchased for which Entity B takes deliver (Arabica coffee from Columbia). This price risk is only hedged for the *current* harvest but Entity B remains exposed to this risk for deliveries that relate to the next harvest (irrespective of whether the coffee price risk reflecting the benchmark quality has been hedged). Entity B does not seek to hedge this exposure before the current harvest and to the extent it hedges it for the current harvest it does so using coffee supply contracts. The coffee futures do not hedge this risk at any point in time. In fact, Entity B could hedge only the spread risk by only entering into coffee supply contracts (ie without a corresponding volume of coffee futures)—this would fall under executory contract accounting and not involve any financial instrument or hedge accounting.

(c) The variable logistics costs that depend on cost factors like fuel prices, port fees, insurance, etc. Entity B does not hedge this risk and hence remains exposed to the variability of these costs until delivery.

26. Hence, the staff consider that designating the coffee futures as hedging instruments in relation to the *entire* variability in the cash flows for its forecast actual purchases is a misrepresentation of the transactions and exposures of Entity B. It results in comparing hedging instruments to risks that are unrelated to them and does not reflect Entity B's related hedging strategy. In particular, Entity B's hedging strategy regarding the coffee price risk reflecting the *benchmark quality* does *not* change depending on whether the delivery relates to the current or next harvest and whether the spread risk (price differential) is hedged (ie whether coffee supply contracts are entered into).

27. Such a designation mismatch would create hedge ineffectiveness in profit or loss from comparing value changes of items that are unrelated. Hence, an effective risk management strategy would systematically be presented as less effective than it actually is.

28. This is also an important aspect regarding the *interaction with the new effectiveness assessment model*. The staff also note that such a designation mismatch would have a detrimental effect on the application of the new effectiveness test. That requires that an entity chooses a hedge designation that results in a hedge ratio that does not reflect a deliberate mismatch between the weightings of the hedged item and of the hedging instrument within the hedging relationship. Hence, the inability of Entity B to designate a risk component for the non-financial hedged item would also distort the hedge ratio that has to be chosen for accounting purposes. That would result in a misalignment between the effectiveness test and risk management thus defeating one of the objectives of developing the new effectiveness test.

29. The staff note that Entity B remains exposed to different risks and that the coffee futures do not eliminate the entire variability of the actual purchase price for the delivered coffee. However, the staff consider there are two *entirely different aspects* that must not be confused:

    (a) a decision not to hedge a risk but retain an exposure; and

    (b) hedge ineffectiveness (which is the result of hedging an exposure but using a hedging instrument that does not provide a fully offsetting change in value).

[…]