



STAFF PAPER

April 2021

IFRS® Interpretations Committee meeting

Project	Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9)		
Paper topic	Comment letters		
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Introduction

1. This paper reproduces comment letters on the IFRS Interpretations Committee's tentative agenda decision 'Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9)' published in December 2020.

12 February 2021

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Dear Ms Lloyd

Tentative agenda decision – Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9 *Financial Instruments*)

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the December 2020 IFRIC Update of the tentative decision not to take onto the Committee's agenda the request for clarification on the application of hedge accounting requirements in IFRS 9 when the risk management objective is to 'fix' the cash flows in real terms.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda. We have included in this letter some comments on the basis for reaching the conclusion in the decision.

The tentative agenda decision concludes that the rebuttable presumption in IFRS 9:B6.3.13, 'that unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable and hence cannot be designated as a risk component of a financial instrument' has not been rebutted. We understand that this is based on the specific facts and circumstances presented in the original submission.

We would suggest that there is an additional rationale as to why the hedge relationship described in the decision cannot be eligible under IFRS 9 as a cash flow hedge, which could be included within the decision. This rationale is based on the fact that the 'fixing' of the cash flows illustrated in the submission is in real terms as opposed to nominal terms.

For a cash flow hedge of real rate risk to qualify for hedge accounting under IFRS 9, it is necessary for the cash flows to be fixed in nominal terms (in the currency of the debt of the functional currency of the entity). It is not appropriate for the economic relationship of the hedge to be assessed in real terms because reporting in real terms is not recognised under IFRS Standards. The financial statements are presented in nominal terms and therefore hedge effectiveness must also be assessed in nominal terms. Therefore, the hedge relationship described in the agenda decision will not be eligible because the cash flows are not fixed in nominal terms.

Furthermore, if assessing the effectiveness of a cash flow hedge in real terms were permitted, a swap of fixed rate debt cash flows for inflation-linked debt cash flows would, subject to rebutting the presumption in IFRS 9:B6.3.13 for fixed rate debt, reflect an eligible cash flow hedge because in real terms, the fixed rate debt is variable before the hedge but fixed after (i.e. the inflation-linked debt is fixed in real terms). However, for financial reporting purposes, which is in nominal terms, the swap would create significant

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variability in profit or loss rather than reducing it because the debt cash flows are fixed before the hedge and variable after, which is inconsistent with the notion of a cash flow hedge.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

A handwritten signature in grey ink, appearing to read 'V. Poole', with a stylized flourish at the end.

Veronica Poole
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Our ref RD/288

12 February 2021

Dear Ms Lloyd

Tentative Agenda Decision: *Hedging Variability in Cash Flows Due to Real Interest Rate (IFRS 9)*

We appreciate the opportunity to comment on the IFRS Interpretations Committee (Committee) tentative agenda decision *Hedging Variability in Cash Flows Due to Real Interest Rate (IFRS 9)*. We have consulted with, and this letter represents the views of, the KPMG network.

Overall, we do not support the Committee's tentative agenda decision ('TAD'). Our main observation is that we do not believe that the rationale for the conclusion is clearly based on existing requirements in the standards. We recommend that the Committee amend the TAD to provide an analysis that is more linked to existing requirements in IFRS 9.

We believe that whether an inflation risk component, as well as a real interest rate risk component, is a separately identifiable and reliably measurable component depends on the market structure in any jurisdiction as described in IFRS 9.B6.3.13–15. Finally, we note that users may have different interpretations of what constitutes a "real rate". We believe that a conclusion made with an analysis of what the entity actually designates in the hedging relationship and how it determines the change in cash flows of the real interest rate risk component being hedged would assist stakeholders in better understanding the decision and the associated reasoning.

We set out below specific observations and comments:

- IFRS 9.B6.3.13 states that "in limited cases, it is possible to identify a risk component for inflation risk that is separately identifiable and reliably measurable because of the particular circumstances of the inflation environment and the relevant debt market". IFRS 9.B6.3.14 gives an example that if a term structure of zero-coupon real interest rates can be constructed, an inflation risk component could be determined by discounting the cash flows of the hedged debt instrument

using the term structure of zero-coupon real interest rates. These two paragraphs suggest that in a market environment where a liquid real interest rate curve can be constructed, an inflation component can be a risk component which is separately identifiable and reliably measurable.

Given that the identification of a separately identifiable and reliably measurable inflation component depends on the ability to construct a real interest rate curve, it would appear counterintuitive to conclude that the real interest rate curve itself could not be a separately identifiable and reliably measurable component.

- The TAD contains the statement that “The real interest rate, and therefore the effect of inflation, is not a risk component that explicitly or implicitly influences the determination of a nominal benchmark interest rate”. It is unclear:
 - how this statement stands together with IFRS 9.B6.3.13–14 where it states that inflation risk can be a separately identifiable and reliably measurable risk component. In particular, the statements made in IFRS 9.B6.3.13–14 do not include any explicit limitation to fair value hedges or the explicit exclusion of cash flow hedges. The arguments presented in those paragraphs are made in respect of the nature of the market. If it had been the Board’s intention to limit the ability of an entity in the designation of a non-contractually specified inflation component to only fair value hedges, we believe that it would have been made clear; and
 - on what basis IFRIC makes this statement or would be able to make this statement. It appears to be a question of fact that is contingent on the behaviour of market participants and relevant facts and circumstances and thus might be true or not depending on those facts and circumstances. There appear to be divergent views among economists on this subject and some of them disagree with IFRIC’s apparent conclusion – e.g. a nominal interest rate *may be* influenced by expected inflation and an expected real interest rate¹. Alternatively, the statement may be trying to explain some analytical or conceptual point regarding the meaning of the terms used but if so that point is not understandable to us. Furthermore, we note that this statement does not seem to be consistent with the assertion in IFRS 9.B6.3.14 that, in some circumstances, “inflation is a relevant factor that is separately considered by the debt markets”, implying that inflation is something that influences the determination of nominal benchmark interest rates.

¹ For example, extracted from “Long Term Interest Rates”, 01/03/2013 – Speech by Ben Bernanke, Federal Reserve Chairman – “What monetary policy actually controls is nominal short-term rates. However, because inflation adjusts slowly, control of nominal short-term rates usually translates into control of real short-term rates over the short and medium term. In the longer term, real interest rates are determined primarily by nonmonetary factors, such as the expected return to capital investments, which in turn is closely related to the underlying strength of the economy.”

- It is unclear how the statement that “measurement and forecasts of actual inflation are based on statistical methodologies and therefore entail a time lag” is relevant in analysing the fact pattern. If it is relevant and this can be clarified, it would also be necessary to clarify why this would *not* be a factor in preventing an inflation rate from being separately identifiable in the example given in IFRS 9.B6.3.14.
- The TAD states that “to meet the requirements in IFRS 9 for a cash flow hedge designation, the variability of individual cash flow streams attributed to the designated risk component needs to be separately identifiable in currency or nominal terms.” IFRS 9 discusses the requirements for cash flow hedge eligibility principally at IFRS 9.6.3.7(a) and IFRS 9.6.5.2(b). There appears to be no such specific requirement that a cash flow hedged item needs to be separately identifiable in currency or nominal terms. IFRS 9.B6.3.7 states that “a component is a hedged item that is less than the entire item” and “reflects only some of the risks of the item of which it is a part or reflects the risks only to some extent”. IFRS 9.B6.3.8 states only that “a risk component must be a separately identifiable component of the ... item, and the changes in the cash flows ... of the item attributable to changes in that risk component must be reliably measurable”.

Please contact Reinhard Dotzlaw at rdotzlaw@kpmg.ca or Chris Spall at chris.spall@kpmgifrg.com if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited



ASSOCIATION OF NATIONAL ACCOUNTANTS OF NIGERIA

Comments on the Tentative Agenda Decision and comment letter on Hedging Variability in Cash Flows due to Real Interest Rate (IFRS 9)

The Association of National Accountants of Nigeria (ANAN) has critically and painstakingly reviewed the basis of IFRS Interpretations Committee's decision and welcomes the opportunity to comment on the Tentative Agenda Decision and comment letters: hedging variability in cash flows due to real interest rate (IFRS 9).

The basic issue dealt with by the IFRS Interpretations Committee in the tentative agenda decision and comment letter on hedging revolves around the question of whether a non-contractually specified interest risk component can be designated as hedged item in a cash flow hedging relationship. The Committee dealt with this question under two perspectives.

First is whether the floating rate instrument described in the fact pattern has exposure to variability in cash flows that are attributable to real interest risk components as required in paragraph 6.5.2 (b) of IFRS 9.

The Association agrees with the Committee's conclusion that the requirement in IFRS 9 provides an adequate basis to determine whether a hedge of the variability in cash flows arising from changes in the real interest rate, rather than the normal interest rate, could be accounted for as cash flow hedge.

The second perspective is whether the real component interest risk component described in the fact pattern is separately identifiable and reliably measurable as required by paragraph 6.3.7 of IFRS 9.

In relation to this question, the Association agrees with Committee's conclusion that changes in cash flows as a floating instrument arising from the real interest rate risk component cannot be identified independently of changes in cash flows arising from other risk components. To this end, it cannot be reliably measured as required by paragraph 6.3.7 of IFRS 9.

For any further information or clarification, please contact the undersigned.

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Hedging Variability in Cash Flows Due to Changes in Real Interest Rates (IFRS 9)

Response to Tentative Agenda Decision

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1. Executive Summary

International Financial Reporting Standards (“IFRS”) are designed to provide investors a better, more consistent sense of risk and return when reading a set of financial statements. Without certainty in whether IFRS 9 hedge accounting can be applied to inflation¹ swaps used by companies for valid risk management purposes, investors will continue to face material variances between what is being presented in the financial statements and the risk management activities of regulated companies in which they invest i.e. the current accounting is giving users a false sense of risk within the financial statements, even though the risk management activity is minimising long term financial risk.

This variance is being generated by a narrow interpretation of the letter of the standard rather than considering the underlying principles and objectives of IFRS 9 to more closely align to risk management.

To emphasize the importance of this response, participants including regulated entities, listed entities and investors (collectively referred to as “the Group”) have jointly submitted this paper. The Group includes:

Heathrow Airport Limited	National Grid plc	Northumbrian Water Ltd
Northern Gas Networks	Anglian Water Group Limited	UK Power Networks
Yorkshire Water Services Limited	TCI Advisory Services LLP	

This paper aims to provide the committee further background and rationale for the economic risk management strategy and ultimately the validity of the hedge designation, including outlining why real rates are a separately identifiable component in the UK.

By permitting this designation the quality and consistency of financial reporting is improved, with the reduced need for diverse reporting methods and application of reporting compromises to support explanation of fair value movements related to these instruments.

The paper outlines why this designation is applicable by outlining:

1. The market structure for inflation in the UK
2. Why real rates are separately identifiable and reliably measurable
3. The risk management objective
4. Alternate hedge accounting designations not discussed in the original submission
5. Specific thoughts on the Tentative Agenda Decision (“TAD”)

In summary, we believe that guidance contained within IFRS 9 allows this designation, thus, are requesting IFRIC re-consider the TAD. The Group acknowledges the complexity of the subject; hence, would welcome the opportunity to further discuss this with IFRIC staff before the TAD is finalized.

Please contact Nick Golding, Finance Director, Heathrow Airport Limited on Nick.Golding@heathrow.com for further communication in regards to this paper.

¹ For the purposes of this analysis, the only relevant measure of inflation is Retail Price Index (“RPI”)

2. Market Structure

Summary

- *The total size and liquidity of the market in GBP Nominal and Inflation bonds is significant.*
- *The existence and measurability of the nominal, inflation and real yield curve is well-established, both in gilts and swaps.*

Overview of UK market

The inflation-indexed bond market in the UK is well-established. The UK government issued the first inflation-indexed Gilt (“Index-Linked Gilts”) in 1981. Index-Linked Gilts are linked to the General Index of Retail Prices in the UK (“RPI”), one of the main measures of inflation in the UK. The DMO has continued frequent issuance of Index-Linked Gilts in size, issuing more than £25bn of Index-Linked Gilts every year since 2009. Currently, of the c. £1.9tn of Gilts outstanding, 24% are linked to RPI. See below a table of all the current Gilts outstanding split by maturity and nominal vs. inflation.

Table: Current Outstanding Gilts

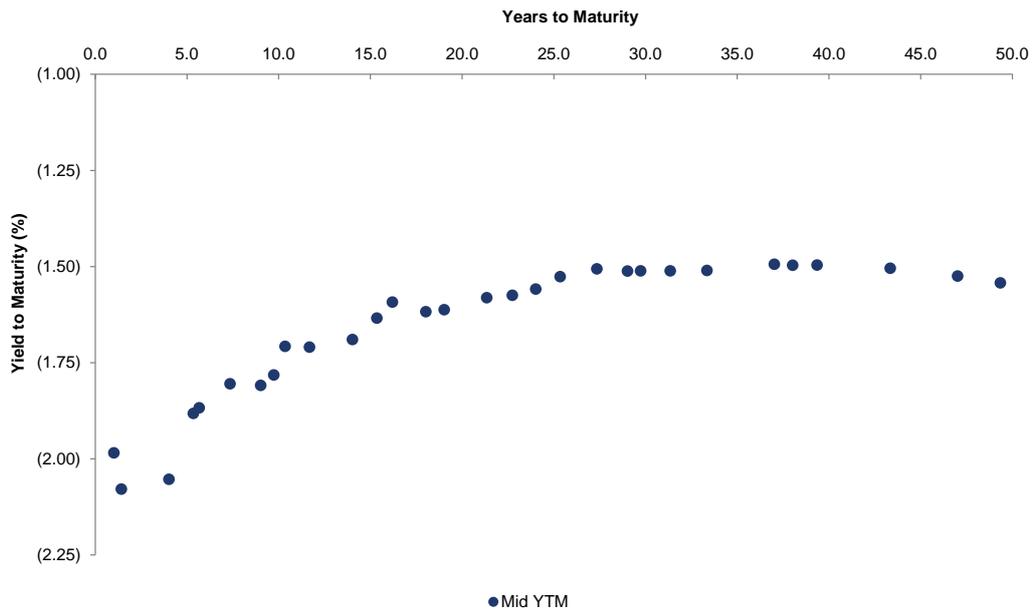
Maturity (years)	x<4	4≤x<7	7≤x<15	15≤x<30	30≤x	Total
Total (£bn)	277	422	408	539	283	1,927
<i>o/w Nominal Gilt</i>	92%	82%	75%	69%	68%	76%
<i>o/w Index-Linked Gilt</i>	8%	18%	25%	31%	32%	24%

Due to the large volume of outstanding Gilts (Nominal and Index-Linked) with various maturities, accurate prices can readily be obtained and used to construct zero coupon curves (using interpolation between bonds maturities). See Appendix 1 for list of outstanding bonds.

A nominal yield curve can be derived from the Nominal Gilts, and notably a real yield curve can be derived from outstanding Index-Linked Gilts².

² Constructing a zero-coupon curve from bond pricing across maturities can be done via the “bootstrapping” method

Chart: Real Yield Curve derived from Index-Linked Gilts

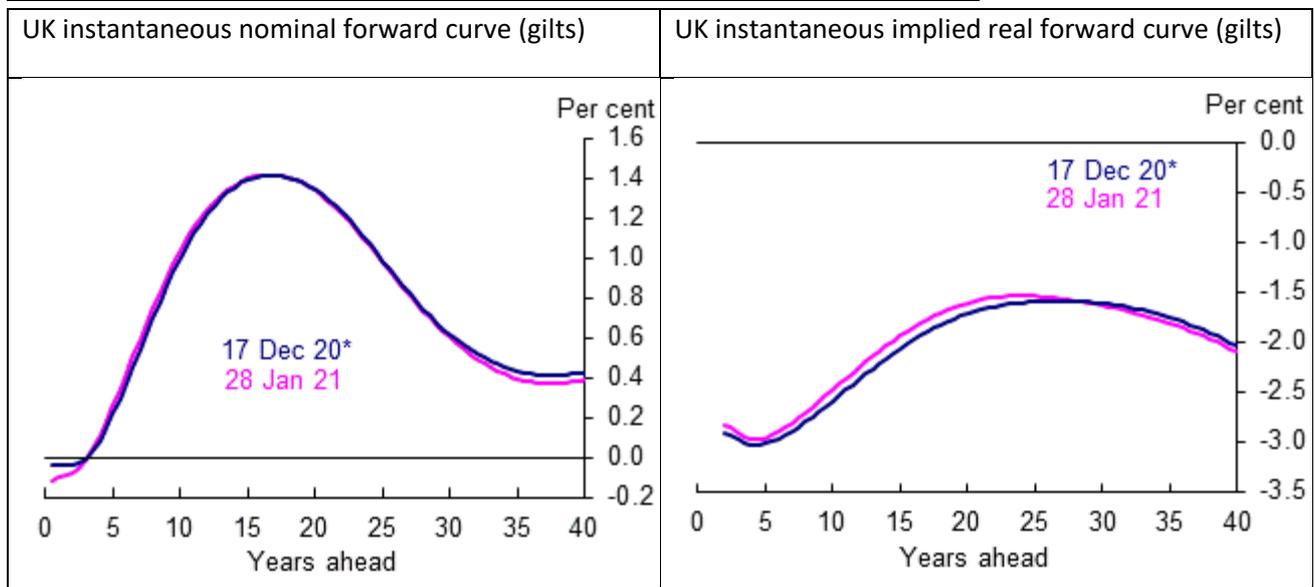


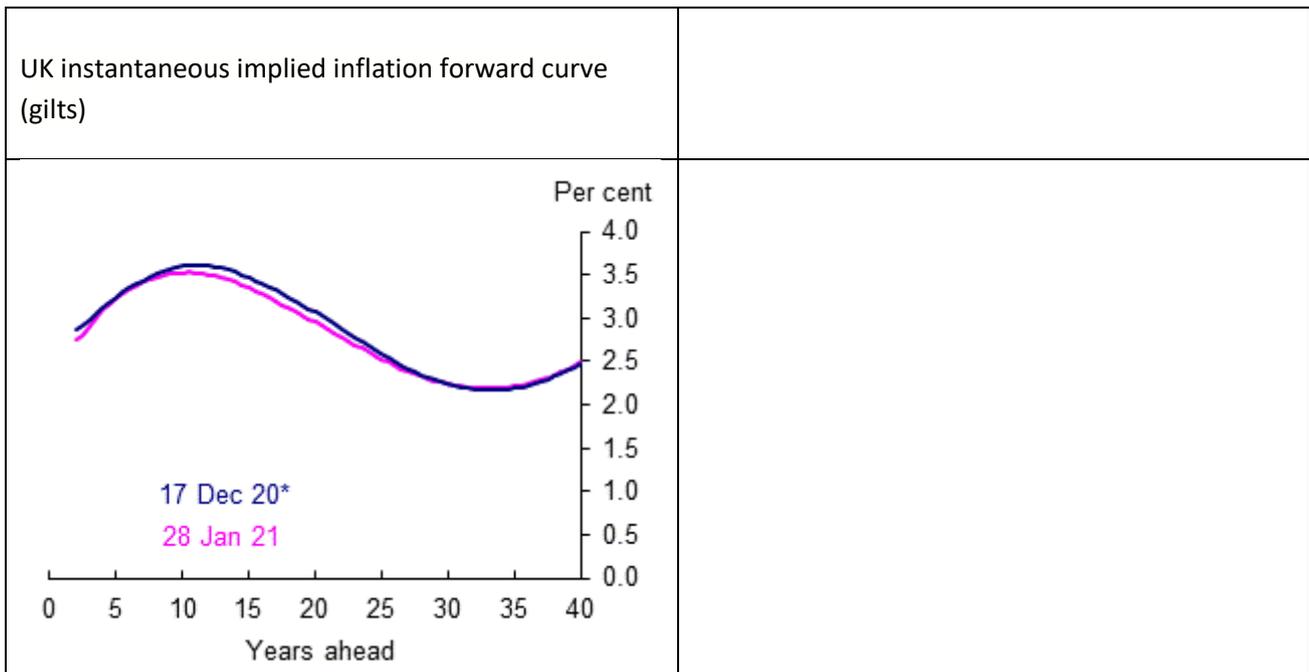
Source: Bloomberg as at 14-Nov-18

Following the construction of a reliably measurable zero coupon nominal and real yield curves from the Gilt market, a zero coupon breakeven inflation curve arises by definition, as the breakeven inflation is the implied rate differential between the real rate curve and the nominal curve. I.e., the breakeven inflation rate is the rate representing the erosion of pricing power, which is the difference between the nominal and real rates.

The existence and measurability of the nominal, inflation and real yield curve is well-established; the Bank of England (“BoE”) publishes these curves on a daily basis (see charts below).

Chart: Bank of England Daily Published Nominal, Real Yield and Inflation Curves





Source: <https://www.bankofengland.co.uk/statistics/yield-curves>. Please also see <https://www.bankofengland.co.uk/statistics/yield-curves/terminology-and-concepts> for a more in-depth explanation of how these curves are constructed.

Fisher Equation

The UK market is an example of a market where the Fisher equation can be directly observed i.e. the pricing of nominal and inflation linked gilts by definition allow market participants to observe and trade the three components (nominal, real and breakeven inflation rates). Given the deep liquidity of the bond markets there is no arbitrage between the two such that either of the following can be observed to be true

Nominal rate – Real rate = Inflation breakeven in a given tenor

Nominal rate – Inflation breakeven = Real rate in a given tenor

The BoE notes the following:

“We have seen that the index-linked gilt market allows us to obtain real interest rates and the conventional gilt market allows us to obtain nominal interest rates. These nominal rates embody the real interest rate plus a compensation for the erosion of the purchasing power of this investment by inflation. The Bank uses this decomposition (commonly known as the Fisher relationship) and the real and nominal yield curves to calculate the implied inflation rate factored in to nominal interest rates.”

The above is all derived from the Gilt market. However, nominal, inflation and real rates are also traded in swap format. In the paragraph below we show that the swap market is also sufficiently liquid and readily observable.

We note that IFRS 9 does not allow the inflation / real component to be identified using the swap market, the below analysis is additive to the Gilt market analysis above and is important as it demonstrates how investors view the inflation market.

Inflation Swap Market

In the UK swaps market nominal, real and breakeven rates can be traded independently and each component is considered liquid and observable with quotes available for every day. The definitions below explain these instruments in terms of cash flows. We have also included a diagram in the appendix.

- **Nominal Swap**: set of cash flows equal to exchanging Fixed Bond vs a Floating Bond
- **Inflation Swap (or Breakeven Swap)**: set of cash flows equal to exchanging an Inflation Bond vs a Fixed Bond
- **Real Yield Swap**: set of cash flows equal to exchanging an Inflation Bond vs a Floating Bond. Hence, a Real Yield Swap can be derived directly from a Nominal Swap and an Inflation Swap.

Nominal Swaps and Inflation Swaps in GBP are very liquid and trade in large volume. See Appendix 2 for LCH Clearing Volumes. GBP interest rate swap (Nominal Swaps) volumes are in excess of £10tn, whereas Inflation Swap volumes are in excess of £1.5tn. As a Real Yield Swap is simply the combination of a Nominal Swap and an Inflation Swap (as per the definitions above), its price and liquidity are of similar magnitude. In addition to the cleared market as indicated in the LCH Clearing Volumes referenced, there exists a bilateral swaps market. A broad estimate would put approximately 40% of total volumes in such swaps as cleared and the remainder would be bilateral. Thus, the total size of the market in GBP Nominal and Inflation swaps is significant.

3. Application of IFRS 9

Summary

- *Prudent risk management and market pricing drive the need to raise inflation-linked debt instruments.*
- *There is sufficient liquidity in the markets for both inflation and real rates to be considered a separately identifiable and measurable components.*
- *Payments are not necessarily nominal and there is no evidence in IFRS literature.*
- *Cash flow hedge designation in real terms meets the criteria of IFRS9.*
- *Real rates are not the residual factor but a separately identifiable and reliably measurable component.*

3.1. Risk Management Objective

Regulated clients have a revenue model which is based on a percentage of the Regulatory Asset Base (“RAB”). This is determined by the respective regulator for each industry and is based on funding provided by respective government agencies which is also funded by inflation linked debt (e.g. UK Gov RPI bonds). By linking their debt payments and borrowings to inflation these regulated entities can ensure that as their revenue and value of regulated assets fluctuate for changes in inflation rates, so too will their debt payments and borrowings. Should a regulated entity not link a portion of their debt to inflation then they are at risk of a mismatch between their income streams and their debt obligations.

Where possible, funding requirements for these businesses will be met by issuing index linked Index bonds. However, many entities usually achieve this by issuing nominal fixed / floating rate debt and subsequently swapping the cash flows into inflation linked cash flows in order to synthetically create inflation linked debt. The combination of issuing a nominal bond and an inflation swap is often preferable to issuers as it allows them to obtain the best credit spread pricing (without limiting themselves to only investors interested in

inflation) as well as the best inflation pricing. This leaves corporates with the choice of more expensive debt or nonsensical volatility reporting.

Fundamentally holding inflation linked debt instruments clearly provides a valid economic offset. The current status quo whereby the issuance of an inflation bond and the issuance of a nominal bond plus an inflation swap which combine to give exactly the same end cashflows but produce materially different results in the reporting of annual performance is not beneficial for users of accounts and undermines the value of hedge accounting in such businesses as all volatility is often then disregarded for meaningful reporting.

Assuming that the nominal fixed rate issued on a debt instrument is made up of the day 1 values of expected credit, inflation and real rates for the relevant tenor, by entering into the inflation swap, the entity has protected itself against fair value changes in the inflation component of the fixed rate debt while retaining fair value exposure to the fixed real rate component.

RAB is not a valid hedged item as it is not recognised on the balance sheet.

In many cases it has also been difficult to achieve hedge accounting for the inflation component of revenue, see Section 3.3.1 below.

3.2. Separately Identifiable and Measurable

Rebutting the presumption that inflation is not separately identifiable and reliably measurable.

IFRS 9:B6.3.13 states that:

“There is a rebuttable presumption that unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable and hence cannot be designated as a risk component of a financial instrument. However, in limited cases, it is possible to identify a risk component for inflation risk that is separately identifiable and reliably measurable because of the particular circumstances of the inflation environment and the relevant debt market.”

As discussed in Section 2, based on the UK market structure, it is accepted that there is sufficient liquidity / depth in the inflation bond markets for inflation to be considered a separately identifiable and measurable component.

The analysis in Section 2 shows that real rates are separately identifiable and measurable. Real rates are not the residual component as they are recognised as being the rate that an investor requires as compensation to invest in inflation instruments. The real rate component is priced individually by bond issuance (similar for swap pricing) depending on market conditions at a point in time.

Therefore, it is concluded that both inflation and real rates are considered separately identifiable and measurable for the UK market.

3.3. Alternative Hedge Accounting Designations

3.3.1 Cash Flow Hedge Accounting for Revenue

As mentioned in the original submission to IFRIC, for regulated entities revenue is inflation linked. However, as is often the case, while inflation is specified as part of a regulator's published revenue mechanism for these businesses, it is not directly related to the overall allowed revenue and therefore in many cases cannot be designated in a hedge accounting relationship. The reason that revenue cannot be designated as the hedged risk is that revenue is determined by the regulated asset base of each entity and inflation is a

component of determining the regulated asset value which is not reflected in IFRS accounting. Hence the relationship of revenue to inflation, although real, is indirect.

There are limited circumstances where a cash flow hedge for the inflation component in revenue is eligible for hedge accounting.

3.3.2 Fair value hedge of the inflation component in fixed rate debt

The IFRIC Agenda paper AP06 refers to IFRS 9 B6.3.14 in relation to how fair value hedge accounting has been contemplated as an eligible designation. The hedged risk in this designation is the variability in the fair value of the identified debt payments, attributable to changes in inflation. The inflation component of the coupon is designated at inception of the hedge.

The hedged item can be discounted using a range of different curve constructions in order to isolate the inflation component.

All examples arrive at a similar result as they are just varying representations of similar / the same market inputs.

Each designation has been modelled, with all hedges showing volatility in with some same way movements between the hedged item and hedging instrument. The analysis shows that if the hedged fixed rate debt is adjusted only for changes in inflation a significant P/L mismatch from the fair value change of the inflation swap due to changes in real rates i.e. the cash flows of the swap have been fixed in real terms.

The fair value of the inflation pay leg is driven by the fair value due to the retained fixed real rate i.e. it does not reset to par. For example, an increase in inflation will result in an increase in the cash flows payable on the derivative. These cash flows are subsequently discounted at LIBOR, comprising of inflation and real rates. Variable inflation cash flows discounted by inflation results in no fair value movements. The remaining impact is due to fixed real rates discounted at current real rates.

The mechanics and current market practice of fair value hedge accounting means that this designation will inevitably result in high levels of ineffectiveness due to the volatility in real rate changes being greater than the volatility of inflation change. The entity has retained the real rate fair value risk but exposed itself to fair value accounting, the ineffectiveness truly reflects the risk management activities of the company.

For this designation to work, the mechanics of fair value hedge accounting would be required to be amended in order to allow the fair value change in real rates to be included in the fair value hedge adjustment.

We are happy to share our analysis with the Staff.

3.4. Cash Flow Hedge Accounting - Hedging Variability in Cash Flows Due to Real Interest Rate

We believe that the key points in the TAD can be summarised as:

1. 'Cash is by nature a nominal denomination in a respective currency'
2. For cash flow hedge accounting, cash flows can only be fixed in nominal terms
3. A real rate index / parameter does not exist but is a residual of the LIBOR and inflation curves

Each point is discussed below.

'Cash is by nature a nominal denomination in a respective currency'

There is an assertion that cash is by nature nominal, an assertion that is not found in IFRS literature. The paper concludes that all payments on the swap are nominal payments and not payments linked to real rates. The paper further explains that all cash payments on inflation linked bonds (and all other variable financial instruments) are nominal payments and not inflation payments.

This differs to how corporates, investors and other institutions view the rationale for holding such investments, as the return is fixed in real terms and not nominal terms. The parties would believe that cash flows have been fixed in real terms.

For cash flow hedge accounting, cash flows can only be fixed in nominal terms

'The Committee observed that, to meet the requirements in IFRS 9 for a cash flow hedge designation, the variability of individual cash flow streams attributed to the designated risk component needs to be separately identifiable in currency or nominal terms.'

Therefore, a cash flow hedge for variability in real rates is not an eligible hedge accounting relationship, even if real rates can be shown to be separately identifiable.

The above interpretation is not outlined in IFRS 9, including in the definition of cash flow hedge accounting. IFRS has previously permitted designating non-contractually specified risk components which can be shown to separately identifiable and reliably measurable.

The cash flow hedge designation achieves the objective that it intended to i.e. reduce volatility in real terms. Cash flow hedge accounting has not been viewed in nominal terms but with the criteria that it reduces variability in cash flows. Therefore, we believe the proposed cash flow hedge designation meets the criteria of paragraph 6.5.2 of IFRS 9.

A real rate index / parameter does not exist but is a residual of the LIBOR and inflation curves

The TAD states that 'In addition, the Committee considered that, in the proposed cash flow hedging relationship, the real interest rate would be an implied residual risk component (after combining the variable inflation-linked cash flows and the floating benchmark rate-based cash flows). The Committee therefore concluded that changes in cash flows on a floating rate instrument arising from the real interest rate risk component cannot be identified independently of changes in cash flows arising from other risk components. Consequently, the real interest rate risk component does not meet the requirements in paragraph 6.3.7 of IFRS 9 to be designated as a risk component. It therefore is not an eligible hedged item as required by paragraph 6.4.1 of IFRS 9.'

The analysis in Section 2 proves that real rates are not the residual factor but a separately identifiable and reliably measurable component.

An additional data point is the routine use of inflation in pensions, pay arrangements and regulated agreements that often reference a real rate, showing that real rates are not the residual component.

4. Summary

In summary we believe that the proposed designation in the submission meets the criteria as outlined in IFRS 9. Allowing this designation would allow the risk management objectives of the company to be aligned with the accounting and provide more insight for the users of the financial statements.

5. Appendices

5.1. Current Outstanding Gilts

Nominal Gilts	£m Notional
8% Treasury Stock 2021	24,594
3¾% Treasury Gilt 2021	29,001
4% Treasury Gilt 2022	38,771
0½% Treasury Gilt 2022	29,260
1¾% Treasury Gilt 2022	29,682
0 1/8% Treasury Gilt 2023	33,824
0¾% Treasury Gilt 2023	33,731
2¼% Treasury Gilt 2023	35,265
0 1/8% Treasury Gilt 2024	18,371
1% Treasury Gilt 2024	34,205
2¾% Treasury Gilt 2024	34,366
5% Treasury Stock 2025	35,838
0 5/8% Treasury Gilt 2025	41,356
2% Treasury Gilt 2025	38,328
0 1/8% Treasury Gilt 2026	30,895
1½% Treasury Gilt 2026	41,896
1¼% Treasury Gilt 2027	39,338
4¼% Treasury Gilt 2027	31,677
0 1/8% Treasury Gilt 2028	26,730
1 5/8% Treasury Gilt 2028	36,332
6% Treasury Stock 2028	19,441
0 7/8% Treasury Gilt 2029	41,865
0 3/8% Treasury Gilt 2030	37,339
4¾% Treasury Gilt 2030	41,096
0¼% Treasury Gilt 2031	10,250
4¼% Treasury Stock 2032	38,709
4½% Treasury Gilt 2034	34,803
0 5/8% Treasury Gilt 2035	19,079
4¼% Treasury Stock 2036	30,408
1¾% Treasury Gilt 2037	30,683
4¾% Treasury Stock 2038	25,748
4¼% Treasury Gilt 2039	23,260
4¼% Treasury Gilt 2040	25,385
1¼ % Treasury Gilt 2041	24,831
4½% Treasury Gilt 2042	27,213
3¼% Treasury Gilt 2044	27,938
3½% Treasury Gilt 2045	28,222
7/8 Treasury 2046	6,500
4¼% Treasury Gilt 2046	24,114
1½% Treasury Gilt 2047	24,687
1¾% Treasury Gilt 2049	26,759
4¼% Treasury Gilt 2049	20,201
0 5/8% Treasury Gilt 2050	28,133
3¾% Treasury Gilt 2052	24,104
1 5/8% Treasury Gilt 2054	21,960
4¼% Treasury Gilt 2055	26,559
1¾% Treasury Gilt 2057	28,254
4% Treasury Gilt 2060	24,121

0½% Treasury Gilt 2061	13,500
2½% Treasury Gilt 2065	19,747
3½% Treasury Gilt 2068	19,908
1 5/8% Treasury Gilt 2071	15,206

Source: DMO website as of 28-Jan-2021

Index-linked Gilts	£m Notional (Including Index-Linked Uplift)
1 7/8% Index-linked Treasury Gilt 2022	22,473
2½% Index-linked Treasury Stock 2024	20,407
0 1/8% Index-linked Treasury Gilt 2024	18,461
0 1/8% Index-linked Treasury Gilt 2026	15,296
1¼% Index-linked Treasury Gilt 2027	21,436
0 1/8% Index-linked Treasury Gilt 2028	18,858
0 1/8% Index-linked Treasury Gilt 2029	19,115
4 1/8% Index-linked Treasury Stock 2030	10,471
1¼% Index-linked Treasury Gilt 2032	19,817
0¾% Index-linked Treasury Gilt 2034	18,419
2% Index-linked Treasury Stock 2035	15,290
0 1/8% Index-linked Treasury Gilt 2036	15,699
1 1/8% Index-linked Treasury Gilt 2037	18,966
0 5/8% Index-linked Treasury Gilt 2040	19,104
0 1/8% Index-linked Treasury Gilt 2041	13,048
0 5/8% Index-linked Treasury Gilt 2042	17,354
0 1/8% Index-linked Treasury Gilt 2044	19,044
0 1/8% Index-linked Treasury Gilt 2046	15,358
0¾% Index-linked Treasury Gilt 2047	16,513
0 1/8% Index-linked Treasury Gilt 2048	12,586
0½% Index-linked Treasury Gilt 2050	16,813
0¼% Index-linked Treasury Gilt 2052	14,998
1¼% Index-linked Treasury Gilt 2055	15,533
0 1/8% Index-Linked Treasury Gilt 2056	7,137
0 1/8% Index-linked Treasury Gilt 2058	12,567
0 3/8% Index-linked Treasury Gilt 2062	15,536
0 1/8% Index-linked Treasury Gilt 2065	8,595
0 1/8% Index-linked Treasury Gilt 2068	14,814

Source: DMO website as of 28-Jan-2021

5.2. LCH Clearing Volumes (as at 12 November 2018)

GBP LCH Clearing Volumes by Product

Product	Volume GBP
IRS	£10,007,188,722,540
OIS	£9,166,591,960,658
Basis	£5,185,489,719,760
Zeroes	£269,315,328,013
FRAs	£6,726,745,215,225
VNS	£238,611,764,398
Inflation	£1,548,796,963,367
Total	£33,142,739,673,961

Source: LCH

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

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Registrar/Chief Executive

AHMED M. KUMSHE (PROF.), FCA

February 8th, 2021.

ICAN/CP/R&T/FEB8/2020

IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD.

Dear Sir,

Re: Hedging Variability in Cash Flows Due to Real Interest Rate (IFRS 9)

Please find below our comments on the above-named Tentative Agenda Decision.

Conclusion:

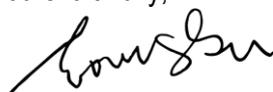
The Committee concluded that the requirements in IFRS 9 provide an adequate basis for an entity to determine whether a hedge of the variability in cash flows arising from changes in the real interest rate, rather than the nominal interest rate, could be accounted for as a cash flow hedge. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Response:

We agree with the Committee's conclusion that the principle and requirements in IFRS Standards provide an adequate basis for an entity to determine whether a hedge of the variability in cash flows arising from changes in the real interest rate, rather than the nominal interest rate, could be accounted for as a cash flow hedge. We will appreciate it if the Committee provides clarifications or an illustrative example, of circumstances where real interest rate can be designated as a hedged item.

We thank you for giving us the opportunity to contribute to the Agenda Decision and we are available should there be need for further clarification.

Yours faithfully,



**For: Ahmed M. Kumshe (Prof.), FCA
Registrar/Chief Executive**

International Accounting Standards Board
7 Westferry Circus
Canary Wharf
London
E14 4HD

15 February 2021

Dear Interpretations Committee,

Invitation to comment – Hedging Variability in Cash Flows Due to Real Interest Rate (IFRS 9)

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the above Tentative Agenda Decision (“TAD”) of the IFRS Interpretations Committee (‘Committee’) published in the December 2020 IFRIC Update.

We appreciate the Committee addressing this question. The fact pattern outlined in the submission is common in the United Kingdom (“UK”), which has one of the most established inflation-linked government bond markets, and hence has been considered as one of the rare environments where the criteria outlined in paragraph B6.3.13 of IFRS 9 could be met.

Our chief concern is that three key assertions are made in the TAD which conflict with our understanding of the UK inflation market or would appear to be interpretations of the standard, rather than being apparent from its words. These are discussed below, along with other points that we would like to bring to the Committee’s attention.

Prior to discussing the assertions, we believe it is useful to outline briefly our understanding of the UK inflation market and the use of inflation-linked derivatives by certain regulated UK companies.

- ▶ We believe that there is sufficient liquidity in the UK inflation-linked government bond market to overcome the rebuttable presumption in B6.3.13 of IFRS 9 and that, consequentially, inflation¹ is a separately identifiable component of interest rates in the UK.
- ▶ Revenue for many regulated UK entities is inflation-linked. However, revenue is generally determined according to the regulated asset base, which is adjusted for inflation so, as the asset value changes, the revenue generated from those assets also changes. In these cases, inflation is only indirectly contractually specified and, thus, is not considered to be a separately identifiable component of the revenue.
- ▶ While the entity could achieve a natural hedge by issuing inflation-linked bonds, the market to issue inflation-linked corporate bonds is not very liquid. This is in contrast to the UK market for inflation-linked government bonds, which is highly liquid.
- ▶ Consequently it is common practice for many regulated companies to enter into inflation-linked derivatives to manage their exposure to inflation in their revenue, but to seek to designate the derivatives as a hedge of the real rate of floating rate bonds, so as to reflect their risk management practices in their accounting treatment.

¹ The measure of inflation in the UK is currently the Retail Price Index (“RPI”)

The above helps set out the context for our concerns as discussed below.

The TAD sets out three key assertions:

1. *“Measurement and forecasts of actual inflation are based on statistical methodologies and therefore entail a time lag. The real interest rate, and therefore the effect of inflation, is not a risk component that explicitly or implicitly influences the determination of a nominal benchmark interest rate. There is therefore no identifiable variability in the benchmark rate-based nominal cash flows (for example, LIBOR cash flows) on a floating rate financial instrument that is attributable to the real interest rate risk component as required by paragraph 6.5.2(b) of IFRS 9.*
2. *“...in the proposed cash flow hedging relationship, the real interest rate would be an implied residual risk component (after combining the variable inflation-linked cash flows and the floating benchmark rate-based cash flows). The Committee therefore concluded that changes in cash flows on a floating rate instrument arising from the real interest rate risk component cannot be identified independently of changes in cash flows arising from other risk components”.*
3. *“...to meet the requirements in IFRS 9 for a cash flow hedge designation, the variability of individual cash flow streams attributed to the designated risk component needs to be separately identifiable in currency or nominal terms.*

Taking each of these assertions in turn:

1. B6.3.13 of IFRS 9 states that, in limited cases, the presumption that inflation risk is not separately identifiable, can be rebutted, because of the particular circumstances of the environment and the relevant debt market. B6.3.14 goes on to say that in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market, a term structure of zero-coupon real rates can be constructed, from which the inflation risk component can also be determined. This implies that, in such an environment, zero-coupon real rates as well as inflation risk would be separately identifiable.

The assertion in the TAD would appear to conflict with paragraph B6.3.14 of IFRS 9. If the Committee believes that real rates and inflation do not influence the determination of nominal rates, then this would appear to question the validity of B6.3.14. Furthermore, this assertion disputes the validity of the Fisher² equation, which specifies the relationship between nominal, inflation and real rates and which underpins the issuance and use of inflation-linked bonds.

Given that the UK is an environment in which inflation-linked government bonds have a volume and term structure that results in a liquid market that allows zero-coupon real rates to be constructed³, it follows that real rates are generally considered a separately identifiable component of nominal UK government bond interest rates.

As inflation-linked bonds are actively traded both at inception and on secondary markets, the yield on these instruments is repriced by the market on a real-time basis. The yield on an inflation linked bond is determined by the buyers' and sellers' expectations of real rates over the remaining or issued tenor in the same way as a nominal bond's yield is calculated. Hence, inflation-linked bonds are priced on a forward-looking basis, projecting future cash flows, rather than on historical data; i.e., there is no time lag involved, as asserted in the TAD.

Importantly, the real rate designated in the hedging relationship can be derived from inflation-linked bond prices. I.e., just as a zero-coupon nominal curve is derived via bootstrapping yields on a set of traded fixed nominal rate instruments, a zero-coupon real rate curve is derived via bootstrapping yields (the fixed real rate spread which drives the fair value of the inflation-linked bond) on a set of traded inflation-linked bonds. Hence, it meets the requirements of paragraph B6.3.14.

The above analysis is corroborated by the Bank of England, who note:

Implied inflation rates

We have seen that the index-linked gilt market allows us to obtain real interest rates and the conventional gilt market allows us to obtain nominal interest rates. These nominal rates embody the real interest rate plus a compensation for the erosion of the purchasing power of this investment by inflation. The Bank uses this decomposition (commonly known as the Fisher relationship) and the real and nominal yield curves to calculate the implied inflation rate factored into nominal interest rates.⁴

2. The TAD'S assertion, that it is not possible to identify separately a residual component, is presumably based on the discussion in BC 6.469-517 on the eligibility of credit risk as a risk component that can be hedged. The concern of the Board there was that the spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and other unidentified risk component and margin elements, making it impossible to isolate just credit risk. In contrast, as already discussed above,

² As defined in the initial submission

³ While corporate bond prices vary for changes due to a number of factors, such as credit risk and liquidity, in the context of liquid and highly rated inflation-linked government bonds, such as those issued by the UK Government, bond prices at issuance and subsequent trading are driven primarily based on macroeconomic factors, as is the case with nominal Government issued debt in the UK. Government issued nominal bonds, are routinely used to derive risk-free zero-coupon rates.

⁴ Source: [Yield curve terminology and concepts | Bank of England](#)

while nominal and real rates are indeed inter-related, as two elements of the Fisher equation, they can both be separately identified. As mentioned above, real rates are not an implied residual component but a component of nominal rates that can be independently calculated from inflation-linked government bond issuances. The difference between the zero-coupon nominal curve and the zero-coupon real rate curve is the implied forward inflation curve, i.e., the market's measure of future inflation. Therefore, one could argue that in the context of zero-coupon rates, if either component is the residual, it is inflation rather than the real rate.

Also relevant in the Standard is the requirement of paragraph B6.3.14 of IFRS 9, that “the entity cannot simply impute the terms and conditions of the actual hedging instrument by projecting its terms and conditions onto the nominal interest rate debt”. In this fact pattern, since the zero-coupon real rate curve is identified separately from inflation-linked bonds, rather than the hedging instrument, the requirement of B6.3.14 is met.

3. The assertion that ‘*the variability of individual cash flow streams attributed to the designated risk component needs to be separately identifiable in currency or nominal terms*’ would appear to be an interpretation, since this requirement is not expressed in the Standard. This is not surprising, since, prior to the possibility of hedging for inflation risk, the issue has never been relevant.

According to 6.5.2, a cash flow hedge is “a hedge of exposure to variability in cash flows attributable to a particular risk”. While a cash flow will always be a nominal amount, there is no requirement that a portion of the cash flow is fixed in nominal terms.

However, for this particular fact pattern, we do not believe that the assertion is relevant as the real rate component has been fixed in nominal terms. The effect of a cash flow hedge of the real rate component of the overall nominal rate of interest cash flow, is that the exposure to variability is reduced, since it will no longer vary with changes in the designated risk component (the real rate), but only with changes in inflation.

As the inflation-linked bond market demonstrates, the components of a nominal rate cash flow can be settled in their individual component parts, hence even though the real rate component has been fixed, all payments are expressed in nominal terms. Further, the reduction in variability of future nominal cash flows provided by a cash flow hedge can be expressed and measured in nominal terms.

We believe that the fact pattern supporting cash flow hedge accounting of the real rate component of variable rate debt outlined in the submission meets the requirements of paragraph 6.5.2. of IFRS 9.

Finally, paragraph B6.3.14 implies that it may be possible to designate a fair value hedge of the inflation component of a fixed rate bond. We have carried out substantial analysis and we believe that such a hedge may never meet the requirements of the Standard. The main reason for this is that the dominant fair value driver on inflation-linked bonds and swaps is the fair value changes due to the fixed real rates, rather than floating inflation⁵. We would be happy to discuss this further with the Committee. Consequently, if hedge accounting is not considered

⁵ The fair value of the inflation pay leg of the derivative is driven by the fair value changes due to the fixed real rate, i.e., unlike fair value hedges of LIBOR, where the present value of floating rate LIBOR debt remains constant if discounted with the zero coupon LIBOR. As the real rate has been fixed, the present value of cash flows discounted using a zero-coupon inflation curve cannot remain constant. As the fair value of the pay leg does not stay constant, the change in fair value of the hedging instrument does not necessarily move in line with the hedged item.

possible for the fact pattern set out in the submission, then it is unlikely ever to be achievable for the inflation component in debt. Hence, if the Committee believes that cash flow hedge accounting is not available, our recommendation would be for the Committee to recommend that the IASB reconsiders the guidance in IFRS 9 B6.3.13 to 15.

Should you wish to discuss the contents of this letter with us, please contact Laure Guégan at laure.guegan@fr.ey.com or on + 33 (0) 1 46 93 63 58.

Yours faithfully

Ernst + Young Global Limited