



# TRADE RISKS®

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Dear Sir/Madam,

## RESPONSE TO IFRS 9 PHASE 3: HEDGE ACCOUNTING EXPOSURE DRAFT

We are writing to obtain clarification on how to interpret clause B18 of the IFRS 9 Hedge Accounting Exposure Draft in relation to the specific inflation risk management activities of our UK housing association clients.

We welcome the changes proposed by IFRS 9 in moving towards a more principles based approach to the application of hedge accounting. However, we believe that B18 (in its current form) is confusing and may lead to auditors deeming highly effective economic inflation hedges to be ineligible for hedge accounting. This would go against the key objective of IFRS 9, which is to align hedge accounting more closely to the true economics of risk management practices.

B18 states that “inflation... cannot be designated as a risk component of a *financial instrument* unless it is contractually specified”:

**B18** Inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified. A contractually specified inflation component of the cash flows of a recognised inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation component.

Clause B18 only refers to financial instruments. Clearly, any inflation derivative instrument will contractually reference inflation (which is separately identifiable and reliably measurable), as will any inflation-linked bonds. However, we are concerned that auditors will infer from B18 the same treatment for non-financial items which do not precisely specify inflation in a contract.

It is certainly possible in the real world that non-financial items which have a genuine and measurable inflation risk component do not have this inflation linkage precisely specified in a contract. One such example of a non-financial item with a direct and measurable inflation linkage which is not contractually specified are UK social housing rents. Social housing rents are subject to UK housing regulation. The housing regulator prescribes a formula to set a target rent for each housing property. This target is indexed annually at RPI + 0.5%. The rental agreement between the landlord and tenant does not contain this formula, merely referring to



the ability to review rents annually. Although there is some flexibility for the landlord to deviate from the target, this discretion is very limited. Please see Appendix 1 which explains how a correctly structured cumulative RPI inflation forms a highly effective economic hedge for the RPI risk component in social housing rents.

If the proposed IFRS 9 hedge accounting rules are left in their current form with respect to inflation, then we believe this will contribute to two market failures:

- 1) Housing associations will be discouraged from entering into genuine inflation hedges because of fears around accounting treatment. This could result in financial difficulties for housing associations in a protracted recession scenario.
- 2) The flow of scarce RPI cashflows into the inflation market would be impaired. This would contribute to greater market illiquidity and an ultimate reduction in the supply of RPI cashflows to entities like defined benefit pension schemes (who need to carry out RPI inflation hedging in their hedging processes)

As such, we propose that clause B18 is clarified to make clear that it applies only to financial instruments and it does not apply to non-financial items, where there can exist identifiable and measurable inflation components which are not explicitly contractually specified.

We welcome your response to this letter.

Yours sincerely

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TradeRisks Limited



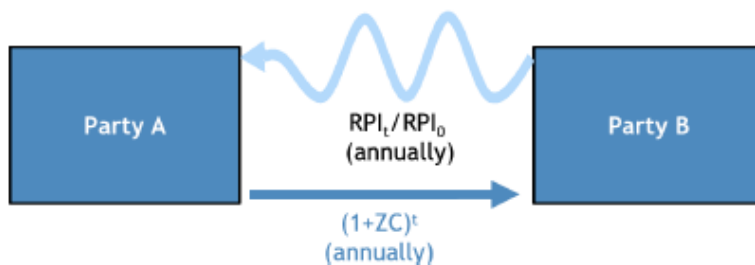
## **Appendix: Inflation Swaps in English Housing Associations**

Housing associations run a residual RPI risk in their business plan which arises from the linkage of their rental income to September annual RPI + 0.5%. Housing associations are positively exposed to inflation, which means that in periods of high inflation, a housing association business plan will benefit because their operating surplus will inflate while the real burden of debt will fall. The converse is true in periods of low (or negative) inflation, where operating surplus is under pressure from lower nominal rents and the real burden of debt rises. Therefore, the worst case scenario for a housing association is to have a high proportion of fixed debt in a prolonged deflationary environment. Such an environment was experienced by Japan in the 1990s following its domestic banking crisis, which had many notable similarities to the global financial crisis of August 2007 – present.

Many housing associations are keen to hedge the residual RPI risk which poses a major long term financial risk to their business plans. Hedging inflation risk is most commonly achieved through entering into a series of zero coupon RPI swaps which together form a revenue hedge. Housing associations can also gain inflation exposure in their debt portfolios either through the issuance of inflation-linked debt, or by transforming floating rate or fixed rate debt synthetically using RPI swaps.

### **RPI Inflation Swaps**

The appropriate inflation swap structure for housing associations is the cumulative RPI inflation swap. A cumulative structure is one where the cashflow on the inflation leg of the swap is calculated from the cumulative inflation since a base reference date, multiplied by the notional amount. The reason this is the appropriate hedge is that it exactly matches the inflation exposure of the underlying social housing rents (at September annual RPI + 0.5%). A cumulative RPI swap can be represented by the following diagram, where Party A is the bank and Party B is the housing association:



The housing association effectively pays away the cumulative variable inflation it receives on the underlying social housing rents annually, and in return it receives a cumulatively compounded fixed amount. In this way, the housing association is effectively hedged against inflation risk up to the notional amount of the swap.