



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 on tentative agenda decision		
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Introduction

1. In December 2020, the IFRS Interpretations Committee (Committee) published a tentative agenda decision in response to a submission about applying the hedge accounting requirements in IFRS 9 *Financial Instruments* when the objective is to fix the cash flows in real terms.
2. The submission asked 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. More specifically, the request describes a fact pattern in which an entity wants to hedge a floating rate (LIBOR) debt with an inflation swap (which swaps the variable interest cash flows of the floating rate debt for variable cash flows based on an inflation index) in a cash flow hedge.
3. To apply cash flow hedge accounting in the fact pattern described in the submission, the Committee considered that it would be necessary to determine:
 - (a) whether the floating rate instrument has exposure to variability in cash flows that are attributable to the real interest rate risk component as required by paragraph 6.5.2(b) of IFRS 9; and
 - (b) whether that risk component is separately identifiable and reliably measurable as required by paragraph 6.3.7 of IFRS 9.

4. The Committee observed that, to meet the requirements in IFRS 9 for a cash flow hedge designation, the exposure to variability in individual cash flow streams attributed to the designated risk component needs to be separately identifiable in currency or nominal terms. The Committee concluded that there is 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.
5. 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).
6. The Committee concluded that, in the proposed cash flow hedging relationship, 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 and, therefore, is not an eligible hedged item as required by paragraph 6.4.1 of IFRS 9.
7. The objectives of this paper are to:
 - (a) analyse comments on the tentative agenda decision; and
 - (b) ask the Committee whether it agrees with our recommendation to finalise the agenda decision.
8. Appendix A sets out the proposed wording of the agenda decision.

Comment letter summary

9. We received six comment letters by the comment letter deadline. One comment letter submitted by Heathrow Airport Limited represents the opinion of a group of eight entities ('the group of preparers').¹ All comment letters received, including any late

¹ The group includes Heathrow Airport Limited, Northern Gas Networks, Yorkshire Water Services Limited, Nation Grid plc, Anglian Water Group Limited, TCI Advisory Services LLP, Northumbrian Water Ltd and UK Power Networks.

comment letters, are available on our [website](#).² This agenda paper includes analysis of only the comment letters received by the comment letter deadline, which are reproduced in Agenda Paper 4A.

10. Two respondents (the Association of National Accountants of Nigeria and the Institute of Chartered Accountants of Nigeria) agree with the Committee’s analysis and conclusion. However, the Institute of Chartered Accountants of Nigeria suggests including an example or otherwise clarifying when the real interest rate can be designated as a risk component when applying IFRS 9.
11. One respondent (Deloitte) agrees with the outcome as explained in the tentative agenda decision. However, the respondent recommends clarifying in the final agenda decision that the hedging relationship described in the submission cannot be eligible as a cash flow hedge when applying the requirements in IFRS 9 because the cash flows to be designated are fixed in real terms and not in nominal terms.
12. Three respondents (KPMG, EY and the group of preparers) do not support the tentative agenda decision as published but cite different reasons for their disagreement. KPMG and EY say the tentative agenda decision is based on an interpretation of IFRS 9 rather than actual requirements. The group of preparers says the tentative agenda decision is based on a narrow interpretation of the letter of the Standard and does not consider the underlying principles and objectives of IFRS 9, which are to more closely align the application of hedge accounting with an entity’s risk management strategy.
13. The main reasons given by these respondents are summarised as follows:
 - (a) the tentative agenda decision (‘TAD’) is not sufficiently linked to existing requirements in IFRS 9 and therefore represents an interpretation of the requirements;
 - (b) whether an inflation risk or real interest rate risk component is separately identifiable and reliably measurable depends on the ability to construct a relevant zero-coupon curve. Respondents are of the view that if a zero-

² At the date of posting this agenda paper, there was one late comment letter.

coupon real interest rate curve can be constructed, it results in a risk component that is separately identifiable and reliably measurable in any hedging relationship in which the hedged risk is inflation risk; and`

- (c) changes in the real interest rate directly influence contractual benchmark interest rate (LIBOR) cash flows and these alleged real interest rate cash flows can be fixed in nominal terms.

14. Further details about these matters, together with our analysis, are presented below.

Staff analysis

15. To provide a logical flow through the relevant qualifying criteria for hedge accounting as set out in paragraph 6.4.1 of IFRS 9, we have grouped respondents' comments and our analysis as follows:

- (a) Eligible hedged items:
 - (i) the application of the rebuttable presumption in paragraph B6.3.14 of IFRS 9 to the proposed cash flow hedging relationship (paragraphs 16–24);
 - (ii) variability in cash flows attributable to a particular (hedged) risk (component) (paragraphs 25–50); and
- (b) Risk management objective and strategy for undertaking the hedge (paragraphs 51– 54).

Eligible hedged item

Application of the rebuttable presumption to the proposed cash flow hedging relationship

Respondents' comments

16. The three respondents that disagree with the tentative agenda decision (TAD) say the TAD concluded that the real rate of interest is not separately identifiable and reliably measurable as presented in the submission. These respondents agree that IFRS 9 requires the market structure to support inflation risk as a risk component. Therefore,

they are of the view that if a term structure of zero-coupon real interest rate can be identified in a specific market as set out in paragraph B6.3.14 of IFRS 9, the rebuttable presumption in paragraph B6.3.13 of IFRS 9 can equally be applied to fair value and cash flow hedging relationships.

17. The group of preparers and EY refer to the yield curves published by the Bank of England to illustrate how zero-coupon real interest rate curves can be derived in the UK inflation-indexed bond market and how the Fisher equation is elementary in specifying the relationship between nominal, inflation and real rates. These respondents are of the view that there is sufficient liquidity in the UK inflation-linked bond market to overcome the rebuttable presumption in paragraph B6.3.13 of IFRS 9 and that, consequently, inflation is a separately identifiable component of interest rates in the UK.
18. KMPG says whether an inflation component is separately identifiable and reliably measurable depends only on the ability to construct a term structure of zero-coupon real interest rates. They believe that paragraphs B6.3.13 and B6.3.14 of IFRS 9 do not include an explicit limitation on rebutting the presumption in paragraph B6.3.13 for fair value hedges only or an explicit exclusion of cash flow hedges. They are of the view that once an inflation risk component is identified using the zero-coupon real interest rate curve, it would be counterintuitive to conclude that the real interest rate curve itself could not be a separately identifiable and reliably measurable risk component.

Staff analysis

19. The staff analysis in [Agenda paper 6](#) for the December 2020 meeting stated in paragraph 23 that the analysis has not focussed on whether a zero-coupon real interest rate curve exists in a particular market and, therefore, whether the *inflation risk component* is separately identifiable and reliably measurable. Notwithstanding the contradictory statements in the submission, for the purpose of the analysis, it was assumed that the inflation risk component is separately identifiable and reliably measurable.
20. The Fisher equation (which has been referred to by two respondents) provides an analytical breakdown of a nominal rate, so that the nominal rate represents the sum of

the real interest rate and the breakeven inflation rate.³ In turn, the breakeven inflation rate represents the sum of the *expected inflation* and the inflation risk premium.

However, the equation applies in *all* markets, regardless of whether there is a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates as required in paragraph B6.3.14. Therefore, the Fisher equation cannot be used to rebut the presumption in paragraph B6.3.13 that inflation is separately identifiable and reliably measurable only in limited cases.

21. Using a zero-coupon real interest rate curve demonstrates that a debt instrument could be priced in a particular market (using that curve) to isolate an inflation risk component. The zero-coupon curve therefore allows the entity to *measure* the changes in the value/price of debt instruments in a particular market for the effect of expected inflation in the same way as for an interest rate component in a fair value hedge.

22. This is consistent with the example described in paragraph B6.3.14 of IFRS 9 that describes how to separately identify the fair value changes attributable to the inflation risk component (ie by using a term structure of zero-coupon real interest rates). In other words, the inflation rate in a particular market could be separately identifiable and reliably measurable as a risk component that influences the fair value of debt instruments. However, this does not automatically lead to the conclusion that the inflation rate in a particular market is separately identifiable and reliably measurable in *all* hedging relationships where the inflation rate is the hedged risk.

23. As the determination of an eligible hedged item is one of the qualifying criteria for hedge accounting in paragraph 6.4.1 of IFRS 9, this requirement needs to be satisfied for each individual hedging relationship. In other words, the fact that a particular hedged item is eligible in one hedging relationship does not automatically result in that hedged item being eligible in all hedging relationships with the same hedged risk (see paragraph 35 for an example). The staff also note that the Board deliberately placed a high burden of proof on concluding that a non-contractually specified

³ Solving the multiplicative relationship of the Fisher equation one can ascertain that for small changes in the real rate r and expected inflation i the inflation premium effect ri is immaterial.

inflation risk component is separately identifiable and reliably measurable by including the rebuttable presumption in paragraph B6.3.13 of IFRS 9.⁴

24. The staff continues to be of the view that although the rebuttable presumption in paragraph B6.3.13 of IFRS 9 is not explicitly limited to fair value hedges, the example in paragraph B6.3.14 of IFRS 9 illustrates the application of the rebuttable presumption in a fair value hedge. We therefore are of the view that, for the purposes of a cash flow hedge, the existence of a zero-coupon real interest rate curve (as described in the example in paragraph B6.3.14 of IFRS 9) does not in itself overcome the rebuttable presumption to conclude that there is a non-contractually specified real interest rate risk component that is separately identifiable and reliably measurable.

Variability in cash flows attributable to a particular risk (component)

[Respondents' comments](#)

25. The three respondents that disagree with the TAD disagree with the Committee's conclusion 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.
26. KPMG says this appears to be a question of fact that is contingent on the behaviour of market participants and there could be divergent views on whether nominal interest rates are influenced by the expected inflation and expected real interest rate. They also say this statement seems to be inconsistent with the assertion in paragraph B6.3.14 of IFRS 9 that, in some circumstances, inflation is a relevant factor that is separately considered by the debt markets, which implies that inflation is something that influences the determination of nominal benchmark interest rates.
27. In the context of the example in paragraph B6.3.14 of IFRS 9, some of these respondents question the relevance of the statement in the TAD that the measurement and forecasts of actual inflation are based on statistical methodologies and therefore entail a time lag.

⁴ Paragraphs BC6.192 and BC6.193 of IFRS 9.

28. These respondents also disagree with the Committee’s conclusion that the real interest rate risk component, as described in the submission, is a residual risk component in the proposed cash flow hedging relationship. They are of the view that the real interest rate is a separately identifiable and reliably measurable risk component (of the (LIBOR) benchmark interest rate).
29. These respondents further disagree with the statement that cash is by nature in nominal terms, as this statement is in their view not found in IFRS Standards. Other respondents were of the view that the TAD interprets IFRS 9, rather than refers to requirements in IFRS 9, when it 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’.
30. Although Deloitte agrees with the overall conclusion of the Committee, they recommend including an additional rationale as to why the proposed hedging relationship described in the TAD is not eligible under IFRS 9 as a cash flow hedge. In their view, the hedged cash flows in a cash flow hedge need to be ‘fixed’ in nominal terms (ie in currency terms) as opposed to real terms and, therefore, hedge ineffectiveness needs to be measured in nominal terms. It therefore follows that it would be inappropriate for the economic relationship of the hedge to be assessed in real terms because reporting in real terms is not recognised under IFRS Standards.

Staff analysis

Cash in nominal terms

31. The staff disagree with respondents who say there are no requirements in IFRS Standards that state that cash is by nature a nominal denomination or that cash flow streams attributable to designated risk components need to be separately identifiable and reliably measurable in nominal terms.
32. Paragraph 2 of IAS 29 *Financial Reporting in Hyperinflationary Economies* specifically states that, in a hyperinflationary economy, money loses purchasing power in times of hyperinflation at such a rate that comparison of amounts from transactions and events that have occurred at different times is misleading. For this reason, IAS 29 requires financial statements in those economies to be restated so that

non-monetary items are expressed in terms of a measuring unit current at the end of the reporting period. IAS 29 specifically states in paragraph 12 that monetary items in the statement of financial position are not restated because they are already expressed in terms of the monetary unit current at the end of the reporting period (ie the currency amount already reflects the effect of inflation). Monetary items are described as money held and items to be received or paid in money.

33. The staff therefore continues to be of the view that cash is by nature a nominal denomination. The requirement in IAS 29 to reflect the effects of hyperinflation by restating financial statements so that non-monetary items are expressed in terms of a measuring unit confirms that monetary items in the financial statements are recognised and measured in nominal terms. This is also consistent with the definition of cash flows in paragraph 6 of IAS 7 *Statement of Cash Flows* being inflows and outflows of cash and cash equivalents.
34. For that reason, the staff remains of the view that the cash flow streams attributable to designated risk components need to be separately identifiable and reliably measurable in nominal terms. The staff therefore agree with the comment that, to designate a cash flow hedge, the economic relationship between the hedged item and hedging instrument (as required by paragraph 6.4.1(c)(i) of IFRS 9) and hedge ineffectiveness must be assessed and measured in nominal terms.

Exposure to variability in cash flows

35. Paragraph 6.5.2(b) of IFRS 9 describes a cash flow hedge as a hedge of the exposure to variability in cash flows that are attributable to a particular risk associated with all or a component of a recognised asset or liability [...] and could affect profit and loss. When designating a cash flow hedge, the entity needs to determine whether there is variability in the cash flows of the hedged item that are attributable to the hedged risk. A typical example of a cash flow hedge is a variable rate loan where a benchmark interest rate is designated as the hedged risk—as the interest rate on the loan is updated for changes in the benchmark rate, those changes result in variability of the contractual cash flows (ie when the benchmark rate changes, the cash flows being paid on the loan also change). This is different from a fixed rate loan where there are no changes to the contractual cash flows of the loan when the benchmark rate changes

and, therefore, the contractual cash flows cannot be designated in a cash flow hedge to hedge changes arising from the benchmark rate (ie there is no exposure to variability in cash flows arising from changes in the benchmark rate).

36. Paragraph 6.4.1(b) of IFRS 9 requires that, at inception of the hedging relationship, there is formal designation and documentation of the hedging relationship, including the identification of the hedged item and the nature of the risk being hedged. Therefore, the requirement for the risk component to be separately identifiable and reliably measurable needs to be assessed in the context of the hedged risk for each hedged item in the hedging relationship.

37. Paragraph 6.3.7 of IFRS 9 states that an entity may designate only the following types of components (including combinations) as hedged items:
 - (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component);
 - (b) one of more selected contractual cash flows; or
 - (c) components of a nominal amount, ie a specified part of the amount of an item.

38. Based on the proposed hedging relationship described in the submission, it was clear that the proposed cash flow hedging relationship would be based on a risk component approach as described in paragraph 37(a) of this paper and not those described in paragraph 37(b) and (c).

39. As discussed in paragraphs 19–24, the staff are of the view that for the purpose of a cash flow hedge, the existence of a zero-coupon real interest rate curve (as described in the example in paragraph B6.3.14 of IFRS 9) is not relevant to rebut the presumption in paragraph B6.3.13 and conclude that the real interest rate risk component is a non-contractually specified real interest rate risk component that is separately identifiable and reliably measurable.

40. The analysis supporting the TAD therefore focussed on whether there are *changes in the cash flows* (ie exposure to variability in cash flows) of the variable rate debt instrument (the hedged item) that are attributable to changes in the real interest rate

risk component and whether that cash flow variability is separately identifiable and reliably measurable from other risk components.

41. In line with paragraphs 6.3.7(a), B6.3.9 and B6.3.13 of IFRS 9, the market structure in which LIBOR debt is issued and in which the hedging activity takes place needs to support the eligibility of the real interest rate risk component as the hedged risk. For this to be the case, the real interest rate must represent a benchmark pricing element in setting the variable rate and therefore create directly observable and separately measurable cash flow variability in the variable rate debt.
42. Two respondents say a nominal benchmark interest rate such as LIBOR may be influenced by expected inflation and an expected real interest rate and, therefore, creates the aforementioned cash flow variability. The staff acknowledge that the nominal interest rate might be indirectly influenced by the inflation rate and the real interest rate over a period of time. However, the staff also note that in terms of general economic principles, one of the ways central banks control inflation is through monetary policy—in times of high inflation, an increase in nominal interest rates will reduce the demand for money, leading to reduced growth in the economy and therefore lower inflation. Similarly, interest on mortgage loans is often included in the basket of items that determine the measure of inflation such as CPI. It would therefore seem that nominal interest rates are being used to influence inflation (and by implication its complement, the real interest rate) instead of inflation influencing interest rates.
43. Furthermore, the inflation risk component of the nominal interest rate is not a ‘component of nominal interest’ but a component of each current unit of contractual cash flow, each of which is equally exposed to inflation risk as is the case for inflation-linked debt instruments.
44. The staff is therefore of the view that changes in the nominal interest rate is not attributable to changes in the real interest rate, ie there is no direct relationship between changes in the nominal interest rate and the real interest rate, even if the changes are correlated. This is because a correlation between variables does not automatically mean that the change in one variable is the cause of the change in the values of the other variable. For a risk component to be eligible for hedge accounting,

there needs to be causation, ie a change in one variable is the result of a change in another variable. This is consistent with the discussion in paragraph 32 of [Agenda Paper 3B](#) for the July 2011 Board meeting, which stated that correlation is an aspect that relates to the hedge effectiveness assessment rather than to determining eligible risk components.

45. We therefore continue to be of the view that the ‘link’ between a change in the nominal interest rate and the inflation rate is too indirect to rebut the presumption in paragraph B6.3.13 that inflation risk is not separately identifiable and reliably measurable (as required by paragraph 6.3.7(b) of IFRS 9) and hence cannot be designated as a risk component.

Residual component

46. The staff continue to be of the view that, in the proposed cash flow hedging relationship, the real interest rate is an implied residual risk component. This is because the submission describes a proposed hedging relationship that offsets/combines the cash flow variability of the floating nominal rate against the cash flow variability of the inflation-linked swap, assuming that the remaining net cash flows (ie the residual) represent the real interest rate component.
47. However, in the designated hedging instrument, the ‘market’ real interest rate is merely the swap rate inherent in pricing the swap and not necessarily the real interest rate independently observable in the relevant market. As such, the real interest rate can be seen (at designation of the hedging relationship) as the residual of the prevailing LIBOR rate and actual inflation inputs.
48. Also, excluding the effect of credit risk, such a designation would be 100% effective all the time because it does not involve any independent measurement of the effect of inflation on the LIBOR floating rate debt instrument (but instead uses the mirror image of the inflation leg of the derivative to represent that effect). That is the type of “*projecting the terms and conditions of the inflation derivative*” that the Board was concerned about and which resulted in establishing the rebuttable presumption to prevent it (see paragraphs BC6.192 and BC6.193 of IFRS 9).

49. The staff is therefore of the view that the proposed cash flow hedging relationship as described in the submission has not offered an independent assessment of the changes in contractual benchmark interest rate (such as LIBOR) cash flows attributable to the non-contractual real interest rate risk component.
50. Consequently, the staff continues to be of the view that the facts presented in the submission do not support a cash flow hedging relationship applying IFRS 9 where variable nominal interest rate cash flows are designated as the hedged item for exposure to changes in cash flows due to changes in the real interest rate.

Risk management strategy and objective for undertaking the hedge

Respondents' comments

51. The group of preparers emphasises that for regulated entities, the use of inflation-related IFRS 9 hedge accounting is important in order for their reported financial statements not to be misleading to investors. In particular, the use of inflation swaps is an important tool to manage debt issuances on a cost-effective basis.
52. Other respondents say the use of inflation-linked swaps in combination with a fixed rate debt, to replicate the economic effect of issuing inflation-linked debt, provides a valid economic offset to regulated entities' exposure to inflation-linked revenue. In their view, because the use of inflation-linked swaps is aligned with the entity's risk management strategy and the economic substance of the transactions is the same, hedge accounting should be applied so that the transactions can be accounted for in the same way.

Staff analysis

53. The staff acknowledge that one of the qualifying criteria for hedge accounting is for the hedging relationship to be consistent with the entity's risk management strategy. Paragraph 6.1.1 of IFRS 9 states that the objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income).

54. It is important to note that the staff is not questioning the validity of particular risk management strategies such as the strategy described in the submission. However, an entity’s risk management strategy is only one of the qualifying criteria and is, in itself, not determinate of whether a hedging relationship qualifies for hedge accounting. As discussed in the staff analysis in the previous sections of this paper, the staff remains of the view that the hedged item in the proposed cash flow hedging relationship does not satisfy the requirements for an eligible hedged item. Therefore, the proposed hedging relationship does not qualify for hedge accounting applying IFRS 9.

Other comments

55. Although not directly related to the question asked in the submission, EY says in their view the designation of the inflation risk component of a fixed rate bond in a fair value hedging relationship (as discussed in paragraph B6.3.14 of IFRS 9) will never meet the requirements for hedge accounting in IFRS 9. EY therefore recommends amending paragraphs B.6.13–B.6.15 of IFRS 9.
56. The staff also acknowledge the request from the Institute of Chartered Accountants of Nigeria to provide clarifications or an illustrative example of circumstances in which the real interest rate can be designated as a hedged item.
57. However, these suggestions are unrelated to the fact pattern in the submission and are beyond the scope of the Committee’s discussions on this matter.

Staff recommendation

58. Based on our analysis, we recommend finalising the agenda decision, with changes to the tentative agenda decision as suggested in Appendix A to this paper. If the Committee agrees with our recommendation, we will ask the Board whether it objects

to the agenda decision at the first Board meeting at which it is practicable to present the agenda decision.

Question for the Committee

Does the Committee agree with our recommendation to finalise the agenda decision set out in Appendix A to this paper?

Appendix A—proposed wording of the agenda decision

- A1. We propose the following wording for the final agenda decision (new text is underlined, and deleted text is struck through).

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

The Committee received a request about applying the hedge accounting requirements in IFRS 9 when the risk management objective is to ‘fix’ the cash flows in real terms.

The request asked 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. More specifically, the request describes a fact pattern in which an entity with a floating rate instrument referenced to an interest rate benchmark, such as LIBOR, enters into an inflation swap (which swaps the variable interest cash flows of the floating rate instrument for variable cash flows based on an inflation index). The request asked whether the entity can designate the swap in a cash flow hedging relationship to hedge changes in the variable interest payments for changes in the real interest rate.

Hedge accounting requirements in IFRS 9

Paragraph 6.4.1 of IFRS 9 sets out the qualifying criteria for hedge accounting. Paragraph 6.1.1 of IFRS 9 states that the objective of hedge accounting is to represent, in the financial statements, the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income).

One type of hedging relationship described in paragraph 6.5.2 of IFRS 9 is a cash flow hedge in which an entity hedges the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability and could affect profit or loss.

Paragraph 6.3.7 of IFRS 9 specifies that an entity may designate an item in its entirety, or a component of an item, as a hedged item. A risk component may be designated as the hedged item if, based on an assessment ~~within the context~~ of the particular market structure, that risk component is separately identifiable and reliably measurable within the context of the specific hedging relationship.

With respect to inflation risk, paragraph B6.3.13 of IFRS 9 states ‘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’.

Paragraph B6.3.14 of IFRS 9 states that an entity cannot simply impute the terms and conditions of an inflation hedging instrument by projecting its term and conditions onto a nominal interest rate debt instrument. This is because, when developing IFRS 9, the Board specifically considered inflation risk and put in place restrictions to address its concern that entities might impute the terms and conditions of a hedging instrument onto the hedged item ‘without proper application of the criteria for designating risk components’ as a hedged item (paragraph BC6.193 of IFRS 9). To appropriately account for hedge (in)effectiveness, paragraph B6.5.5 of IFRS 9 requires an entity to measure the (present) value of the hedged item independently of the measurement of the value of the hedging instrument.

Given the request asked whether the real interest rate component could be designated as a risk component in a cash flow hedge, the Committee’s analysis focussed on whether a non-contractually specified real interest rate risk component is separately identifiable and reliably measurable in the context of the proposed cash flow hedging relationship described in the request.

Can a non-contractually specified real interest rate risk component be designated as the hedged item in the proposed cash flow hedging relationship?

When considering the qualifying criteria in paragraph 6.4.1 of IFRS 9, the Committee observed that for ~~To apply~~ cash flow hedge accounting to be applied in the fact pattern described in the request, ~~the Committee considered that~~ it would be necessary to determine:

- whether the floating rate instrument has exposure to variability in cash flows that are attributable to the real interest rate risk component as required by paragraph 6.5.2(b) of IFRS 9; and
- whether that risk component is separately identifiable and reliably measurable as required by paragraph 6.3.7 of IFRS 9.

The Committee noted that a nominal interest rate comprises a real interest rate, an inflation component (for example, breakeven inflation and inflation premium), and other components (for example, a liquidity premium). The Committee considered that it is the market structure—in which a floating rate instrument is issued and in which hedging activity will take place—that needs to support the eligibility of the real interest rate risk component as a non-contractually specified risk component. For this to be the case, the real interest rate must represent a benchmark pricing element in setting the floating benchmark rate, thereby creating separately identifiable (that is, directly observable) and reliably measurable cash flow variability in the floating rate instrument. Unlike a currency, inflation varies based on the underlying methodology used to determine actual inflation (and can vary within a currency area). This means, even within a jurisdiction, there can be multiple rates of inflation depending on the inflation index to which the financial instrument is referenced—for example, a retail price index, consumer price index or another inflation index.

The Committee observed that cash is, by nature, denominated in nominal terms. Therefore, 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. The Committee considered that the interest rate for variable rate financial instruments is defined in nominal terms for a given currency. Each currency unit of cash flow of a financial asset or financial liability (that is, each principal and interest cash flow) is equally exposed to inflation risk. A nominal interest rate (such as LIBOR) may be influenced by expected inflation and the real interest rate over a period of time. However, nominal interest rates do not change as a direct result of changes in the inflation rate (that is, there is no causation). 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. The Committee therefore concluded that changes in the nominal interest rate are not attributable to changes in the real interest rate and, consequently, do not satisfy the separately identifiable and reliably measurable requirement in paragraph 6.3.7(a) of IFRS 9 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.~~

In addition, the Committee considered that, to designate a risk component in a hedging relationship, this risk component must be separately identifiable and reliably measurable for each individual hedging relationship. Although IFRS 9 does not limit the rebuttable presumption in paragraph B6.3.13 of IFRS 9 to fair value hedges only, the example in paragraph B6.3.14 of IFRS 9 illustrates a rebuttal of the presumption in a fair value hedge. The Committee therefore concluded that, for the purpose of a cash flow hedge, the existence of a term structure of zero-coupon real interest rates does not, in itself, overcome the rebuttable presumption to conclude that there is a non-contractually specified real interest rate risk component that is separately identifiable and reliably measurable.

Further, 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). This is because in the proposed hedging instrument, the ‘market’ real interest rate is the swap rate in pricing the swap and not necessarily the real interest rate independently observable in the relevant market.

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 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.