

STAFF PAPER

May 2021

IASB® meeting

| | | | |
|--------------------|--|--|--|
| Project | Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9) | | |
| Paper topic | Finalisation of agenda decision | | |
| CONTACT(S) | Matthias Schueler Riana Wiesner | mschueler@ifrs.org rwiesner@ifrs.org | +44 (0) 20 7246 6410 +44 (0) 20 7332 2742 |

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

Introduction and purpose

1. At its April 2021 meeting, the IFRS Interpretations Committee (Committee) decided not to add a standard-setting project to the work plan 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 Committee instead decided to finalise an agenda decision that would include material explaining how the applicable principles and requirements in IFRS Standards apply to the fact pattern described in the submission.
3. 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.
4. In analysing 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.
5. The Committee published a [tentative agenda decision](#) in December 2020 on the topic, having concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine if cash flow hedge accounting is possible as described in the submission.
6. The Committee considered feedback on the tentative agenda decision at its April 2021 meeting and decided to finalise the agenda decision. The purpose of this meeting is to ask Board members whether they object to the agenda decision, as required by paragraph 8.7 of the IFRS Foundation *Due Process Handbook*.

Overview of the feedback on the tentative agenda decision

7. The Committee received six comment letters on its tentative agenda decision by the comment letter deadline of 15 February 2021. One comment letter submitted by Heathrow Airport Limited represents the views of a group of eight entities ('the group of preparers').¹ One comment letter was received late.
8. Two respondents agreed with the Committee's analysis and conclusion. One respondent also agreed with the outcome as explained in the tentative agenda decision but suggested including additional rationale as to why the cash flow hedging relationship would not meet the requirements in IFRS 9.
9. Three respondents did not support the tentative agenda decision; they cited different reasons for their disagreement. The main reasons given by these respondents are summarised as follows:
- (a) the tentative agenda decision was not sufficiently linked to 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

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.

relevant zero-coupon curve. Respondents were of the view that if a zero-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.
10. After publication of the staff paper analysing the comment letters, the group of preparers sent additional comments the day before the April 2021 Committee meeting. These additional comments were circulated to all Committee members and posted to our website as an addendum to the comment letter from the group of preparers before the public meeting.
 11. The Committee considered this feedback at its April meeting². Having done so, the Committee confirmed the technical analysis and observations in the tentative agenda decision. The Committee made some changes to the wording of the tentative agenda decision to address respondents' comments. Those changes in wording changed the overall structure, but not the content, of the tentative agenda decision to reflect the Committee's discussions and wording suggestions.
 12. Thirteen of 14 Committee members voted to finalise the agenda decision.
 13. Appendix A to this paper includes the wording of the agenda decision, approved by the Committee.

Questions for the Board

Do Board members object to the Committee's:

- (a) decision that a standard-setting project should not be added to the work plan; and
- (b) conclusion that the agenda decision does not add or change requirements in IFRS Standards?

² [Agenda Paper 4](#) to the Committee's April 2021 meeting analyses comments received.

Appendix A—The Agenda Decision

A1. The Agenda Decision below was approved by the Committee at its meeting in April 2021.

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

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 6.1.1 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). Paragraph 6.4.1 of IFRS 9 sets out the qualifying criteria for hedge accounting.

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, the risk component is separately identifiable and reliably measurable.

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 that 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 focused 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 cash flow hedge accounting to be applied in the fact pattern described in the request, it would be necessary to determine:

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

The Committee noted that, to designate a risk component in a hedging relationship, the risk component must be separately identifiable and reliably measurable within the context of

each individual hedging relationship. The Committee also noted 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 a real interest rate risk component as a non-contractually specified risk component as required by paragraph 6.3.7 of IFRS 9. For the market structure to support the eligibility of that risk component in the proposed cash flow hedging relationship, the real interest rate must represent an identifiable pricing element in setting the floating benchmark interest rate, thereby creating separately identifiable and reliably measurable cash flow variability in the floating rate instrument.

Although the rebuttable presumption in paragraph B6.3.13 of IFRS 9 applies to both fair value hedges and cash flow hedges, 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, because nominal rates generally do not change as a direct result of changes in real interest rates, the existence in the relevant debt market of a term structure of zero-coupon real interest rates does not, in itself, overcome the rebuttable presumption in paragraph B6.3.13 of IFRS 9 in the proposed cash flow hedging relationship.

The Committee noted that cash flows as defined by paragraph 6 of IAS 7 *Statement of Cash Flows* are, by nature, denominated in nominal terms. The Committee also noted that the interest rate for floating rate financial instruments is defined in nominal terms for a given currency. Therefore, to meet the requirements in IFRS 9 for a cash flow hedge designation, the variability in the cash flows of the floating rate instrument attributable to the designated risk component needs to be assessed in nominal terms. A nominal interest rate (such as LIBOR) may be influenced by expected inflation and the real interest rate in the long term. However, nominal interest rates do not change as a direct result of changes in inflation or the real interest rate (that is, they are not identifiable pricing elements in setting nominal rates).

The Committee therefore concluded that there is no exposure to variability in cash flows that is attributable to changes in the real interest rate in the proposed cash flow hedging relationship and, thus, the requirements in paragraph 6.3.7 and paragraph 6.5.2(b) of IFRS 9 are not met. Consequently, the real interest rate risk component in the proposed cash flow hedging relationship does not meet the requirements in IFRS 9 to be designated as 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.