Identifying Inflation as a Hedged Risk

Amendments to IAS 39

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July 12, 2010

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Executive summary

On 31 July 2008, the International Accounting Standards Board (IASB) published an amendment to IAS 39 Financial Instruments: Recognition and Measurement providing clarification and guidance for identifying inflation as a hedged risk. Prior to this amendment, IASB guidelines were unclear regarding the hedging of inflation. The following paper examines recent amendments to IAS 39 that discuss the principles that determine whether a hedged risk is eligible for designation.

Introduction

Inflation linked derivatives are becoming a popular method to hedge underlying exposures that are exposed to movements in inflation – either implicit or implied. Such hedging instruments have unique characteristics different from (say) a typical interest rate swap in how they are structured. This, in turn, impacts how the cashflows are modeled and the instrument must be valued.

In light of the recent IASB guidelines on this topic, inflation-linked hedging also present different challenges from a hedge accounting perspective. The IASB changes presented a clear cut, but narrow definition of when hedge accounting was permissible for these derivatives. This paper drills down into those hedging examples and shows what is likely to meet the new criteria, and what is likely to fail.

Background

It is an increasingly common occurrence to see fixed, floating and inflation linked debt in a corporate portfolio. At the very least, inflation linked products are useful additions to a well-diversified investment portfolio. These instruments allow investors to maintain the

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instrument’s relative purchasing power. That is, investors want to make sure that the purchasing power of their dollars in year one will be the same at maturity.

There are many users of index linked instruments. For example, some governments and regulated utilities have issued inflation-linked debt to investors, such as pension funds, foundations and individuals whom are looking for protection against inflation. Other market participants trade and use inflation-linked derivatives to economically hedge assets and liabilities (revenues and costs) specifically linked to inflation. Doing so allows them to diversify interest rate risk by creating exposure to changes in real (as opposed to nominal) interest rates and for protection during periods of low inflation.

The two most common types of inflation protected securities are:

**Capital Indexed Bond:** Capital Indexed bonds have a fixed real rate and a nominal principal value that rises with inflation. The periodic coupon payments are calculated as the real rate times the inflation adjusted principal, and the inflation adjusted principal itself is repaid at maturity.

**Interest Indexed Bond:** Interest Indexed bonds have a fixed real rate plus an indexation of the fixed principal every period. The principal repayment at maturity is not adjusted (i.e., the nominal principal is repaid at par, as for a conventional bond). All inflation adjustment comes through the coupons, which are calculated simply by adding the real rate to the periodic inflation rate.

To hedge these, users will typically use inflation-linked swaps. These allow entities to swap inflation-linked payments for fixed payments, and vice versa. Therefore, an entity could swap inflation-linked payments for fixed payments over a predetermined period, effectively creating a fixed rate borrowing. They will be attracting investment from investors wishing to diversify into government type borrowing, but wanting to earn a higher rate of return than the government rate. An investor may wish to do so to match its inflation linked cost base.
Impact of IAS Amendment

The amendment to IAS 39 examines underlying hedge accounting principles and explains how they should be applied in certain instances. Per the amendment, inflation may only be hedged when changes in inflation are a contractually-specified portion of cash flows of a recognised financial instrument. This may be the case where an entity acquires or issues inflation-linked debt.

Cash Flow Hedge
For example, if an entity holds an inflation-indexed bond that pays interest at inflation plus 1.501 per cent, the inflation portion is identifiable and separately measurable, because inflation is a contractually specified cash flow and the remaining cash flows of the instrument (1.501 per cent) do not change when the inflation portion changes. In such circumstances, the entity has a cash flow exposure to changes in future inflation that may be designated as a cash flow hedge.

Fair Value Hedge
The amendment does not permit an entity to designate an inflation component of issued or acquired fixed-rate debt in a fair value hedge as the Board considers that such a component is not separately identifiable and reliably measurable. To illustrate, if one were to swap a fixed rate liability to indexed linked debt via a receive fixed pay RPI, this strategy would not qualify for hedge accounting treatment under IAS 39 as the inflationary component in the fixed rate is not separately identifiable and reliably measureable.

A Practical Example

For example, Company A has undertaken a large capital expenditure project and wishes to attract investors who want to diversify into government type risk in order to hedge the inflation risk inherent in their own business. Company A then swaps the issued RPI debt to a fixed rate to match the duration of its assets.

Suppose, on the 19 June 2007 they issue 10 year GBP 50m index linked debt with a coupon of 1.501%. The reference gilt is the 10 year 1¼% Index-linked Treasury 2017. The coupon and redemption amount are to be indexed to UK RPI according to the 3 month lag convention.
If Company A were to swap this out to a fixed rate of 3.1% semi-annual basis they will have changed their borrowing to fixed rate debt (Example 1.1).

**Example 1.1**

In the above instance the changes in inflation are a contractually-specified portion of the cash flows of the index linked debt and qualify for hedge accounting treatment under the recent amendment to IAS 39. Company A would still be required to comply with the other requirements of IAS 39 in order to qualify for hedge accounting treatment.
By designating the index-linked debt in a cash flow hedge relationship and creating a hypothetical derivative to assess the extent of hedge effectiveness, the hedge is highly effective and the impact to the Income statement is nil.

In the absence of hedge accounting, the full mark-to-market value of the swap would be booked to the income statement, generating income statement volatility as the underlying bond would be accounted for on an amortised cost basis.

However, if an entity was to issue a bond and swap it to indexed-linked debt, the entity would not be able to hedge the inflation component of the debt. Although the benchmark rate can be hedged, the inflationary portion cannot, as it is not a contractually-specified portion of the cash flows. Instead, the swap is marked-to-market and the debt is booked on an amortised cost basis through the income statement.
Conclusion

Many consider inflation has simply one other uncertainty in their business that derivatives can manage – much like interest rates. While this is generally true economically, the recent IASB ruling has presented some challenges from an accounting perspective. Fortunately, the IASB amendment is favourable to entities issuing inflation indexed debt and converting an inflation adjusted rate to a fixed rate through the use of an inflation indexed swap.

However, by outlining a relatively narrow definition of eligible hedged items, the IASB has denied a fair value hedging scenario for users such as the example described above. As such, all changes to mark to market values in these derivatives must be taken to P&L. Given inflation-linked instruments tend to be very long term, this could mean large P&L movements for an extended period of time. Many users will need to consider this accounting impact if they are looking to fair value hedge their fixed inflation exposure.

The IASB’s amendment to IAS 39 regarding eligible hedged items is favourable to entities issuing inflation-indexed debt and converting an inflation adjusted rate to a fixed rate through the use of an inflation indexed swap. The IASB has acknowledged that this strategy may qualify for favourable hedge accounting treatment.