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Ms Sue Lloyd
International Accounting Standards Board
Columbus Building
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Our ref RD/288

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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, <u>and therefore the effect of inflation,</u> 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 rate[1]. 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

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