

inflation



Companies with assets and liabilities featuring explicit exposure to inflation will increasingly seek to match those exposures through the use of the inflation swaps market.

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While inflation derivatives are not new, it is only recently that they have moved from being an exotic offshoot of inflation linked government bonds, into the mainstream. Turnover in inflation swaps has increased more than ten-fold in the past two years but the potential for further growth remains immense as the emphasis on matching real liabilities increases globally.

The most common type of inflation swap used by liability managers is the 'year-on-year' inflation swap – often referred to as an Annuity Inflation Swap. As represented in the flowchart below, this involves one counterparty agreeing to receive an annual coupon determined by inflation in return for paying a fixed rate.

One of our recent inflation hedges was for a project financing transaction underwritten by Bank of Ireland's Global Project Finance Unit. As is usual with Project Finance* type transactions, the UK Government in this case undertook to pay a private consortium an agreed payment per annum to construct and run a hospital for the next 30 years. Crucially this payment was linked to inflation. In order to finance construction,

the consortium borrowed cash from Bank of Ireland for 30 years at a fixed rate. This meant that the consortium was left with an inflation exposure as their income was inflation linked, whilst their operating costs were not inflation linked. This risk was minimised by entering into the inflation swap whereby the consortium effectively fixed the future income stream.

Inflation exposures exist for most businesses, be they implicit or explicit. For example:

- An explicit inflation linkage can be rent reviews, as the reference point for the review is typically based on inflation.
- Implicit inflation exposures are by their nature harder to spot. However, if you have fixed outgoings (for example a fixed rate loan) and variable incomings that are linked to the Consumer Price Index (CPI) basket, it is worth considering that you may have implicit inflation exposures.

* a term financing arrangement, usually on a limited recourse basis, under which funds are provided for a specified project by banks against the security of the project cash flows.

Bank of Ireland
Global Markets



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INFLATION LEG: Cash flow is indexed to inflation and paid periodically. FIXED LEG: Cash flow accretes up by a percentage rate and is paid periodically.