

STAFF PAPER

29 January–1 February 2013

IASB Meeting

Project	Matters arising from the IFRS Interpretations Committee		
Paper topic	Novation of derivatives and consequences for hedge accounting		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. In November 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify whether an entity is required to discontinue hedge accounting in a circumstance in which the hedging instrument is novated from one counterparty to another following the introduction of new regulations¹. Discontinuation of hedge accounting would require re-designation of the novated derivative in a new hedging relationship if hedge accounting is to be used subsequently.
2. This paper provides a summary of the discussion at the January 2013 IFRS Interpretations Committee (IC) meeting on this issue. This paper also addresses the scope of the proposed amendments and the comment period. The agenda paper submitted to the IFRS IC January 2013 meeting is attached as an appendix.
3. This paper is organised as follows:
 - (a) Summary of IFRS Interpretations Committee discussion
 - (b) Scope of the proposed amendments
 - (c) Comment period.

¹ The new regulation by which the submitter is affected is the Regulation on OTC derivatives, central counterparties (CCPs) and trade repositories (the so-called European Market Infrastructure Regulation—EMIR).

Summary of IFRS Interpretations Committee discussion

4. At its January 2013 meeting, the Interpretations Committee noted that IAS 39 *Financial Instruments: Recognition and Measurement* requires that an entity discontinues hedge accounting when an over-the-counter (OTC) derivative, which is designated as a hedging instrument, is novated to a central counterparty (CCP) under new legislation because the existing novated derivative is to be derecognised and new derivative contracts, with a counterparty being the CCP, are to be recognised at the time of the novation.
5. The Interpretations Committee noted that the requirement to discontinue hedge accounting meant that an entity could only designate the new derivative as the hedging instrument in a new hedging relationship, which would result in more hedge ineffectiveness for cash flow hedges (compared to a continuing hedging relationship). This is because the derivative that would be newly designated as the hedging instrument would have a non-zero fair value at the time of the novation. In addition to the increased hedge ineffectiveness that would have to be measured and recognised², there would also be an increased risk³ that the hedging relationship would fail to meet the 80 per cent-125 per cent hedge effectiveness range required by IAS 39.
6. The Interpretations Committee expressed some concerns about these consequences; because the novation to a CCP arises as a result of a specific change in legislation. In the opinion of the Interpretations Committee, continuing to account for the (pre-novation) hedging relationship would provide more useful information to users. The Interpretations Committee also noted that the change in legislation that prompted the submission arises from a G20 commitment and consequently this is not a single-jurisdiction issue. The Interpretations Committee noted the references made in the submission to steps taken in the United States by the SEC to address an equivalent issue.

² The recognition is subject to the outcome of the 'lower of test' in paragraph 96(a) of IAS 39.

³ That risk can often be successfully mitigated by choosing appropriate methods for assessing the hedge effectiveness. However, those methods often require a bigger effort to perform the testing.

7. The Interpretations Committee identified a possible response to these concerns, but this would require an amendment to the hedge accounting requirements of IAS 39. Furthermore, because the legislative change would come into force within a short time, any amendment would need to be completed quickly. Consequently, the Interpretations Committee decided to recommend a limited-scope amendment to IAS 39 to the IASB.
8. The Interpretations Committee has recommended that the hedge accounting requirements of IAS 39 should be amended to allow the continuation of hedge accounting for an OTC derivative designated as a hedging instrument in the event of novation of that hedging instrument, but only if both the following two conditions are met and not under any other circumstances:
 - the OTC derivative is novated to a CCP as a consequence of the requirement of a legislative or regulatory change; and
 - as a result of the novation, all parties to the original contract are affected in the same way (ie each of the parties to the original derivative contract will be subject to the same terms and conditions as in the original contract after the novation, except that each of the parties has a CCP as counterparty.)
9. Although the Interpretations Committee's discussion focused on IAS 39, the staff note that a similar amendment would also be required to IFRS 9 *Financial Instruments*, because the proposals in the Review Draft would lead to the same issue arising under IAS 39.

Scope of the proposed amendments

10. If the IASB agrees that it should provide a relief from discontinuing hedge accounting in the circumstances described above, we think that the proposed amendment should be as narrow as possible, but at the same time, should be applicable regardless of jurisdiction. Hedge accounting has only recently been the subject of a fundamental review, during which a more general change to accommodate novation was neither proposed nor requested during the consultation process. Consequently, we think it would be appropriate to ensure that the change is designed to specifically address this issue.

11. Consistently with this, we think that the amendment to IAS 39 and IFRS 9:
 - (a) should be applied only to a novation required as a result of legislation, regulation or similar statutory requirement. This means that voluntary novation to a CCP would not be included within the scope of the exception because such a novation does not arise as a result of laws and regulations;
 - (b) all parties to the original contract must be affected in the same way (ie each of the parties to the original derivative contract will be subject to the same terms and conditions as in the original contract after the novation except that each of the parties has a CCP as counterparty); and
 - (c) there should be no changes to the terms of the derivative contract other than the change of counterparty.
12. However, to prevent diversity across jurisdictions, the amendment should not be limited to a specific law or regulation in a specific jurisdiction(s). Taking a jurisdiction-specific approach could necessitate the IASB making piecemeal changes if additional jurisdictions introduce such legislation, which would be inappropriate for an international standard-setter.

Comment period

13. If the IASB agrees to make an exception to the hedge accounting requirements of IAS 39 and IFRS 9 to address the concerns raised in this paper, we think any such amendments should be made as quickly as possible. This is because the novation to a CCP under the EMIR regulations is expected to take place later this year.
14. We think that a comment period of 90 days is justified in these circumstances because any proposed amendment would be short, we think there will be broad consensus on the topic, and the expected timing of the effects of the EMIR legislation mean that the matter is exceptionally urgent.

Question

1. Does the IASB agree that a narrow-scope exception should be made to IAS 39 and IFRS 9 to allow a novation of an OTC derivative that is designated as a hedging instrument, where that novation is required by legislation/regulation of an otherwise unchanged hedging instrument, to be deemed to be a continuation of the existing hedging relationship?
2. If the IASB answers 'Yes' to Question 1, does the IASB agree with the scope of the proposed amendment as set out in paragraphs 11 and 12 above?
3. Does the IASB agree that a comment period of 90 days (ie shorter than the standard 120 days) is justified in the circumstances?

Appendix A—Agenda paper submitted to the January 2013 IFRS IC meeting



STAFF PAPER

January 2013

IFRS Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	Novation of derivatives under EMIR legislation		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

Introduction

1. In November 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify whether an entity is required to discontinue hedge accounting in a circumstance where the hedging instrument is novated from one counterparty to another following the introduction of new regulations. Discontinuation of hedge accounting would require re-designation of the novated derivative in a new hedging relationship if hedge accounting is to be used subsequently.
2. Specifically, the issue relates to a circumstance in which over-the-counter (OTC) derivatives that are designated as hedging instrument under IAS 39 *Financial Instruments: Recognition and Measurement* are required to be novated to a central counterparty (CCP) by new legislation.
3. This agenda paper is organised as follows:
 - (a) Background information.
 - (b) Summary of the issue.
 - (c) Staff analysis.

- (c) Outreach activities to date.
- (d) Agenda criteria assessment.
- (e) Annual improvements criteria assessment.
- (f) Staff recommendation.
- (g) Appendix A—Submission.

Background information

4. In July 2012, the Regulation on OTC derivatives, central counterparties (CCPs) and trade repositories (the so-called European Market Infrastructure Regulation - EMIR)⁴ was adopted by the European Commission and published in the Official Journal. The main obligations under EMIR are as follows:
- central clearing for certain classes of OTC derivatives;
 - application of risk mitigation techniques for non-centrally cleared (ie OTC) derivatives;
 - reporting to trade repositories;
 - application of organisational, conduct of business and prudential requirements for CCPs; and
 - application of requirements for trade repositories, including the duty to make certain data available to the public and relevant authorities.
5. This regulation is intended to resolve the problems in the OTC derivative market that were highlighted during the recent financial crisis, in line with the EU's G20 commitment made in Pittsburgh in September 2009 that all standardised OTC derivative contracts should be cleared through a central counterparty (CCP) by the end of 2012 and that OTC derivative contracts should be reported to trade repositories.

⁴ On 19 December 2012, the European Commission has adopted nine regulatory and implementing technical standards as regards EMIR, submitted by the European Securities and Markets Authority (ESMA). These standards are subject to the approval of the European Parliament and the Council.

6. EMIR is also similar in some respects to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the so-called Dodd-Frank Act) passed by the United States Congress in July 2010 in that both EMIR and the Dodd-Frank Act aim to impose OTC derivatives to be cleared through central counterparties.

Summary of the issue

7. The issue is whether an entity should discontinue hedge accounting for hedging relationships in which an OTC derivative is designated as hedging instrument under IAS 39 *Financial Instruments: Recognition and Measurement* when the OTC derivative is novated to a central counterparty (CCP) in accordance with EMIR.
8. The submitter expresses a view that a novation to a CCP would not result in discontinuation of hedge accounting under IAS 39 because it is not an expiry of an existing contract. The submitter bases its view on the following grounds:
- Paragraph 91(a) and paragraph 101(a) of IAS 39 require an entity to discontinue hedge accounting when the hedging instrument expires or is sold, terminated or exercised. However, these paragraphs are silent on whether a novation of derivative to a new counterparty would constitute an expiry.
 - Paragraph 88 of IAS 39 specifies the designation and documentation requirements of a hedging relationship, but it does not specify the counterparty as one of the key elements of the designation.
9. The submitter also pointed out that if the novation to a CCP required discontinuing hedge accounting and re-designating the hedging instrument in a new hedging relationship, it would result in more hedge ineffectiveness for cash flow hedges (compared to a continuing hedging relationship). This is because the derivative that would be re-designated as hedging instrument would have a non-zero fair value at the time of the novation. In addition to the increased hedge ineffectiveness that would have to be measured and recognised⁵, there would also

⁵ The recognition is subject to the outcome of the ‘lower of test’ in paragraph 96(a) of IAS 39.

be an increased risk⁶ that the hedging relationship would fail to meet the 80%-125% hedge effectiveness range required by IAS 39.

Staff analysis

Derecognition of existing contracts and recognition of new contracts

10. As the submitter describes, the effect of novation to a CCP under the introduction of EMIR is that a CCP becomes the new counterparty to two new derivative contracts; one with each of the original parties to the original derivative contract, instead of the original parties remaining counterparties to each other via the original bilateral contract.
11. Expressed differently, as a result of the novation, each party to the original bilateral contract will have a credit risk exposure to the CCP, but will no longer have a credit risk exposure to one another. Through the novation, they essentially exchange the credit risk of their original counterparties for the credit risk of the CCP.
12. Considering the changes to the contract as described in the preceding paragraph, we think that an initial analysis should be performed on the basis of the derecognition requirements for financial instruments, before considering the hedge accounting requirements. This is because if the derivative which was designated as a hedging instrument is required to be derecognised as a result of the novation to a CCP, hedge accounting shall be discontinued as the hedging instrument in the existing hedge relationship no longer exists.
13. We analyse two interpretations with respect to applying the derecognition requirements to the novation. The two views are as follows:
 - (a) **View A.** The novation meets the derecognition requirements.
 - (b) **View B.** The novation does not meet the derecognition requirements.

⁶ That risk can often be successfully mitigated by choosing appropriate methods for assessing the hedge effectiveness. However, those methods often require a bigger effort for performing the testing.

View A – The existing contracts are derecognised

14. Take as an example an interest rate swap contract between party A and party B, and at the time of a novation to a CCP, party A has a positive fair value of the swap and party B has a negative fair value of the swap.
15. We observe that a derivative should be derecognised only when it meets both the derecognition criteria for financial asset and the derecognition criteria for financial liability if the derivative involves bi-directional payments between parties (ie the payments are or could be from and to each of the parties), like a swap contract⁷. In other words, party A, in the above example, shall derecognise its derivative asset at the time of the novation only when it meets the derecognition criteria both for a financial asset and for a financial liability.
16. Therefore, we examine both criteria to determine whether the novation requires party A to derecognise the derivative. Obviously, we do not need to separately examine the case of party B because the analysis for party B would be the same as for party A.
17. Paragraph 17(a) of IAS 39 (ie paragraph 3.2.3(a) of IFRS 9) requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. We note that through novation, party A has new contractual rights to the cash flows from a derivative contract with the CCP, and this new contract replaces the existing contract with party B. Thus the existing derivative contract with party B has expired. Hence, the existing derivative that party A has shall meet the derecognition criteria for financial asset
18. Paragraph AG57(b) of IAS 39 (ie paragraph B3.3.1(b) of IFRS 9) requires that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. Paragraph AG60 of IAS 39 further states that if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.

⁷ At the IFRIC meeting November 2006 (Please refer to Agenda Paper 10 of the meeting and IFRIC Update), the staff reported the views of the Board that “Derivative instruments can be either assets or liabilities. Consequently, a derivative such as an interest rate swap that is transferred as part of a derecognition transaction must pass both the asset and the liability derecognition tests.”

19. The novation to the CCP would release party A from the responsibility to make payments to party B and would also oblige party A to make payments to the CCP. Therefore, the existing derivative that party A has shall also meet the derecognition criteria for a financial liability.
20. Based on this analysis, party A who has a positive fair value of the swap shall derecognise the derivative at the point of the novation. Concurrently, party A shall recognise a new derivative with the counterparty being the CCP.
21. Per this analysis, the novation to a CCP under EMIR requires an entity to derecognise its existing derivative contract and recognise a new derivative contract with the CCP.

View B – The existing contracts are not derecognised

22. Although the counterparty changes due to the novation, party A and B in the example above still have rights (obligations) to receive (pay) the same amounts of cash as before; the only thing that has changed is from (to) whom those cash flows will be received (paid).
23. Accordingly, some would argue that the novation should not lead to derecognition of the existing contracts.

Staff's view

24. We think that the change from one contract between parties A and B to two contracts between A and CCP and B and CCP cannot be ignored. As analysed above, the novation of the contract results in derecognition of the original derivatives pursuant to IAS 39.
25. Furthermore, we observe the decision⁸ of the Interpretations Committee in its discussion about Greek Government Bonds (GGBs). The Interpretations Committee noted that paragraph 40 of IAS 39 sets out that a substantial

⁸ The Interpretations Committee, in its May 2012 meeting, tentatively decided that the restructuring of GGBs would result in derecognition, and the Interpretations Committee decided not to add the issue to its agenda in its September 2012 meeting.

modification of terms shall lead to the derecognition of the original financial liability and the recognition of a new financial liability, and it concluded that if the paragraph is applied by analogy to the case of restructuring GGBs, the restructuring would result in derecognition.

26. We think that the novation to a CCP constitutes a ‘substantial modification of terms’ as referred in paragraph 40 of IAS 39 because the counterparty is a crucial element in terms and conditions of an agreement and the counterparty changes due to the novation.
27. We therefore support view A.

Discontinuation of hedge accounting

28. We first note that paragraph 91(a) and paragraph 101(a) of IAS 39 state that an entity shall discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. We therefore think that the conclusions reached on the question of derecognition above are relevant for the assessment of discontinuation of hedge accounting.
29. If we take view A above, we think that the novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.
30. We further note that paragraph 91(a) and paragraph 101(a) of IAS 39 also specify that the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity’s documented hedging strategy.
31. We think that in this situation the new contract with a CCP could not prevent discontinuation of hedge accounting under IAS 39 because the novation to the CCP was not documented at the inception of the hedge.
32. Hence, we think that hedge accounting should be discontinued when the OTC derivatives, which are designated as hedging instruments, are novated to a CCP under EMIR.

33. However, if we took view B, it would result in the conclusion that the novation does not require an entity to discontinue hedge accounting because the fact that the derivative is not derecognised means that the hedging instrument designated in the hedging relationship has not expired (or been sold, terminated or exercised) in accordance with paragraph 91(a) and paragraph 101(a) of IAS 39.

Summary of staff analysis

34. The current standards lead us to the conclusion that the novation of a derivative contract to a CCP results in the original hedge accounting ceasing and so an entity that had been using such a derivative for hedge accounting would need to re-designate the novated derivative as the hedging instrument in a new hedging relationship (if it wanted to achieve hedge accounting).
35. The re-designation, however, would have an impact on profit or loss for cash flow hedges because at that time the derivatives that are re-designated as hedging instruments will have a non-zero fair value.
36. Taking into account the fact that this issue has arisen from a specific legislative change and that the effect of the change is likely to be widespread, many desire to see hedge accounting continued, but given the analysis above, we think this would require a change to IFRSs. Those of this view think it is inappropriate to upset hedge accounting as a result of the imposition of legislation which they do not view as fundamentally changing the nature of their (economic) hedging activities.
37. If the Committee is sympathetic to that view the Committee could recommend that the IASB make a narrow-scope amendment to IAS 39 to deem such a regulation/legislation-led novation to be an exception to the requirement to discontinue hedge accounting.

Outreach activities to date

38. We sent out a request for information to the IFASS to help assess the Committee's agenda criteria, which was still outstanding (due 17 January 2013) when this agenda paper was completed. Specifically, we asked:

Q1. Have you observed, or do you expect to observe in your jurisdiction the introduction of any laws or regulations that require OTC derivatives to be novated and settled and cleared through a central clearing house? Please provide details.

Q2. If you answered “yes” to Q1, what is the prevalent approach in your jurisdiction to account for derivatives that have been novated to a clearing house in a hedging relationship, and why? (If your jurisdiction is considering the establishment of such laws or regulations, what do you expect to be the prevalent approach in your jurisdiction to account for novated derivatives to a clearing house in a hedging relationship, and why?)

Q3. Do you see any diversity in practice in that accounting / expected accounting? If so, please explain how and why the accounting is diversified.

We will present any update at the 2013 January Committee meeting.

Agenda criteria assessment

39. Our preliminary assessment of the agenda criteria is as follows:

(a) *The issue is widespread and has practical relevance.*

To be updated once the outreach activity is completed, however given the fact that EMIR introduces this change across Europe and Dodd-Frank introduces similar changes in the US, we expect that the issue will be widespread.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). An item will not be added to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

To be updated once the outreach activity is completed.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

To be updated once the outreach activity is completed.

- (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework, and the demands of the interpretation process.*

We think that existing IFRSs provide sufficient guidance as to how this fact pattern should be accounted for. However, we think that a relief could be given by the creation of an exception to the current requirements, as in the summary of staff analysis, and that this could be achieved efficiently.

- (e) *It is probable that the Interpretations Committee will be able to reach a consensus on the issue on a timely basis.*

Not Applicable

- (f) *If the issue relates to a current or planned IASB project, there is a pressing to provide guidance sooner than would be expected from the IASB activities. The Interpretations Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Interpretations Committee requires to complete its due process.*

A draft IFRS on general hedge accounting has been prepared and we expect that will soon be incorporated in IFRS 9. The draft has incorporated virtually the same paragraphs that are relevant to this issue as in IAS 39 (ie paragraph 88, 91(a), and 101(a)). Therefore the current IFRS 9 project will not address this issue. However, this issue is an urgent one; given the timing of the novation requirements, we think that if an exception is to be made it should be made as quickly as possible (within the confines of the IASB's due process requirements). Given the mandatory effective date of IFRS 9 we think that it would be necessary to amend IAS 39 and to propose a similar amendment to the new hedge accounting chapter of IFRS 9.

Annual improvements criteria assessment

40. In planning whether an issue should be addressed by amending IFRSs within the Annual Improvements project, the IASB assesses the issue against certain criteria. All the criteria (a)–(d) must be met to qualify for inclusion in annual improvements. We have assessed the potential amendment against the annual improvements criteria, which are reproduced in full below:

Annual improvements criteria	Staff assessment of the proposed amendment
<p>(a) The proposed amendment has one or both of the following characteristics:</p> <p>(i) clarifying—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> • clarifying unclear wording in existing IFRSs, or • providing guidance where an absence of guidance is causing concern. <p>A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.</p> <p>(ii) correcting—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> • resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirements should be applied, or • addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs. <p>A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.</p>	<p>(a) No. The possible standard-setting action referred to above to address requires the introduction of a new exception to the principles in IFRSs and therefore does not meet the requirements for Annual Improvements</p>
<p>(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.</p>	<p>(b) NA</p>
<p>(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.</p>	<p>(c) NA</p>

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.	(d) NA
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Staff recommendation

41. On the basis of the staff analysis, the staff think that under existing IAS 39 requirements:
- (a) When OTC derivatives are novated to a CCP in accordance with EMIR, the existing OTC derivative contracts should be derecognised and new derivative contracts, with a counterparty being the CCP, should be recognised.
 - (b) Consequently, an entity shall discontinue hedge accounting in which the OTC derivatives are designated as hedging instrument under IAS 39 at the time of the novation to the CCP.
42. However, the Interpretations Committee may wish to recommend that the IASB makes a narrow-scope amendment to IAS 39 to provide a limited exception to existing hedge accounting requirements such that the novation of a derivative contract that is otherwise unchanged, as a result of legislative or regulatory changes does not, of itself, cause an existing hedge relationship to be discontinued.

Question to the Interpretations Committee

1. Does the Interpretations Committee agree with staff analysis?
2. Does the Interpretations Committee want to recommend to the IASB that a narrow-scope exception should be made to IAS 39 to permit a legislative/regulation-led novation of an otherwise unchanged hedging instrument to be deemed to be a continuation of the existing hedge relationship?

Appendix A—Submission⁹

Submission received – Novation of Derivatives under EMIR legislation

All information has been copied without modification, but the submitter has been rendered anonymous.

Mr Hans HOOGERVORST
Chairman
International Accounting Standards Board
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30 Cannon Street
London
EC4M 6XH
By Email: hhoogervorst@ifrs.org

28 November 2012

Reference: Novation of Derivatives under EMIR legislation

Dear Sirs,

We are writing to express our concerns about a matter that has arisen as a result of the interaction between IAS 39 and the new European legislation concerning the European Market Infrastructure Regulation (EMIR). Specifically, we would like to highlight our concern over the ‘novation of derivatives’ to a Clearing House under the EMIR legislation, which is expected to become effective by the middle of 2013, and its impact on hedge accounting.

[Information about the submitter].

Over the next year, in response to the reforms of the derivatives market, many OTC derivatives will be required to be novated to central clearing houses. The effect of this is that a clearing house will become the new counterparty to two new derivative contracts, one with each of the original parties to the original derivative, instead of the original parties remaining counterparties to each other via the original bilateral contract. There is

⁹ This is an appendix of the agenda paper for the January 2013 IFRS IC meeting.

an additional possibility that, as part of these reforms, some of the derivatives will need to be transferred to different entities within the same group.

These reforms have led to a concern as to whether it is possible to continue the designation of novated derivatives in a hedge relationship, or whether the process of novation forces a dedesignation of the existing relationship and the designation of a new one. The main significance is that, for cash flow hedges, a redesignation of a derivative that already has an accumulated fair value will result in future hedge ineffectiveness to be recorded in profit or loss. Such ineffectiveness may result even though the derivative's terms and cash flows are unaffected and the clearing house now merely stands between the original two counterparties. Recognising ineffectiveness in such a scenario would not result in meaningful information being presented in the accounts. Further, in the case of collateralised swaps there won't be significant fair value differences and this effect might be pervasive if the entire industry would start recognising ineffectiveness on their cash flow hedges due to the novation where none such ineffectiveness exists.

Paragraph 101 of IAS 39, for cash flow hedges, states that "In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95-100" and sub-paragraph (a) lists as one of the circumstances, "The hedging instrument expires or is sold, terminated or exercised." (There is similar wording for fair value hedges in paragraph 91). It does not say whether a novation of a derivative to a new counterparty would constitute an expiry, and we note that paragraph 88, that specifies the designation and documentation requirements of a hedging relationship, does not specify the counterparty as one of the key elements of the designation. However, we are aware that some audit firms have not fully formed a view about whether the novation of derivative, resulting in the replacement of one original contact with two, to which the clearing house is counterparty, would trigger a requirement to discontinue a hedging relationship.

We also note that paragraph 101 (a) for cash flow hedges (and similarly paragraph 91 for fair value hedges) specifies that "the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy." This has been taken to mean

that, if a novation would not result in the discontinuation of a hedge relationship, as long as the novation had been anticipated at the time the hedge was first designated. However, we believe that a novation in these circumstances would not be a discontinuation and therefore there would be no need for the hedge accounting documentation to anticipate such a situation, consistent with the statements below.

[The submitter] raised the same concerns to the Chief Accountant of the Securities and Exchange Commission (SEC), with respect to U.S. GAAP. His response set out in his letter to [the submitter] of [date] 2012, was as follows:

“The Staff of OCA would not object to a conclusion for accounting purposes that the original derivative has not been terminated and replaced with a new derivative contract, nor would the staff object to the continuation of existing hedge relationships when there is a novation of a derivative contract to effect a change in counterparties to the underlying contract, provided that other terms of the contract has not been changed, in any of the following circumstances:

“For an OTC derivative transaction entered into prior to the application of the mandatory clearing requirements, an entity voluntarily clears the underlying OTC derivative contract through a central counterparty, even though the counterparties had not agreed in advance (ie at the time of entering in the transaction) that the contract would be novated to effect central clearing.

“For an OTC derivative transaction entered into subsequent to the application of the mandatory clearing requirements, the counterparties to the underlying contract agree in advance that the contract will be cleared through a central counterparty in accordance with standard market terms and conventions and hedging documentation describes the counterparties’ expectation that the contract will be novated to the central counterparty.

“A counterparty to an OTC derivative transaction who is prohibited by Section 716 of the Act (or expected to be so prohibited) from engaging in certain types of derivative transactions novates the underlying contract to a consolidated

affiliate...”

The Chief Accountant goes on to say that the FASB has been requested to “consider the accounting for a change in counterparties when a derivative contract is designated as a hedging instrument as part of their existing project on financial instruments.” This has been read to mean that the Chief Accountant’s confirmation that ‘the Staff wouldn’t object’ is an exception from the normal requirements of U.S. GAAP. However, the letter nowhere says that the confirmation constitutes an exception and the request to the FASB can be read as a request for more formal clarification.

For these reasons, [the submitter] strongly urge the IASB to follow the FASB’s example and provide a formal clarification on this matter with respect to IFRS as it would be confusing for users if changes to derivative contracts arising from structural / regulatory changes to financial markets were accounted for on significantly different basis by IFRS preparers compared with U.S. GAAP preparers. In addition, the effect of forcing a redesignation would not result in meaningful information, as contemplated above.

We hope you find [the submitter’s] comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

Appendix B—Results of the outreach activities performed in accordance with the Interpretations Committee due process

Introduction

1. We sent out a request for information to the members of International Forum of Accounting Standard Setters (IFASS) and securities regulators to help assess the Interpretations Committee’s agenda criteria. This request was still outstanding (due 17 January 2013) when the agenda paper for the January 2013 IFRS IC meeting was completed. Consequently, we presented an oral update on the result of outreach activities at the January 2013 IFRS IC meeting.
2. The following analysis is therefore supplementary.
3. We asked the members of IFASS and securities regulators about the issue. The specific question asked were:

Q1. Have you observed, or do you expect to observe in your jurisdiction the introduction of any laws or regulations that require OTC derivatives to be novated and settled and cleared through a central clearing house? Please provide details.

Q2. If you answered “yes” to Q1, what is the prevalent approach in your jurisdiction to account for derivatives that have been novated to a clearing house in a hedging relationship, and why? (If your jurisdiction is considering the establishment of such laws or regulations, what do you expect to be the prevalent approach in your jurisdiction to account for novated derivatives to a clearing house in a hedging relationship, and why?)

Q3. Do you see any diversity in practice in that accounting / expected accounting? If so, please explain how and why the accounting is diversified.

Responses from the members of IFASS and securities regulators

4. We received thirteen responses from the members of IFASS:

Asia	3
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Europe	3
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North America	3
Oceania	2
Africa	1
South America	<u>1</u>
Total	<u>13</u>

5. We also received responses from four regulators.

Responses from the members of IFASS

6. Six respondents stated that similar laws or regulations either have been enacted or are expected to come into force. Another respondent also stated that it was conducting extensive consultation on this matter.
7. With regard to Question 2, the comments we received from the six respondents who answered ‘yes’ to Question 1 are as follows:
- three respondents viewed that hedge accounting would be continued;
 - one respondent said that hedge accounting would be discontinued;
 - one respondent expected that there would be diversity; and
 - one respondent said that it did not encounter the same issue because OTC derivatives that are subject to clearing are those entered after the enforcement of the law, and thus novation of existing OTC derivatives is not mandatory.
8. Two comments we received from the other seven respondents are as follows:
- one respondent said that hedge accounting would be continued; and
 - one respondent said that hedge accounting would be discontinued.
9. With regard to Question 3, three respondents expected that there might be diversity and four respondents did not expect diversity.
10. Some of other comments are as follows:
- one of the respondents who said the novation will lead to discontinuation of hedge accounting, agreed that there needs to be a relief from

discontinuing hedge accounting. Its suggested solution was limited amendment to IAS 39, Interpretation, or binding communication by the European Securities Markets Authority (ESMA).

- two respondents commented that diversity may arise depending on hedging documentation. That is, if the novation to a CCP is included as a rollover in the documentation, the novation would qualify as continuation of hedge accounting, but if the novation is not included in the hedge documentation, it would lead to discontinuation of hedge accounting.
- one respondent said that one of its constituent had indicated that it is important that the Interpretations Committee should also consider situations in which a novation is commercially driven rather than imposed.

11. In summary, several jurisdictions are affected and diversity in practice is expected.

Responses from securities regulators

12. The regulators generally expressed a concern that there might be diversity in practice.

Preliminary findings from outreach activities

13. The result of outreach activities indicates that this issue is not limited to a single jurisdiction, because the result shows that many jurisdictions have introduced the novation of OTC derivatives to a CCP, or are expected to mandate legislation or regulation that would do so. The result also suggests that divergent views exist as to whether the novation of OTC derivatives to a CCP would lead to discontinuation of hedge accounting in circumstances in which the OTC derivatives are designated as hedging instruments.