ISDA® Safe, Efficient Markets

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25th March 2013

Ref.: Exposure Draft 2013/2 'Novation of Derivatives and Continuation of Hedge Accounting – Proposed amendments to IAS 39 and IFRS 9'

Chère Mme Flores,

ISDA's European Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA[1] has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and, specifically, derivative financial instruments.

ISDA welcomes the opportunity to contribute to the EFRAG's draft comment letter on the above referenced Exposure Draft (ED). We acknowledge that this is an important issue that has a direct impact on all European jurisdictions and indeed across the globe.

ISDA has participated in the discussions held at EFRAG's Financial Instruments Working Group on this topic. Our responses to the main issues highlighted by EFRAG are set out below and also in our response letter to the IASB. A copy of our response to the IASB is attached to this letter. Please refer to this response for our detailed views on the IASB's proposals.

MAJOR POINTS

We agree with EFRAG that action is needed. Also like EFRAG, we are happy that the IASB is acting quickly in response to the legislative changes that are taking place in the wake of the G20's commitment to improve transparency.

We also agree that the exception is drafted too narrowly. However, our members believe that the amendment to the standard is not necessary, except for clarification by the Board that a novation would not lead to discontinuation of hedge accounting, which could be achieved by amending

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. The buy-side represents 25% of ISDA's membership and continues to grow. Information about ISDA and its activities is available on the Association's web site: www.isda.org

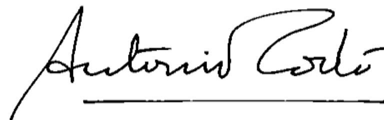
paragraphs 91 or 101 of the ED. We set out our reasons for this clarification in the appendix to our response letter to the IASB.

Therefore, like EFRAG, we have some concerns about the scope of the proposed amendment. We agree that the exception to the requirement to discontinue hedge accounting is drafted too narrowly as those derivatives that are novated in advance of the mandatory date of any new law or regulation would not be within its scope of the exception. Furthermore, like EFRAG, we believe that the exception should be extended to all 'voluntarily' novations where only 'limited changes' to the terms occur, regardless of whether such novations are to a central counterparty or any other counterparty.

Further, some of our members consider that a novation does not necessarily result in derecognition. Our preference would be for the Board not to state that a novation to a CCP would meet the derecognition requirements. Either the limited scope amendment could be applied to hedge accounting without prejudice as to whether there has been a derecognition or discontinuation, or else it could just be applied to address hedge discontinuation. We believe that if the Board continues to take the view that there has been a derecognition and a discontinuation, we consider it to be an interpretation. Given that this is not the interpretation that has always been applied in the past, we request that the Board provides transitional relief, to 'grandfather' the accounting for past novations that may have been treated otherwise.

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,



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20th March 2013

Ref.: Exposure Draft 2013/2 'Novation of Derivatives and Continuation of Hedge Accounting – Proposed amendments to IAS 39 and IFRS 9'

Dear Board members,

ISDA's European Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA[2] has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and, specifically, derivative financial instruments.

We are writing to you to comment on the above referenced Exposure Draft (ED). ISDA welcomes the opportunity to comment on this important issue that have an impact on many different jurisdictions across the globe.

Our members are grateful that the IFRS Interpretations Committee and the Board have taken this issue onto its agenda and have sought to provide a workable solution. In this letter we outline our key messages in response to the ED and in the Appendix we provide our more detailed responses to the specific questions.

Key Messages:

- Our members believe that an amendment to the standard is not necessary, except for clarification by the Board that a novation would not lead to discontinuation of hedge accounting, which could be achieved by amending paragraphs 91 or 101 of the ED. We set out our reasons for this clarification in the appendix to this letter.

- Should the Board decide that it cannot provide such a clarification, we believe the scope of the proposed amendment should be broadened to cover a wider range of circumstances. In

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particular, the scope should include not only those novations that are required by laws and regulations but also the 'back book' of derivatives which banks will be forced to novate to avoid onerous capital requirements as a result of the new regulations.

- Further, some of our members consider that a novation does not necessarily result in derecognition. Our preference would be for the Board not to state that a novation to a CCP would meet the derecognition requirements. Either the limited scope amendment could be applied to hedge accounting without prejudice as to whether there has been a derecognition or discontinuation, or else it could just be applied to address hedge discontinuation. If the Board continues to take the view that there has been a derecognition and a discontinuation, we consider it to be an interpretation. Given that this is not the interpretation that has always been applied in the past, we request that the Board provides transitional relief, to 'grandfather' the accounting for past novations that may have been treated otherwise.

We hope you find ISDA'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,

Tom Wise	Antonio Corbi
HSBC Bank plc	International Swaps and Derivatives Association
Chair of Accounting Policy Committee	Risk and Capital

Appendix – Responses to specific questions raised in the exposure draft.

Appendix: Answers to the specific questions

Question 1

The IASB proposes to amend IAS 39 so that the novation of a hedging instrument does not cause an entity to discontinue hedge accounting if, and only if, the following conditions are met:

(i) the novation is required by laws or regulations;

(ii) the novation results in a central counterparty (sometimes called 'clearing organisation' or 'clearing agency') becoming the new counterparty to each of the parties to the novated derivative; and

(iii) the changes to the terms of the novated derivative arising from the novation of the contract to a central counterparty are limited to those that are necessary to effect the terms of the novated derivative. Such changes would be limited to those that are consistent with the terms that would have been expected if the contract had originally been entered into with the central counterparty. These changes include changes in the collateral requirements of the novated derivative as a result of the novation; rights to offset receivables and payables balances with the central counterparty; and charges levied by the central counterparty.

Do you agree with this proposal? If not, why? What criteria would you propose instead, and why?

Our members are grateful that IFRS Interpretations Committee and the Board have taken this issue onto its agenda and have sought to provide a workable solution. We would contend however, as set out below, that all that is needed is a clarification by the Board that a novation would not lead to discontinuation of hedge accounting. Should the Board decide that it cannot provide such a clarification, we believe the proposed change needs to be broadened to cover a wider range of circumstances forced upon our members by the new regulations.

Need for clarification rather than amendment

The Board in its Basis for Conclusions in paragraph BC 5 states that it "concluded that the novation to a CCP would meet the derecognition requirements... Consequently, the IASB concluded that an entity is required to discontinue the hedge accounting..." Should the Board decide to progress with its proposals it would be helpful for the final BC to set the reasoning out in more detail, as it is not clear to our members that discontinuation is necessarily required for novations where the only amendment to the contract is the counterparty (and, possibly, credit risk mitigation practices).

First, some of our members do not consider that a novation is necessarily a derecognition of the original hedging instrument. While it involves a change in counterparty, and may require a change in credit mitigation practices, in substance it is the same contract. There is normally no change in the other key terms, such as the various settlement dates or the maturity, or prices; there has been no 'substantial modification', to borrow the term from IAS 39 paragraph 40.

Second, we note that paragraph 88 of IAS 39, which specifies the designation and documentation requirements of a hedging relationship, does not specify the counterparty as one of the key elements of the designation. It is therefore not clear that a change in counterparty is material to the designation and documentation of the hedging instrument. The Standard is silent on the subject of novations and there is potential for different interpretations in how they should be treated.

Third, IAS 39 already permits continuation if "the replacement or rollover of a hedging instrument into another hedging instrument is part of the entity's documented hedging strategy".

While novation differs from a 'replacement or roll over', it can be argued by analogy that the exemption already permitted for rollovers can be applied to novations. Whereas a rollover necessarily involves a change in settlement dates, and a replacement or rollover may well also involve a change in contractual price or counterparty, a novation (as already mentioned) normally involves a much less substantial modification: merely the change of the counterparty (that may be accompanied by a reduction in credit risk). The price and settlement dates are normally left unchanged and, as a consequence, the entity stays exposed to exactly the same risks (except perhaps for counterparty risk) before and after the novation. Also, many of the derivatives due to be novated according to the new regulations will already be subject to (bilateral) cash margining procedures and so the counterparty risk may not significantly change either. It would be inappropriate to permit replacements and rollovers to qualify for continuation, but not novations. Even if it were decided that it is necessary to derecognise the hedging instrument, our members consider that preparers who had included in their hedge documentation that they may replace or roll over the hedging instrument, would be able to continue hedge accounting if they novate the contract.

Broadening the amendment

Even if the Board decides that it cannot clarify that it was always possible to continue hedge accounting after novating a derivative contract, given that a novation is a less substantial change that a replacement or rollover, our members believe the proposed change needs to be broadened to cover a wider range of circumstances imposed upon entities. In particular, our members are concerned about the need for the novation to be 'required by laws or regulations'. The relevant laws and regulations have been developing over the last year but it now appears that most 'required' novations will be prospective, applying to newly traded derivatives, and so the proposed amendment would not be needed. The main use for the amendment, as drafted, will only cover those derivatives that will be required to be novated and which had previously been designated as hedges. The amendment, as proposed, will not however, cover those hedging instruments that are not required to be novated but where the entity chooses to do so, as the regulatory capital requirements for not doing so are expected to be onerous, in accordance with the proposed regulations. The proposed amendment would not cover such "voluntary" novations. Our members, therefore, request that the amendment be broadened to cover this category of hedging instruments.

Extension of the proposal to "voluntary" novations would also permit greater consistency on this subject between IFRS and US GAAP. The SEC included in its letter to ISDA of May 11 2012, that it would not object to continuation of hedge accounting if "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 (i.e., at the time of entering in the transaction) that the contract would be novated to effect central clearing."

Should an amendment be needed along the lines of the IASB's proposal, our members agree with the IASB's proposal to permit modifications to the terms of the novated derivative that are both 'necessary to effect the terms of the novated derivative' and 'limited to those that are consistent with the terms that would have been expected if the novated derivative had originally been entered into with the central counterparty'.

Transition

Should the Board progress with its proposals, given that our members do not believe that a novation necessarily entails derecognition or dedesignation, they believe that the Board would be providing an interpretation. Rather than require entities to amend the accounting treatment of previous novations, we ask the Board to allow 'grandfathering' of previous novations which resulted only in the change of counterparty and credit mitigation techniques, as a transitional relief.

Question 2

The IASB proposes to address those novations arising from current changes in legislation or regulation requiring the greater use of central counterparties. To do this it has limited the scope of the proposed amendments to a novation that is required by such laws or regulations. Do you agree that the scope of the proposed amendment will provide relief for all novations arising from such legislation or regulations? If not, why not and how would you propose to define the scope?

Please see our response to Question 1.

In addition, our members are concerned that there may be a need, due to changing regulation and other reasons, to extend the treatment to cover novations to parties other than central counterparties, such as transfers of derivatives between two counterparties within the same group.

Again, to include this in the amendment would help to bring IFRS in line with U.S. GAAP and will not impose a bigger burden again to those entities reporting under IFRS in comparison with those reporting under U.S. GAAP. The SEC, in its letter to ISDA, agreed not to object to the continuation of hedge accounting if "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..."

Question 3

The IASB also proposes that equivalent amendments to those proposed for IAS 39 be made to the forthcoming chapter on hedge accounting which will be incorporated in IFRS 9 Financial Instruments. The proposed requirements to be included in IFRS 9 are based on the draft requirements of the chapter on hedge accounting, which is published on the IASB's website.

Do you agree? Why or why not?

See our response to Questions 1 and 2. Our members agree that the same relief should be offered under IFRS 9.

Question 4

The IASB considered requiring disclosures when an entity does not discontinue hedge accounting as a result of a novation that meets the criteria of these proposed amendments to IAS 39. However, the IASB decided not to do so in this circumstance for the reason set out in paragraph BC13 of this proposal.

Do you agree? Why or why not?

Our members agree that no specific disclosures should be required. To the extent that there is a significant change in credit risk or the fair value of the hedging instrument, disclosure is already required by IFRS 7 and IFRS 13.

Other important issues:

We believe that these amendments should include an effective date with early application permitted as they are more a clarification of the existing requirements. Furthermore, such early application should permit entities to apply the requirements to novations that take place prior to the finalisation of these amendments.