

**DRAFT COMMENT LETTER**  
**Comments should be submitted by 25 March 2013 to**  
[Commentletters@efrag.org](mailto:Commentletters@efrag.org)

XX April 2013

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir/Madam,

**Re: Novation of Derivatives and Continuation of Hedge Accounting**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft 2013/2 *Novation of Derivatives and Continuation of Hedge Accounting – Proposed amendments to IAS 39 and IFRS 9*, issued by the IASB on 28 February 2013 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive standard in the European Union and European Economic Area.

EFRAG welcomes the IASB's responsiveness in addressing this issue in a quick and pragmatic manner.

EFRAG supports the proposals as discontinuation of hedge relationships in this specific situation would not provide useful information.

However:

- EFRAG believes the IASB should clarify that novations that take place to meet the requirements of (substantially) enacted laws or regulations – but that are voluntary only in the sense that they take place before the legal novation deadline – would also fall within the scope of the proposed amendment;
- Early application should be permitted so that entities can apply the requirements to novations that take place prior to the finalisation of these amendments.

If you would like to discuss our comments further, please do not hesitate to contact Ralitzla Ilieva, Marc Labat or me.

Yours sincerely,

Françoise Flores  
**EFRAG, Chairman**

## APPENDIX

### **EFRAG's responses to the questions raised in the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting – Proposed amendments to IAS 39 and IFRS 9***

#### **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?

#### **Notes for EFRAG's constituents**

- 1 *A novation is the substitution of a new contract in place of an old one.*
- 2 *In July 2012, the Regulation on OTC derivatives, central counterparties (CCPs) and trade repositories (European Market Infrastructure Regulation (EMIR)) was adopted by the European Commission, which requires among others central clearing for certain classes of OTC derivatives. 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. EMIR is similar in to the Dodd-Frank Wall Street Reform and Consumer Protection Act in the sense that both aim to impose OTC derivatives to be cleared through central counterparties.*
- 3 *IAS 39 Financial Instruments: Recognition and Measurement requires hedge accounting to be discontinued when the hedging instrument expires or is sold, terminated or exercised (unless the replacement or rollover of a hedging instrument into another hedging instrument is part of the entity's documented hedging strategy).*
- 4 *The IASB concluded that under the existing requirements of IAS 39 an entity is required to discontinue the hedge accounting for an OTC derivative that has been designated as a hedging instrument in the existing hedging relationship if the OTC derivative is novated to a central counterparty.*

- 5 *The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this would result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship.*
- 6 *Therefore, the IASB decided that such a novation was not to be treated as an expiration or termination, as it was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship in this specific situation would provide more useful information to users of financial statements. Any fair value changes of the hedging instrument that arise from such a novation of the hedging instrument should be reflected in the measurement of the novated derivative and therefore in the measurement of hedge effectiveness.*

#### **EFRAG's response**

**EFRAG supports the proposals as discontinuation of hedge relationships in this specific situation would not provide useful information.**

- 7 EFRAG supports the planned amendments to IAS 39 and IFRS 9 in relation to novation of derivatives, when such novation is required by legislation or regulation, because discontinuation of all hedge relationships affected would in this specific situation not provide useful information to users of financial statements.
- 8 EFRAG recommends that the scope of the amendments be extended to novations that arise from statutory requirements that are similar to laws and regulations to avoid over-restrictive interpretations.
- 9 EFRAG believes that the nature of mandatory novations to central counterparties differs from conventional novations in that both original counterparties remains exposed to the same market risk and that the changes in the terms are limited to those that are necessary to effect the terms of the novated derivative.
- 10 We note that the IASB had originally intended to limit the scope to novations in which only the name of the counterparty had changed, but concluded that this restriction would make the relief ineffective in practice. Therefore, EFRAG believes that IASB strike a pragmatic balance by accepting minor modifications to the terms of the 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'.
- 11 Finally, we note that by restricting the scope to mandatory novations, these amendments are unlikely to result in inappropriate accounting for novations that have commercial substance and that are of interest to users of financial statements.

#### **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?

**EFRAG's response**

...

- 12 EFRAG understands that most entities will probably novate their derivatives before the legal novation deadline, if only to avoid the administrative and legal burden of having to novate all derivatives on a single date. Therefore, we believe the IASB should clarify that novations that take place to meet the requirements of (substantially) enacted laws or regulations – but that are voluntary only in the sense that they take place before the legal novation deadline – would also fall within the scope of the proposed amendment.

**Questions to EFRAG's constituents**

- 13 Are you aware of additional novations that should also be covered by these amendments? Please describe those novations and the reasons why you believe they should qualify for the same relief.
- 14 EFRAG understands that also in circumstances where existing OTC derivatives are not required to be novated to central counterparties; there may be an economic compulsion to do so (either because of market collateral requirements or new regulatory capital requirements). Are you aware of circumstances in which OTC derivatives are novated absent a direct legal obligation (i.e. the novation is not *directly* required by laws or regulations)? If so, please (i) describe those voluntary novations and (ii) explain whether or not they should be covered by the proposed relief and how this would result in appropriate financial reporting.

**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?

- 15 *The IASB also considered the draft requirements of the forthcoming hedge accounting chapter that will be incorporated into IFRS 9. The IASB noted that those draft requirements would also require hedge accounting to be discontinued if the novation to a central counterparty occurs. Consequently, the IASB concluded amendments that are equivalent to the proposed amendments to IAS 39 should also be proposed to be included in IFRS 9.*

**EFRAG's response**

**EFRAG agrees that the same relief should be offered under IFRS 9.**

- 16 EFRAG believes that the proposed relief is also relevant under IFRS 9 for the reasons described in our response to Question 1.

#### **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?

#### **Notes for EFRAG's constituents**

17 *The IASB discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposed amendments to IAS 39 and IFRS 9. The IASB decided that it was not appropriate to mandate specific disclosure in this situation as from the perspective of a user of financial statements, the hedge accounting would be on-going.*

#### **EFRAG's response**

**EFRAG agrees that no specific disclosures should be required.**

18 EFRAG agrees that no specific disclosures are necessary, as IFRS currently does not require disclosures of other ongoing hedge relationships. In addition, we note that requiring one-off disclosures about mandatory novations would potentially be costly and offer little or no benefit to users of financial statements.

19 Furthermore, we note that entities would follow – in disclosing the impact of counterparty risk changes as a result of novation – the specific disclosure requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (paragraphs AG69, AG107, IG F.5.2), *IFRS 7 Financial Instruments: Disclosures* (paragraphs 36 to 38) on credit risk disclosures and *IFRS 13 Fair Value Measurement* (paragraphs 9, 37, 42 to 44 and 69) on the non-performance risk in fair value measurement.

#### **Other issues**

##### *Effective date*

20 EFRAG believes that these amendments should include an effective date with early application permitted as they are more than a clarification of existing requirements. Such early application should permit entities to apply the requirements to novations that take place prior to the finalisation of these amendments.

##### *Drafting*

21 We believe that the wording of the final sentence of paragraph BC6 of the ED is potentially confusing. While we agree that going forward the amendments improve hedge effectiveness, paragraph AG113A requires any fair value changes of the hedging instrument that arise from the novation of the hedging instrument to be included in the measurement of hedge effectiveness and thereby cause a hedge relationship to fall outside the 80 per cent to 125 per cent hedge effectiveness range. Therefore, the IASB should clarify the wording of the Basis for Conclusions.