EFRAG
European Financial Reporting Advisory Group

11 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').

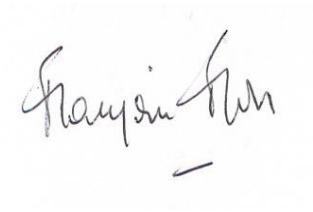
This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive standard in the European Union and European Economic Area.

EFRAG welcomes the IASB's responsiveness in providing relief from having to discontinue hedge accounting when entities novate hedging instruments to central counterparties. However, we believe that the IASB should remove condition (i) (i.e. that the novation is required by laws or regulations) as this condition unnecessarily restricts the scope of the relief. EFRAG believes that all voluntary novations with a central counterparty should be included in the relief, because the economic impact of a novation to a central counterparty is the same, regardless whether the novation is required by law, done in anticipation of a legal requirement, done to obtain regulatory relief or done on a purely voluntary basis.

We note that diversity in practice exists regarding the interpretation of the derecognition requirements as applied to novations, as some constituents have historically considered that certain novations (e.g. novations to a different legal entity within the same group) do not lead to derecognition. Without expressing a view on whether this is an appropriate interpretation, we do note that the wording 'if and only if' in paragraphs 91(a) and 101(a) of the ED would prohibit such interpretation. Therefore, we believe the IASB should include an effective date (with early application permitted) and only require prospective application.

If you would like to discuss our comments further, please do not hesitate to contact Ralitza 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?

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

EFRAG welcomes the IASB's efforts to provide relief from having to discontinue hedge accounting when entities novate hedging instruments to central counterparties. However, we believe that the IASB should remove condition (i) (i.e. that the novation is required by laws or regulations) as this condition unnecessarily restricts the scope of the relief. EFRAG believes that all voluntary novations with a central counterparty should be included in the relief, because the economic impact of a novation to a central counterparty is the same, regardless whether the novation is required by law, done in anticipation of a legal requirement, done to obtain regulatory relief or done on a purely voluntary basis.

EFRAG notes that the wording 'if and only if' in paragraphs 91(a) and 101(a) of the ED may lead to a change in practice. Therefore, we believe the IASB should include an effective date (with early application permitted) and only require prospective application.

1 EFRAG welcomes the IASB's efforts to provide relief from having to discontinue hedge accounting when entities novate hedging instruments to central counterparties, because discontinuation of such hedge relationships would not provide useful information to users of financial statements.

2 However, EFRAG understands that legislation or implementing regulation would require only certain existing OTC derivatives to be cleared through central counterparties. In addition, we are aware that many entities have already started to novate OTC derivatives before they are legally required to do so (e.g. when exact requirements of the secondary legislation have not yet been finalised).

3 Therefore, we believe the proposed amendments are too restrictive as many novations that take place in response to the European Market Infrastructure Regulation (EMIR) and the US Dodd-Frank Act would not qualify for the relief, even though those novations aim to reduce counterparty risks and thereby increase overall hedge effectiveness prospectively. Furthermore, we note that the nature of novations to central counterparties differs from conventional novations in that both original counterparties remain 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.

4 For these reasons, we believe that the IASB should remove condition (i) (i.e. that the novation is required by laws or regulations) as this would unnecessarily restrict the scope of the relief. We believe that conditions (ii) and (iii) by themselves appropriately limit the scope of relief. Thus EFRAG believes that all voluntary novations with a central counterparty should be included in the relief, because the economic impact of a novation to a central counterparty is the same, regardless whether the novation is required by law, done in anticipation of a legal requirement, done to obtain regulatory relief or done on a purely voluntary basis.

5 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 strikes 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'.

6 Furthermore, EFRAG notes that diversity in practice exists regarding the interpretation of the derecognition requirements as applied to novations. We understand some constituents have historically considered that certain novations (e.g. novations to a different legal entity within the same group) do not lead to derecognition. Without expressing a view on whether this is an appropriate interpretation, we do note that the wording *'if and only if'* in paragraphs 91(a) and 101(a) of the ED would prohibit such interpretation.

7 Therefore, EFRAG believes that these amendments should include an effective date with early application permitted. As these amendments may change practice and it would not be reasonably possible to restate past novations that may not have been considered derecognition events, we believe that the requirements should apply prospectively. In allowing early application, the IASB should ensure that entities are permitted to apply the requirements to novations that take place prior to the finalisation of these amendments.

8 Finally, EFRAG would recommend that the IASB further considers the broader issue of novation in the context of hedge accounting separately (e.g. novations involving entities within the same group and novations to clearing members).

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?

EFRAG's response

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

9 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?

EFRAG's response

EFRAG agrees that no specific disclosures should be required.

10 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.

11 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

Drafting

12 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.