Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting* –
Proposed amendments to IAS 39 and IFRS 9

Feedback to Constituents

May 2013

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Introduction

Objective of this feedback statement

EFRAG published its final comment letter on the Exposure Draft *2013/2 Novation of Derivatives and Continuation of Hedge Accounting – Proposed amendments to IAS 39 and IFRS 9* ('the ED') on 11 April 2013. This feedback statement summarises the comments received on EFRAG Draft Comment Letter and explains how those comments were considered by the EFRAG Technical Expert Group (EFRAG TEG) during its technical discussions.

Background to the ED

On 28 February 2013, the International Accounting Standards Board (IASB) published proposed amendments to IAS 39 and corresponding amendments in IFRS 9 with the objective to provide an exception to the requirement for the discontinuation of hedge accounting in IAS 39 and IFRS 9 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.

Further details are available on the EFRAG website.

EFRAG's draft comment letter

EFRAG published a draft comment letter on the proposals on 11 March 2013. In the draft comment letter EFRAG supported the proposals as discontinuation of hedge relationships in this specific situation would not provide useful information. However, EFRAG believed that:

– 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.

Comments received from constituents

Fourteen comment letters were received from constituents and considered by EFRAG TEG in its discussions. The Appendix provides the list of respondents.

The comment letters received came from national standard-setters, business associations, professional organisations, listed companies, regulators and EU authorities.

Feedback statement

Scope of the amendments

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG noted that 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;

EFRAG asked constituents to provide cases of additional novations that should also be covered by the amendments.

Constituents comments

A majority of the respondents believed the proposed amendments to be too restrictive and therefore did not think that they would achieve the intended outcome. A majority of respondents believed the scope of the proposed amendment should be broadened to cover a wider range of novations using the following arguments:

Two standard setters and an international association believed 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. A standard setter stated that they were aware of the fact that many entities have already started to voluntarily novate their derivatives in light of the new legislation and would, hence, be outside the scope of the proposed amendments so that the scope might potentially be a null set. Furthermore, they noted that neither EMIR nor the Dodd-Frank Act require existing OTC derivative contracts to be novated to a central counterparty. Therefore, they suggested that the IASB delete the requirement that 'the novation is required by laws or regulations'.

One preparer argued that the US Securities and Exchange Commission (SEC) explicitly permits the continuation of hedge accounting even if the counterparties did not agree to clear and novate when they entered into the transaction. They claimed entities in Europe would be disadvantaged compared to entities reporting under US GAAP if the IASB did not allow hedge accounting continuation after a voluntary central counterparty novation.

A standard setter also recommended that the IASB deliberate mid-or long-term

EFRAG's response to respondents' comments

In its final comment letter, EFRAG welcomed the IASB's responsiveness in providing relief from having to discontinue hedge accounting when entities novate hedging instruments to central counterparties.

Based on the comments received, EFRAG understands that many entities have already started to voluntarily novate their derivatives ahead of the legislation or laws and therefore agreed that such novation should not be scoped out as they are done with the same economic incentive.

EFRAG agrees that scoping out novations to central counterparties that are done on a voluntary basis may disincentivise companies from novation to central counterparties. In most cases novation to central counterparties have increased hedge effectiveness and the economic reasons for doing so are the same as when they are required by law or regulation.

For those reasons, EFRAG believed the IASB should remove the condition that the novation is required by laws or regulations as this condition unnecessarily restricts the scope of the relief.

EFRAG agreed with constituents' views 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.

Scope of the amendments

EFRAG's tentative views and respondents' comments

solutions, which may also encompass novations to other counterparties (not to a central counterparty, e.g. within a group) and the distinction from collateral promises and assumption agreements.

A regulator supported that all novations of derivative contracts resulting clearing through a central counterparty without changing the other major terms of the contracts benefit from the proposed exception, even when this is not required by laws or regulations, as this would avoid a negative incentive against central clearing on a voluntary basis. Many standard setters also supported this scope for the ED.

Two standard setters believed that the drafting should include also novations from one counterparty to a central counterparty due to coming laws or regulations. Furthermore, they believe that the relief should also apply to novations resulting from the indirect effects of legislation (such as CRD IV) that creates an economic compulsion to novate.

Only one standard setter fully supported only novations required by laws or regulations as per the ED and EFRAG's draft comment letter.

EFRAG's response to respondents' comments

Current novation accounting practices

EFRAG's tentative views and Respondents' comments

One constituent raised an issue that was not specifically addressed in EFRAG's draft comment letter.

An international association expressed the view that an amendment to the standard was not necessary; rather they believed that the Board should amend paragraphs 91 or 101 of the ED to clarify that a novation would not lead to discontinuation of hedge accounting. In its comment letter the association noted that their members did not consider that novations necessarily lead to derecognition of the original hedging instruments as in their view 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. While the members of this association believe that novation differs from a 'replacement or roll over', they argue that by analogy the exemption already permitted for rollovers can be applied to novations.

EFRAG's response to respondents' comments

EFRAG noted that diversity in practice exists regarding the interpretation of the derecognition requirements as applied to novations. The comments received confirmed that some constituents have historically interpreted that certain novations should not lead to derecognition such as novations to a different legal entity within the same group. Without expressing a view on whether this is an appropriate interpretation, EFRAG noted that the wording 'if and only if' in paragraphs 91(a) and 101(a) of the ED would prohibit such interpretation.

Therefore, EFRAG believed the IASB should include an effective date (with early application permitted) and only require prospective application.

Disclosures and other issues

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG agreed with the IASB's decision *that no spec*ific disclosures are necessary. EFRAG noted that *IFRS currently does not require disclosures of other ongoing hedg*e relationships. In addition, EFRAG *noted that requiring one-off disclosures about mandatory novations would potentially be costly and offer little or no benefit to users of financial statements.*

Constituents' comments

One constituent expressed doubts whether in certain situations it would not be appropriate to disclose information, especially when the novation leads to significant changes.

Another constituent argued that specific disclosure is appropriate and useful for the users of financial statements because the novation considered in the ED changes significantly the counterparty risk inherent in the portfolio of derivative contracts (i.e. minimise the risk of default). Even more, in the case of voluntary novation where, all other terms being equal, a change in the creditworthiness of the counterparty (and in the current value of the derivative) could happen. Therefore, that constituent believed that the IASB should provide some minimal disclosure requirements to ensure the comparability of the financial statement when a novation occurs.

EFRAG's response to respondents' comments

The issue of adding disclosures had been discussed by EFRAG TEG previously and the constituent's letters had not provided new arguments that had not been considered previously.

For those reasons, EFRAG agreed that no specific disclosures are necessary, as IFRS currently does not require disclosures of other ongoing hedge relationships.

In addition, EFRAG noted that requiring one-off disclosures about mandatory novations would potentially be costly and offer little or no benefit to users of financial statements.

Appendix

List of respondents

CL01 – Portugal National Standard Setter (CNC)

CL02 – Swedish Financial Reporting Board

CL03 – DZ Bank

CL04 – Accounting Standards Committee of Germany (ASCG)

CL05 – Institute of Chartered Accountants in England and Wales (ICAEW)

CL06 – International Swaps and Derivatives Association (ISDA)

CL07 – Danish Accounting Standards Committee set up by (FSR)

CL08 – International Energy Accounting Forum (IEAF)

CL09 – Dutch Accounting Standards Board (DASB)

CL10 – Financial Reporting Council (FRC)

CL11 – European Security and Markets Authority (ESMA)

CL12 – Organismo Italiano di Contabilità (OIC)

CL13 – French Banking Federation (FBF)

CL14 – Autorité des Normes Comptables (ANC)