IFRS in Focus
IASB publishes exposure draft on novation of derivatives

Contents

The Bottom Line

- The ED proposes to allow the continuation of hedge accounting (under IAS 39 and the forthcoming chapter on hedge accounting in IFRS 9) when a hedging derivative is novated to a central counterparty and certain conditions are met.
- The ED is a response to changes in laws and regulations in some jurisdictions for over-the-counter derivatives, requiring many of them to be transacted with a central counterparty.
- Comments on the proposals are due by 2 April 2013.

Introduction and background

In February 2013, the International Accounting Standards Board (IASB) published exposure draft ED/2013/2 *Novation of Derivatives and Continuation of Hedge Accounting* (Proposed amendments to IAS 39 and IFRS 9) ('the ED') proposing a limited scope amendment to IAS 39 *Financial Instruments: Recognition and Measurement* and the forthcoming chapter on hedge accounting in IFRS 9 *Financial Instruments*. The ED proposes some relief to the hedge accounting requirements when a derivative is required to be novated to a central counterparty (CCP), under certain circumstances.

Laws and regulations on over-the-counter (OTC) derivatives are changing in several jurisdictions (based on the G20 commitments arising out of the financial crisis), requiring many of them to be transacted with a CCP.

Observation

The *European Market Infrastructure Regulation* (EMIR) is one such example of a jurisdictional change designed to improve transparency and regulatory oversight of OTC derivatives in an internationally consistent way by requiring centralised clearing and exchange trading of derivatives. The IFRS Interpretations Committee originally considered the issue of whether hedge accounting should be discontinued following the introduction of regulation requiring novation (i.e., where one party of the derivative contract is replaced with a new party) in the context of the EMIR. The IFRS Interpretations Committee referred the matter to the IASB which led to this ED.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Many derivatives that are subject to these laws and regulations have been designated in hedging relationships. IAS 39 requires an entity to discontinue hedge accounting in these circumstances (assuming the novation was not contemplated in the original hedging documentation) because the novation involves the termination or expiration of the original hedging instrument.

While both the IASB and IFRS Interpretations Committee believed the analysis under IAS 39 was clear in accounting for the novation, they did not believe the accounting outcome of discontinuing existing hedging relationships was favourable as they did not view the imposition of legislation as fundamentally changing the nature of economic hedging activities. Therefore, a limited exception to the requirements in IAS 39 (and the requirements expected to be included in the forthcoming chapter on hedge accounting in IFRS 9) has been proposed.

> Observation
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> Following the release of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the U.S. Securities and Exchange Commission (SEC) has taken steps to address a similar issue for hedge accounting under U.S. GAAP.

The proposals

The ED proposes the novation of a hedging instrument should not be considered an expiration or termination giving rise to the discontinuation of hedge accounting when a hedging derivative is novated to a CCP and the following criteria are met:

- the novation is required by laws or regulations;
- the novation results in a CCP becoming the new counterparty to each of the parties to the novated derivative; and
- the changes in terms of the novated derivative are limited to those necessary to effect the terms of the novated derivative.

Any changes to the derivative's fair value arising from the novation would be reflected in its measurement and therefore in the measurement of hedge effectiveness.

> Observation
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> The proposals would not permit continuation of hedge accounting for any voluntarily novated derivative, nor would they allow hedge accounting continuation if changes arising from the novation are inconsistent with the terms that would have existed if the novated derivative had originally been entered into with the CCP. The ED provides several examples of allowable changes in terms such as changes in the contractual collateral requirements of the novated derivative as a result of the novation; rights to offset receivables and payables balances with the CCP; and charges levied by the CCP. However, a change in the maturity date or contractual cash flows would not permit the continuation of hedge accounting.

Effective date and comment period

The ED does not specify an effective date, but early application is proposed to be permitted. The IASB will determine the effective date after considering the comments received on the ED and performing necessary due process steps.

Comments on the ED are due by 2 April 2013.

> Observation
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> The ED has a 30 day comment period – the minimum allowable exposure period under the IFRS Foundation *Due Process Handbook*. The IASB considers the short comment period necessary as the new laws or regulations to mandate CCP clearing of OTC derivatives are due to take effect imminently.

Key contacts

IFRS global office
Global IFRS Leader – Clients and Markets
Joel Osnoss
ifrsglobalofficeuk@deloitte.co.uk

Global IFRS Leader – Technical
Veronica Poole
ifrsglobalofficeuk@deloitte.co.uk

Global IFRS Communications Co-Directors
Mario Abela and Neil Laverty
ifrsglobalofficeuk@deloitte.co.uk

IFRS centres of excellence

Americas		
Canada	Karen Higgins	iasplus@deloitte.ca
LATCO	Fermin del Valle	iasplus-LATCO@deloitte.com
United States	Robert Uhl	iasplusamericas@deloitte.com
Asia-Pacific		
Australia	Anna Crawford	iasplus@deloitte.com.au
China	Stephen Taylor	iasplus@deloitte.com.hk
Japan	Shinya Iwasaki	iasplus-tokyo@tohmatsu.co.jp
Singapore	Shariq Barmaky	iasplus-sg@deloitte.com
Europe-Africa		
Belgium	Thomas Carlier	BEIFRSBelgium@deloitte.com
Denmark	Jan Peter Larsen	dk_iasplus@deloitte.dk
France	Laurence Rivat	iasplus@deloitte.fr
Germany	Andreas Barckow	iasplus@deloitte.de
Italy	Franco Riccomagno	friccomagno@deloitte.it
Luxembourg	Eddy Termaten	luiasplus@deloitte.lu
Netherlands	Ralph ter Hoeven	iasplus@deloitte.nl
Russia	Michael Raikhman	iasplus@deloitte.ru
South Africa	Graeme Berry	iasplus@deloitte.co.za
Spain	Cleber Custodio	iasplus@deloitte.es
United Kingdom	Elizabeth Chrispin	iasplus@deloitte.co.uk

Designed and produced by The Creative Studio at Deloitte, London. 25328A