

IFRS in Focus

IASB publishes an amendment to IAS 39 on novation of derivatives

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The Bottom Line

- This amendment allows the continuation of hedge accounting (under IAS 39 and the forthcoming chapter on hedge accounting in IFRS 9) when a derivative is novated to a clearing counterparty and certain conditions are met.
- The amendment 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 or entity acting in a similar capacity.
- Mandatory application date is for annual periods beginning on or after 1 January 2014 with early application permitted.

Introduction and background

In June 2013, the International Accounting Standards Board (IASB) published *Novation of Derivatives and Continuation of Hedge Accounting – Amendments to IAS 39*, a limited scope amendment to IAS 39 *Financial Instruments: Recognition and Measurement* and the forthcoming chapter on hedge accounting in IFRS 9 *Financial Instruments*. This amendment provides some relief from the requirement to cease hedge accounting when a derivative is required to be novated to a central counterparty (CCP) or entity acting in a similar capacity, 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 or with an entity acting in a similar capacity.

Many derivatives that are subject to these laws and regulations have been designated in hedging relationships. Prior to this amendment, IAS 39 would require 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. Discontinuation of hedge accounting, particularly for cash flow hedges, is particularly problematic as it makes it more difficult for entities to apply hedge accounting in future periods.

While both the IASB and the 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 or economics of hedging activities.

For more information please see the following websites:

www.iasplus.com

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Observations

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 amendment.

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 amendment

The amendment states that 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:

- As a consequence of laws and regulations, or the introduction of laws and regulations, one or more clearing counterparties replace the original counterparty; and
- And any changes in terms of the novated derivative are limited to those necessary to effect the replacement of the counterparty (for example, changes in all collateral requirements, rights to offset receivables and payables balances, and charges levied).

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

There are no additional disclosures introduced by this amendment.

The amendment shall be applied retrospectively for annual periods beginning on or after 1 January 2014 with early application permitted. However, even with retrospective application, if an entity had previously discontinued hedge accounting, as a result of novation, that (pre-novation) hedge accounting relationship cannot be reinstated because doing so would be inconsistent with the requirements for hedge accounting (i.e., hedge accounting cannot be applied retrospectively).

Significant changes from the exposure draft

The exposure draft (ED) proposed that the amendment should be limited to circumstances where novation is required by laws or regulations. Many respondents to the ED thought that the scope was too restrictive. In particular, voluntary novation should be treated in the same way as novations required by law or regulations. The IASB noted that voluntary novations could include anticipation of regulatory changes, novation due to operational ease and novations induced but not actually mandated by laws or regulations as a result of the imposition of charges or penalties. However, the Board decided not to extend the scope of the amendment beyond novations required by laws or regulations.

The ED also proposed that the amendment should be limited to those that have been made directly to a CCP. Many respondents thought that this was too restrictive. For example, in some cases a CCP has a contractual relationship only with its 'clearing members', and therefore an entity must have a contractual relationship with a clearing member to be able to enter into a transaction with a CCP. Some jurisdictions also make use of 'indirect clearing'. In other words, a client of a clearing member of a CCP provides a (indirect) clearing service to its clients in the same way a clearing member of a CCP provides a clearing service to its clients. Intragroup novations can also occur to allow access to a CCP. Consequently, the IASB expanded the scope of the amendment by providing relief for novations to entities other than a CCP, if such a novation is undertaken with the objective of effecting clearing with a CCP rather than limiting relief to situations in which novation is directly to a CCP.

1 A clearing counterparty is a central counterparty or entity, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that is acting as counterparty in order to effect clearing by a central counterparty

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