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IFRS Developments

Proposed amendments to IAS 39 and IFRS 9 to allow novated derivatives to be continuing hedges

What you need to know

- On 28 February 2013, the IASB published an ED proposing that hedge accounting need not be discontinued when derivatives designated in hedging relationships are required to be novated to a central counterparty as a result of a law or regulation.
- The exception to the discontinuation requirements would only apply to novations *required by* a law or regulation.
- The relief does not apply to *voluntary* novations.
- The comment period ends on 2 April 2013.

Highlights

On 28 February 2013, the International Accounting Standards Board (IASB, the Board) published the exposure draft (ED) *Novation of Derivatives and Continuation of Hedge Accounting – Proposed amendments to IAS 39 and IFRS 9*. The ED proposes an exception to the requirement to discontinue hedge accounting in situations where derivatives designated in hedging relationships are required to be novated to a central counterparty (CCP) as a result of a law or regulation.

The proposal

A submission to the IFRS Interpretations Committee (IFRIC) highlighted that the European Market Infrastructure Regulation (EMIR), which has not yet been enacted, would result in entities novating derivatives that are designated in hedging relationships. When it first discussed the issue in its January 2013 meeting, the IFRIC noted that IAS 39 *Financial Instruments: Recognition and Measurement* "... requires an entity to discontinue hedge accounting when the OTC derivative, which is designated as a hedging instrument, is novated to a CCP under EMIR, because the existing novated derivative is derecognised and the new derivative contracts, with a counterparty being the CCP, are recognised at the time of the novation."[1] The only exception to this would be where the novation was already contemplated in the hedge documentation. Otherwise, entities can re-designate derivatives after novation. This would, however, likely result in accounting ineffectiveness for cash flow hedges as the derivatives would in most cases have a fair value other than zero.

[1] IFRIC Update January 2013

The IFRIC also recommended that the IASB make a narrow-scope amendment to permit the continuation of hedge accounting in certain circumstances. As a result, the IASB now proposes an exception to the hedge accounting discontinuation requirements in IAS 39 and the (soon to be published) hedge accounting requirements in IFRS 9 *Financial Instruments*. The exception would be limited to novations:

- That are required as a result of a law or regulation
- Where the novation results in a CCP becoming the new counterparty to each of the parties to the novated derivative
- That did not result in changes to the terms of the original OTC derivative other than changes directly attributable to the novation. Such changes are 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 (e.g., collateral requirements, rights to offset receivables and payables balances with the CCP and charges levied by the CCP).

The third requirement above means that any change in the fair value of a derivative as a result of changes to the terms of the contract, directly attributable to the novation, would have to be recorded as ineffectiveness, but would not jeopardise the continuation assessment.

Central clearing of over-the-counter derivatives in response to the financial crisis

The collapse of some financial institutions during the financial crisis exposed the impact that credit risk can have on the global derivatives markets. In a response to this, the G20 agreed at its Pittsburgh summit in September 2009 that standardised over-the-counter derivatives (OTC derivatives) should be cleared through a CCP. The CCP would usually require the derivatives to be collateralised, thereby (potentially) significantly reducing the counterparty credit risk.

As a result, several jurisdictions have introduced, or are in the process of introducing, legal or regulatory requirements that OTC derivatives have to be novated to a CCP. Examples include the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in the United States and the EMIR in the European Union.

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Mandatory vs voluntary novations

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Certain regulations, for example the Dodd-Frank Act, must be applied prospectively, meaning that only new derivatives will have to be novated to a CCP. The proposed exception would not be required for such derivatives, considering that entities could simply include the subsequent novation in the hedge documentation. On the other hand, some entities may wish to voluntarily novate existing derivatives to make use of the standardised processes of a CCP. Also, increased capital requirements will give financial institutions an economic incentive to voluntarily novate OTC derivatives to a CCP, rather than being required to do so.

Furthermore, it is common for derivatives to be novated from the acquiree to the acquirer as a result of a business combination. This would result in a change in the counterparty for any entity holding a derivative with the acquiree. Some constituents query whether such novations would have to be treated as a discontinuation when the derivatives are designated in a hedging relationship.

Looking ahead

The legislation and regulations on OTC derivatives begin to take effect later this year; to ensure timely finalisation of the new requirements, the IASB has restricted the comment period for the ED to a minimum of only approximately one month. Constituents are urged to analyse whether the proposal would address their concerns relating to novations of OTC derivatives under their existing or expected local legislation or regulation.

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