MEMO

To:	Due Process Oversight Committee
From:	David Loweth, Director for Trustee Activities
Date:	27 February 2013

Novation of Derivatives and continuation of hedge accounting (Exposure Draft for proposed amendments to IAS 39 *Financial Instruments: Classification and Measurement* and IFRS 9 *Financial Instruments*)

Overview

1. The purpose of this note is to update the DPOC on the progress of the forthcoming above Exposure Draft (ED) and to send you the Due Process Protocol table that has been prepared by the technical staff on the due process steps that have been followed.

Background

2. The background to this issue was set out in Michael Stewart's note of 1 February to the DPOC, which was circulated under cover of an e-mail from me. As was explained in the note and e-mail, the proposal to amend the above standards has arisen from regulatory changes introduced in line with commitments given by the G20 that require the novation of Over The Counter (OTC) derivatives to a central counterparty (CCP). This regulatory change is part of the European Market Infrastructure Regulation (EMIR) and legislation to bring the requirement into effect has recently been passed and published in the EU Official Journal.

Accounting consequences

3. The requirements of IAS 39 when applied to such a novation would require an entity holding an OTC derivative for hedge accounting purposes to cease hedge accounting on novation. Although the entity could elect to immediately restart hedge accounting using the novated derivative, the detailed requirements of IAS 39 would lead to increased volatility in the income statement because of the way that IAS 39 would require the effectiveness of the (new) hedge to be measured. In some circumstances the (new) hedge might even fail to qualify for hedge accounting under IAS 39.

IASB proposal

4. The IASB was concerned about the effects on an entity's hedge accounting that these regulatory changes would introduce, and questioned the usefulness of the information that would result for users of financial statements if IAS 39 is not amended. The IASB therefore decided to propose an amendment to IAS 39 to allow the continuation of hedge accounting in this narrow circumstance. The IASB also decided that an equivalent change should be made to the forthcoming hedge accounting guidance in IFRS 9 *Financial Instruments*.
5. At its January 2013 meeting, the IASB proposed that the amendment should be very limited in scope to circumstances in which:
   a) a novation is required as a result of legislation, regulation or similar statutory requirements;
   b) all parties to the original OTC derivative contract are affected in the same way by the novation; and
   c) there are no changes to the terms of the original OTC derivative contract other than the change of counterparty to a CCP
6. However, following that meeting, some stakeholders had advised the staff that the novation to a CCP would in many cases be accompanied by some other changes to the derivative beyond merely the change of counterparty. For example, changes to collateral requirements of the novated derivative may be required.
7. Consequently the staff recommended to the IASB at its February 2013 meeting that the intended relief from the discontinuation of hedge accounting, should be permitted if such changes accompany the novation. The staff also noted that changes to the collateral requirements for the novated derivative would affect the fair value of that derivative, and that this change in fair value would need to be reflected in measurement of the derivative and in the assessment of the effectiveness of the hedge relationship.
8. The IASB agreed with the staff's observations and to the change needed to the proposed amendment. The ED is now with the Board for balloting and is scheduled for publication tomorrow (28 February)

Due Process implications

9. Given the urgency of the situation, Michael's note sought the DPOC's approval for the IASB to have only a short comment period of 30 days on the ED, because of the exceptional circumstances described above. That approval was given. The changes made to the proposed ED as a result of the discussion by the IASB at its February meeting do not impact on the urgency of the proposal.
10. The Due Process Protocol table outlining the (inevitably limited) due process steps for this ED is at Appendix A for your information.

Appendix A

Novation of derivatives and continuation of hedge accounting (Proposed amendments to IAS 39 and IFRS 9)

Due process steps followed for publication of Exposure Draft

General IASB requirements: publication of an ED is a mandatory step in the due process. Irrespective of whether the IASB has published a Discussion Paper (DP), an ED is the IASB's main vehicle for formally consulting the public. Unlike a DP, an ED sets out a specific proposal in the form of a proposed Standard (or amendment to a Standard). Its development is based on the consideration of issues included in staff research and recommendations, as well as comments received on any DP. Suggestions by the IFRS Advisory Council (the 'Advisory Council'), consultative groups and accounting standard-setters and those that arise from public education sessions are also taken into account. The IASB normally allows a period of 120 days for comment on EDs (Due Process Handbook, paragraphs 6.1–6.18 and Section 3).

Due Process Oversight Committee (DPOC) objective: to satisfy the DPOC that the process for developing an ED is extensive. The DPOC responds as necessary to comments received on the due process that the IASB followed when developing and publishing an ED and in response to comments received.

Step	*Required/ Optional*	*Metrics or evidence*	*Actions*
Board meetings held in public, with papers available for observers. All decisions are made in public session.	Required	Meetings held. Project website contains a full description with up-to-date information. Meeting papers posted in a timely fashion.	This issue was discussed on the basis of publicly available agenda papers at the Interpretations Committee meetings in January 2013. The results of the discussions of the Interpretations Committee was also summarised in the *IFRIC Update* for the meeting. Afterwards, the IASB discussed the issue at its January 2013 meeting and decided to add this issue to its agenda and to propose a narrow-scope amendment to IAS 39 and IFRS 9. Sweep issues were presented orally to the IASB at its February 2013 meeting, and reported in IASB Update A project webpage was created after the February 2013 IASB meeting.
Consultation with the Trustees and the Advisory Council.	Required	Discussions with the Advisory Council and/or Trustees.	This proposed amendment is part of the IASB's and the Interpretations Committee's work on maintenance of IFRSs. The proposed amendment is narrow in scope and occupies little of the IASB's time. Given the limited nature of the project and the narrow scope of the proposed amendment, the IASB does not undertake a separate consultation with the Advisory Council.
Consultative groups used, if formed.	Optional	Extent of consultative group meetings, and evidence of substantive involvement in issues. Consultative group review of the draft ED.	N/A
Fieldwork is undertaken to analyse proposals.	Optional	The IASB has described publicly the approach taken on fieldwork.	N/A

Step	Required/ Optional	Metrics or evidence	Actions
		The IASB has explained to the DPOC why it does not believe fieldwork is warranted, if that is the preferred path. Extent of field tests taken.	
Outreach meetings with a broad range of stakeholders, with special effort to consult investors.	Optional	Extent of meetings held. Evidence of specific targeted efforts to consult investors.	The staff did conduct outreach with the IFASS group and interested parties. The results from the outreach were discussed by the Interpretations Committee at its meeting in January 2013 and presented to the IASB.
Webcasts and podcasts to provide interested parties with high-level updates or other useful information about specific projects.	Optional	Extent of, and participation in, webcasts.	N/A
Public discussions with representative groups.	Optional	Extent of discussions held.	N/A
Online survey to generate evidence in support of or against a particular approach.	Optional	Extent and results of surveys.	N/A
The IASB hosts regional discussion forums, where possible, with national standard-setters.	Optional	Schedule of meetings held in these forums.	N/A
Round-table meetings between external participants and members of the IASB.	Optional	Extent of meetings held.	N/A
Analysis of the likely effects of the forthcoming Standard or major amendment, for example, initial costs or ongoing associated costs.	Required	Publication of the Effect Analysis as part of the Basis for Conclusions.	The staff assessed the likely effects of the proposed amendment as limited because the scope of the proposed amendment is narrow. The staff provided the IASB with a description of the financial reporting effects of the proposed amendment at the January 2013 IASB meeting, which are included in the Basis for Conclusions.
Due process steps reviewed by the IASB.	Required	Summary of all due process steps discussed by the IASB before a Standard is issued.	The discussion of the issues and the decision by the IASB to publish an exposure draft was taken in a single IASB meeting. Consequently there was no history of the project to discuss in the IASB meeting. However, this record of steps followed was completed and circulated to IASB members prior to publication of the exposure draft.
The ED has an appropriate comment period.	Required	The period has been set by the IASB. If outside the normal comment period, an explanation from the IASB to the DPOC has been provided, and the decision has been approved.	The IASB agreed at its January 2013 meeting that a comment period of not less than 30 days will be used for this exposure draft because of the urgency of this issue. This decision to use a 30 day comment period was agreed to by the Trustees' Due Process Oversight Committee and their agreement was notified to the IASB in its February 2013 public meeting.
Drafting			
Drafting quality assurance steps are adequate.	Required	The Translations team has been included in the review process.	The translation team reviewed drafts of these proposals before they were published.
Drafting quality assurance steps are adequate.	Required	The XBRL team has been included in the review process.	The XBRL team reviewed drafts of these proposals before they were published.

Step	*Required/ Optional*	*Metrics or evidence*	*Actions*
Drafting quality assurance steps are adequate.	Optional	The Editorial team has been included in the review process. In addition, external reviewers are used to review drafts for editorial review and the comments collected are considered by the IASB.	The Editorial team reviewed drafts of these proposals before they were published.
Drafting quality assurance steps are adequate.	Optional	Drafts for editorial review have been made available to members of the International Forum of Accounting Standard-Setters (IFASS) and the comments have been collected and considered by the IASB.	N/A
Drafting quality assurance steps are adequate.	Optional	Review draft has been posted on the project website.	N/A
Publication			
ED published.	Required	ED has been posted on the IASB website.	
Press release to announce publication of ED.	Required	Press Release has been published. Media coverage of the release.	Press release has been prepared and reviewed by Comms and Editorial.
Snapshot document to explain the rationale and basic concepts included in the ED.	Optional	Snapshot has been posted on the IASB website.	N/A