IFRS

STAFF PAPER

January 2013

IFRS Interpretations Committee Meeting

Project	**New items for initial consideration**		
Paper topic	Novation of derivatives under EMIR legislation		
CONTACT(S)	Won-Hee Han	whan@ifrs.org	+44 (0)20 7246 6960

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

As of 17 January 2013, paragraph 23 of this paper has been revised to correct a typo. The correction is to add the omitted word of 'not' in the paragraph. All the other parts of this paper have not changed. The revised paragraph of 23 is as follows:

> 23. Accordingly, some would argue that the novation should not lead to derecognition of the existing contracts.

Introduction

1. In November 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify whether an entity is required to discontinue hedge accounting in a circumstance where the hedging instrument is novated from one counterparty to another following the introduction of new regulations. Discontinuation of hedge accounting would require re-designation of the novated derivative in a new hedging relationship if hedge accounting is to be used subsequently.

2. Specifically, the issue relates to a circumstance in which over-the-counter (OTC) derivatives that are designated as hedging instrument under IAS 39 *Financial Instruments: Recognition and Measurement* are required to be novated to a central counterparty (CCP) by new legislation.

3. This agenda paper is organised as follows:

   (a) Background information.

(b) Summary of the issue.

(c) Staff analysis.

(c) Outreach activities to date.

(d) Agenda criteria assessment.

(e) Annual improvements criteria assessment.

(f) Staff recommendation.

(g) Appendix A—Submission.

Background information

4. In July 2012, the Regulation on OTC derivatives, central counterparties (CCPs) and trade repositories (the so-called European Market Infrastructure Regulation - EMIR)[1] was adopted by the European Commission and published in the Official Journal. The main obligations under EMIR are as follows:

- central clearing for certain classes of OTC derivatives;
- application of risk mitigation techniques for non-centrally cleared (ie OTC) derivatives;
- reporting to trade repositories;
- application of organisational, conduct of business and prudential requirements for CCPs; and
- application of requirements for trade repositories, including the duty to make certain data available to the public and relevant authorities.

5. This regulation is intended to resolve the problems in the OTC derivative market that were highlighted during the recent financial crisis, in line with the EU's G20 commitment made in Pittsburgh in September 2009 that all standardised OTC

[1] On 19 December 2012, the European Commission has adopted nine regulatory and implementing technical standards as regards EMIR, submitted by the European Securities and Markets Authority (ESMA). These standards are subject to the approval of the European Parliament and the Council.

derivative contracts should be cleared through a central counterparty (CCP) by the end of 2012 and that OTC derivative contracts should be reported to trade repositories.

6. EMIR is also similar in some respects to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the so-called Dodd-Frank Act) passed by the United States Congress in July 2010 in that both EMIR and the Dodd-Frank Act aim to impose OTC derivatives to be cleared through central counterparties.

Summary of the issue

7. The issue is whether an entity should discontinue hedge accounting for hedging relationships in which an OTC derivative is designated as hedging instrument under IAS 39 *Financial Instruments: Recognition and Measurement* when the OTC derivative is novated to a central counterparty (CCP) in accordance with EMIR.

8. The submitter expresses a view that a novation to a CCP would not result in discontinuation of hedge accounting under IAS 39 because it is not an expiry of an existing contract. The submitter bases its view on the following grounds:

- Paragraph 91(a) and paragraph 101(a) of IAS 39 require an entity to discontinue hedge accounting when the hedging instrument expires or is sold, terminated or exercised. However, these paragraphs are silent on whether a novation of derivative to a new counterparty would constitute an expiry.
- Paragraph 88 of IAS 39 specifies the designation and documentation requirements of a hedging relationship, but it does not specify the counterparty as one of the key elements of the designation.

9. The submitter also pointed out that if the novation to a CCP required discontinuing hedge accounting and re-designating the hedging instrument in a new hedging relationship, it would result in more hedge ineffectiveness for cash flow hedges (compared to a continuing hedging relationship). This is because the derivative that would be re-designated as hedging instrument would have a non-zero fair value at the time of the novation. In addition to the increased hedge

ineffectiveness that would have to be measured and recognised[2], there would also be an increased risk[3] that the hedging relationship would fail to meet the 80%-125% hedge effectiveness range required by IAS 39.

Staff analysis

Derecognition of existing contracts and recognition of new contracts

10. As the submitter describes, the effect of novation to a CCP under the introduction of EMIR is that a CCP becomes the new counterparty to two new derivative contracts; one with each of the original parties to the original derivative contract, instead of the original parties remaining counterparties to each other via the original bilateral contract.

11. Expressed differently, as a result of the novation, each party to the original bilateral contract will have a credit risk exposure to the CCP, but will no longer have a credit risk exposure to one another. Through the novation, they essentially exchange the credit risk of their original counterparties for the credit risk of the CCP.

12. Considering the changes to the contract as described in the preceding paragraph, we think that an initial analysis should be performed on the basis of the derecognition requirements for financial instruments, before considering the hedge accounting requirements. This is because if the derivative which was designated as a hedging instrument is required to be derecognised as a result of the novation to a CCP, hedge accounting shall be discontinued as the hedging instrument in the existing hedge relationship no longer exists.

13. We analyse two interpretations with respect to applying the derecognition requirements to the novation. The two views are as follows:

    (a) **View A.** The novation meets the derecognition requirements.

    (b) **View B.** The novation does not meet the derecognition requirements.

---

[2] The recognition is subject to the outcome of the 'lower of test' in paragraph 96(a) of IAS 39.

[3] That risk can often be successfully mitigated by choosing appropriate methods for assessing the hedge effectiveness. However, those methods often require a bigger effort for performing the testing.

View A – The existing contracts are derecognised

14. Take as an example an interest rate swap contract between party A and party B, and at the time of a novation to a CCP, party A has a positive fair value of the swap and party B has a negative fair value of the swap.

15. We observe that a derivative should be derecognised only when it meets both the derecognition criteria for financial asset and the derecognition criteria for financial liability if the derivative involves bi-directional payments between parties (ie the payments are or could be from and to each of the parties), like a swap contract[4]. In other words, party A, in the above example, shall derecognise its derivative asset at the time of the novation only when it meets the derecognition criteria both for a financial asset and for a financial liability.

16. Therefore, we examine both criteria to determine whether the novation requires party A to derecognise the derivative. Obviously, we do not need to separately examine the case of party B because the analysis for party B would be the same as for party A.

17. Paragraph 17(a) of IAS 39 (ie paragraph 3.2.3(a) of IFRS 9) requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. We note that through novation, party A has new contractual rights to the cash flows from a derivative contract with the CCP, and this new contract replaces the existing contract with party B. Thus the existing derivative contract with party B has expired. Hence, the existing derivative that party A has shall meet the derecognition criteria for financial asset

18. Paragraph AG57(b) of IAS 39 (ie paragraph B3.3.1(b) of IFRS 9) requires that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. Paragraph AG60 of IAS 39 further states that if the

[4] At the IFRIC meeting November 2006 (Please refer to Agenda Paper 10 of the meeting and IFRIC Update), the staff reported the views of the Board that "Derivative instruments can be either assets or liabilities. Consequently, a derivative such as an interest rate swap that is transferred as part of a derecognition transaction must pass both the asset and the liability derecognition tests."

debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.

19. The novation to the CCP would release party A from the responsibility to make payments to party B and would also oblige party A to make payments to the CCP. Therefore, the existing derivative that party A has shall also meet the derecognition criteria for a financial liability.

20. Based on this analysis, party A who has a positive fair value of the swap shall derecognise the derivative at the point of the novation. Concurrently, party A shall recognise a new derivative with the counterparty being the CCP.

21. Per this analysis, the novation to a CCP under EMIR requires an entity to derecognise its existing derivative contract and recognise a new derivative contract with the CCP.

View B – The existing contracts are not derecognised

22. Although the counterparty changes due to the novation, party A and B in the example above still have rights (obligations) to receive (pay) the same amounts of cash as before; the only thing that has changed is from (to) whom those cash flows will be received (paid).

23. Accordingly, some would argue that the novation should not lead to derecognition of the existing contracts.

Staff's view

24. We think that the change from one contract between parties A and B to two contracts between A and CCP and B and CCP cannot be ignored. As analysed above, the novation of the contract results in derecognition of the original derivatives pursuant to IAS 39.

25. Furthermore, we observe the decision[5] of the Interpretations Committee in its discussion about Greek Government Bonds (GGBs). The Committee noted that paragraph 40 of IAS 39 sets out that a substantial modification of terms shall lead to the derecognition of the original financial liability and the recognition of a new financial liability, and it concluded that if the paragraph is applied by analogy to the case of restructuring GGBs, the restructuring would result in derecognition.

26. We think that the novation to a CCP constitutes a 'substantial modification of terms' as referred in paragraph 40 of IAS 39 because the counterparty is a crucial element in terms and conditions of an agreement and the counterparty changes due to the novation.

27. We therefore support view A.

Discontinuation of hedge accounting

28. We first note that paragraph 91(a) and paragraph 101(a) of IAS 39 state that an entity shall discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. We therefore think that the conclusions reached on the question of derecognition above are relevant for the assessment of discontinuation of hedge accounting.

29. If we take view A above, we think that the novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.

30. We further note that paragraph 91(a) and paragraph 101(a) of IAS 39 also specify that the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy.

---

[5] The Interpretations Committee, in its May 2012 meeting, tentatively decided that the restructuring of GGBs would result in derecognition, and the Interpretations Committee decided not to add the issue to its agenda in its September 2012 meeting.

31. We think that in this situation the new contract with a CCP could not prevent discontinuation of hedge accounting under IAS 39 because the novation to the CCP was not documented at the inception of the hedge.

32. Hence, we think that hedge accounting should be discontinued when the OTC derivatives, which are designated as hedging instruments, are novated to a CCP under EMIR.

33. However, if we took view B, it would result in the conclusion that the novation does not require an entity to discontinue hedge accounting because the fact that the derivative is not derecognised means that the hedging instrument designated in the hedging relationship has not expired (or been sold, terminated or exercised) in accordance with paragraph 91(a) and paragraph 101(a) of IAS 39.

Summary of staff analysis

34. The current standards lead us to the conclusion that the novation of a derivative contract to a CCP results in the original hedge accounting ceasing and so an entity that had been using such a derivative for hedge accounting would need to re-designate the novated derivative as the hedging instrument in a new hedging relationship (if it wanted to achieve hedge accounting).

35. The re-designation, however, would have an impact on profit or loss for cash flow hedges because at that time the derivatives that are re-designated as hedging instruments will have a non-zero fair value.

36. Taking into account the fact that this issue has arisen from a specific legislative change and that the effect of the change is likely to be widespread, many desire to see hedge accounting continued, but given the analysis above, we think this would require a change to IFRSs. Those of this view think it is inappropriate to upset hedge accounting as a result of the imposition of legislation which they do not view as fundamentally changing the nature of their (economic) hedging activities.

37. If the Committee is sympathetic to that view the Committee could recommend that the IASB make a narrow-scope amendment to IAS 39 to deem such a

regulation/legislation-led novation to be an exception to the requirement to discontinue hedge accounting.

Outreach activities to date

38. We sent out a request for information to the IFASS to help assess the Committee's agenda criteria, which was still outstanding (due 17 January 2013) when this agenda paper was completed. Specifically, we asked:

    Q1. Have you observed, or do you expect to observe in your jurisdiction the introduction of any laws or regulations that require OTC derivatives to be novated and settled and cleared through a central clearing house? Please provide details.

    Q2. If you answered "yes" to Q1, what is the prevalent approach in your jurisdiction to account for derivatives that have been novated to a clearing house in a hedging relationship, and why? (If your jurisdiction is considering the establishment of such laws or regulations, what do you expect to be the prevalent approach in your jurisdiction to account for novated derivatives to a clearing house in a hedging relationship, and why?)

    Q3. Do you see any diversity in practice in that accounting / expected accounting? If so, please explain how and why the accounting is diversified.

    We will present any update at the 2013 January Committee meeting.

Agenda criteria assessment

39. Our preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance.*

        To be updated once the outreach activity is completed, however given the fact that EMIR introduces this change across Europe and Dodd-

Frank introduces similar changes in the US, we expect that the issue will be widespread.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). An item will not be added to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

To be updated once the outreach activity is completed.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

To be updated once the outreach activity is completed.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework, and the demands of the interpretation process.*

We think that existing IFRSs provide sufficient guidance as to how this fact pattern should be accounted for. However, we think that a relief could be given by the creation of an exception to the current requirements, as in the summary of staff analysis, and that this could be achieved efficiently.

(e) *It is probable that the Interpretations Committee will be able to reach a consensus on the issue on a timely basis.*

Not Applicable

(f) *If the issue relates to a current or planned IASB project, there is a pressing to provide guidance sooner than would be expected from the IASB activities. The Interpretations Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Interpretations Committee requires to complete its due process.*

A draft IFRS on general hedge accounting has been prepared and we expect that will soon be incorporated in IFRS 9. The draft has incorporated virtually the same paragraphs that are relevant to this issue

as in IAS 39 (ie paragraph 88, 91(a), and 101(a)). Therefore the current IFRS 9 project will not address this issue. However, this issue is an urgent one; given the timing of the novation requirements, we think that if an exception is to be made it should be made as quickly as possible (within the confines of the IASB's due process requirements). Given the mandatory effective date of IFRS 9 we think that it would be necessary to amend IAS 39 and to propose a similar amendment to the new hedge accounting chapter of IFRS 9.

Annual improvements criteria assessment

40. In planning whether an issue should be addressed by amending IFRSs within the Annual Improvements project, the IASB assesses the issue against certain criteria. All the criteria (a)–(d) must be met to qualify for inclusion in annual improvements. We have assessed the potential amendment against the annual improvements criteria, which are reproduced in full below:

Annual improvements criteria	Staff assessment of the proposed amendment
(a) The proposed amendment has one or both of the following characteristics: (i) clarifying—the proposed amendment would improve IFRSs by: • clarifying unclear wording in existing IFRSs, or • providing guidance where an absence of guidance is causing concern. A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle. (ii) correcting—the proposed amendment would improve IFRSs by: • resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirements should be applied, or • addressing an oversight or relatively minor unintended consequence of the existing	(a) No. The possible standard-setting action referred to above to address requires the introduction of a new exception to the principles in IFRSs and therefore does not meet the requirements for Annual Improvements

requirements of IFRSs. A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.	
(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.	(b) NA
(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.	(c) NA
(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.	(d) NA

Staff recommendation

41. On the basis of the staff analysis, the staff think that under existing IAS 39 requirements:

    (a) When OTC derivatives are novated to a CCP in accordance with EMIR, the existing OTC derivative contracts should be derecognised and new derivative contracts, with a counterparty being the CCP, should be recognised.

    (b) Consequently, an entity shall discontinue hedge accounting in which the OTC derivatives are designated as hedging instrument under IAS 39 at the time of the novation to the CCP.

42. However, the Interpretations Committee may wish to recommend that the IASB makes a narrow-scope amendment to IAS 39 to provide a limited exception to existing hedge accounting requirements such that the novation of a derivative contract that is otherwise unchaged, as a result of legislative or regulatory changes does not, of itself, cause an existing hedge relationship to be discontinued.

Question to the Interpretations Committee
1. Does the Interpretations Committee agree with staff analysis?
2. Does the Interpretations Committee want to recommend to the IASB that a narrow-scope exception should be made to IAS 39 to permit a legislative/regulation-led novation of an otherwise unchanged hedging instrument to be deemed to be a continuation of the existing hedge relationship?

Appendix A—Submission

Submission received – Novation of Derivatives under EMIR legislation

All information has been copied without modification, but the submitter has been rendered anonymous.

Mr Hans HOOGERVORST
Chairman
International Accounting Standards Board
1st Floor
30 Cannon Street
London
EC4M 6XH
By Email: hhoogervorst@ifrs.org

28 November 2012

Reference: Novation of Derivatives under EMIR legislation

Dear Sirs,

We are writing to express our concerns about a matter that has arisen as a result of the interaction between IAS 39 and the new European legislation concerning the European Market Infrastructure Regulation (EMIR). Specifically, we would like to highlight our concern over the ‘novation of derivatives’ to a Clearing House under the EMIR legislation, which is expected to become effective by the middle of 2013, and its impact on hedge accounting.

[Information about the submitter].

Over the next year, in response to the reforms of the derivatives market, many OTC derivatives will be required to be novated to central clearing houses. The effect of this is that a clearing house will become the new counterparty to two new derivative contracts, one with each of the original parties to the original derivative, instead of the original parties remaining counterparties to each other via the original bilateral contract. There is an additional possibility that, as part of these reforms, some of the derivatives will need to be transferred to different entities within the same group.

These reforms have led to a concern as to whether it is possible to continue the designation of novated derivatives in a hedge relationship, or whether the process of novation forces a dedesignation of the existing relationship and the designation of a new one. The main significance is that, for cash flow hedges, a redesignation of a derivative that already has an accumulated fair value will result in future hedge ineffectiveness to be recorded in profit or loss. Such ineffectiveness may result even though the derivative's terms and cash flows are unaffected and the clearing house now merely stands between the original two counterparties. Recognising ineffectiveness in such a scenario would not result in meaningful information being presented in the accounts. Further, in the case of collateralised swaps there won't be significant fair value differences and this effect might be pervasive if the entire industry would start recognising ineffectiveness on their cash flow hedges due to the novation where none such ineffectiveness exists.

Paragraph 101 of IAS 39, for cash flow hedges, states that "In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95-100" and sub-paragraph (a) lists as one of the circumstances, "The hedging instrument expires or is sold, terminated or exercised." (There is similar wording for fair value hedges in paragraph 91). It does not say whether a novation of a derivative to a new counterparty would constitute an expiry, and we note that paragraph 88, that specifies the designation and documentation requirements of a hedging relationship, does not specify the counterparty as one of the key elements of the designation. However, we are aware that some audit firms have not fully formed a view about whether the novation of derivative, resulting in the replacement of one original contact with two, to which the clearing house is counterparty, would trigger a requirement to discontinue a hedging relationship.

We also note that paragraph 101 (a) for cash flow hedges (and similarly paragraph 91 for fair value hedges) specifies that "the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy." This has been taken to mean that, if a novation would not result in the discontinuation of a hedge relationship, as long as the novation had been anticipated at the time the hedge was first designated. However,

we believe that a novation in these circumstances would not be a discontinuation and therefore there would be no need for the hedge accounting documentation to anticipate such a situation, consistent with the statements below.

[The submitter] raised the same concerns to the Chief Accountant of the Securities and Exchange Commission (SEC), with respect to U.S. GAAP. His response set out in his letter to [the submitter] of [date] 2012, was as follows:

> "The Staff of OCA would not object to a conclusion for accounting purposes that the original derivative has not been terminated and replaced with a new derivative contract, nor would the staff object to the continuation of existing hedge relationships when there is a novation of a derivative contract to effect a change in counterparties to the underlying contract, provided that other terms of the contract has not been changed, in any of the following circumstances:
>
> "For an OTC derivative transaction entered into prior to the application of the mandatory clearing requirements, an entity voluntarily clears the underlying OTC derivative contract through a central counterparty, even though the counterparties had not agreed in advance (ie at the time of entering in the transaction) that the contract would be novated to effect central clearing.
>
> "For an OTC derivative transaction entered into subsequent to the application of the mandatory clearing requirements, the counterparties to the underlying contact agree in advance that the contract will be cleared through a central counterparty in accordance with standard market terms and conventions and hedging documentation describes the counterparties' expectation that the contract will be novated to the central counterparty.
>
> "A counterparty to an OTC derivative transaction who is prohibited by Section 716 of the Act (or expected to be so prohibited) from engaging in certain types of derivative transactions novates the underlying contract to a consolidated affiliate..."

The Chief Accountant goes on to say that the FASB has been requested to “consider the accounting for a change in counterparties when a derivative contract is designated as a hedging instrument as part of their existing project on financial instruments.” This has been read to mean that the Chief Accountant’s confirmation that ‘the Staff wouldn’t object’ is an exception from the normal requirements of U.S. GAAP. However, the letter nowhere says that the confirmation constitutes an exception and the request to the FASB can be read as a request for more formal clarification.

For these reasons, [the submitter] strongly urge the IASB to follow the FASB’s example and provide a formal clarification on this matter with respect to IFRS as it would be confusing for users if changes to derivative contracts arising from structural / regulatory changes to financial markets were accounted for on significantly different basis by IFRS preparers compared with U.S. GAAP preparers. In addition, the effect of forcing a redesignation would not result in meaningful information, as contemplated above.

We hope you find [the submitter’s] comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,