STAFF PAPER

20 May – 24 May 2013

IASB Meeting

Project	**Novation of derivatives and continuation of hedge accounting**		
Paper topic	Comment letter analysis and suggested responses		
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Introduction

1. In February 2013, the IASB published the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting (proposed amendments to IAS 39 and IFRS 9).* The objective of the proposed amendments is to introduce a narrow-scope exception to the requirement for the discontinuation of hedge accounting in IAS 39 and IFRS 9.

2. Specifically, the proposed amendments intend to provide a relief from discontinuing hedge accounting if, and only if, the novation of a hedging instrument meets the following conditions:

   (a) the novation is required by laws or regulations;

   (b) the novation results in a central counterparty (sometimes called a 'clearing organisation' or 'clearing agency') becoming the new counterparty to each of the parties to the novated derivative; and

   (c) the changes to the terms of the novated derivative arising from the novation of the contract to a central counterparty are limited to those that are necessary to effect the terms of the novated derivative. 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. These changes include 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 central counterparty; and charges levied by the central counterparty.

3. The IASB also decided to propose that equivalent amendments to those proposed to IAS 39 should be made to the forthcoming chapter on hedge accounting that will be incorporated in IFRS 9.

4. The IASB decided, however, not to propose to require additional disclosures when an entity does not discontinue hedge accounting as a result of the novation that meets the criteria of these proposed amendments to IAS 39 and IFRS 9.

5. The proposed amendments were a response to an urgent request for guidance for novations arising as a consequence of legislative and regulatory changes resulting in novations to central counterparties. Given the urgency of the issue and the narrow scope of the proposed amendments the comment period was 30 days.

Objective of the paper

6. The objective of this paper is to provide an analysis of the comment letters received and to make recommendations on whether the IASB should:

   (a) proceed with the amendments to IAS 39 and IFRS 9;

   (b) consider expanding the scope of the amendments;

   (c) consider providing a transition relief; and

   (d) consider modifying the wording for the proposed final amendments.

Structure of the paper

7. The structure of the paper is as follows:

   (a) Background information on the issue (see Introduction above);

   (b) Objective of the paper;

   (c) Feedback summary of the comment letters received;

   (d) Analysis of comments received with regard to agreement or disagreement with the proposal;

(e) Analysis of comments received with regard to the three criteria proposed in the Exposure Draft;

(f) Analysis of comments received with regard to the transition requirements and first-time adoption;

(g) Analysis of comments received with regard to wording of the proposed amendments;

(h) Analysis of comments received with regard to equivalent amendments to IFRS 9;

(i) Analysis of comments received with regard to disclosure requirements;

(j) Summary and staff recommendation;

(k) Due process consideration; and

(l) Appendix A: Summary of characteristics of respondents.

Feedback Summary

8. 76 comment letters were received from 6 continents and from global organisations including global accounting firms. A summary of the characteristics of the respondents is provided in **Appendix A**.

9. The vast majority of respondents agreed with the proposal. However, a few respondents[1] expressed disagreement with the proposal. The respondents who disagreed with the proposal viewed that the proposed amendments are not necessary because the current Standards would not necessarily force the hedge accounting to be discontinued as a consequence of the novation that meets the criteria proposed in the Exposure Draft.

10. A considerable majority of respondents disagreed with the scope of the proposed amendments[2]. They pointed out that the proposed scope of 'novation required by

[1] Barclays PLC, The South African Institute of Chartered Accountants, Standard Chartered PLC, International Swaps and Derivatives Association, Inc.

[2] The respondents who agreed with the scope of the proposed amendments include Association of Chartered Certified Accountants, Australian Accounting Standards Board, Brazilian Accounting Pronouncements Committee, Consejo Mexicano de Normas de Informacion Financiera (CINIF), Grant Thorton International,

laws or regulations' is too restrictive and therefore that the scope should be expanded by removing this criterion. In particular, they argued that voluntary novation to a central counterparty (CCP) should be provided with the same relief as novation required by laws or regulation. A few of them[3] further requested that the scope should not be limited to the novation to a central counterparty and that novation in other circumstances should also be considered.

11. Some respondents commented on the third criterion of the proposed amendments, which describes acceptable changes to the terms of the novated derivative other than a change in counterparty to the central counterparty. They viewed that this criterion is potentially confusing, and therefore suggested that the wording be clarified.

12. No respondents disagreed that the equivalent amendments to those proposed to IAS 39 should be made to the forthcoming chapter on hedge accounting that will be incorporated in IFRS 9.

13. Almost all respondents agreed that the proposed amendments do not require additional disclosures.

Analysis of comments received with regard to agreement or disagreement with the proposal

Feedback received

14. The vast majority of respondents supported the proposal to provide relief from discontinuing hedge accounting. However, some respondents objected to the proposal, arguing that the current Standards would not force hedge accounting to be discontinued in the circumstance described in the proposal.

15. The following are major reasons that the respondents who objected to the proposal cited:

Group of Latin American Accounting Standard Setters (GLASS), Institute of Certified Public Accountants of Kenya, Institute of Certified Public Accountants of Singapore, Korea Accounting Standards Board, Malaysia Accounting Standards Board, SwissHoldings, The Linde Group and Zambia Institute of Chartered Accountants.

[3] EADS, The French Banking Federation, The South African Institute of Chartered Accountants

(a) a novation is not necessarily a derecognition of the original hedging instrument because a change in counterparty does not constitute a substantial modification to the terms of the contract;

(b) the current Standards relating to the designation and documentation requirements of a hedging relationship do not specify a change in counterparty as one of the key elements of the designation; and

(c) novation can be analogised to the requirement for the 'replacement' or 'rollover' of the hedging instrument, which permits continuation of the hedge accounting.

Staff analysis and recommendation

16. We think that the deliberations by the IFRS Interpretations Committee[4] and the IASB have already addressed the points above described in paragraph 15.

17. As for the first point in paragraph 15(a), the IASB considered whether the novation to a CCP meets the derecognition requirements of IAS 39 (and IFRS 9) and concluded that the novation of a derivative to a CCP would result in derecognition of the derivative. In reaching this conclusion, the IASB particularly noted that the novation to a CCP would result in the expiry of the original contract and its replacement with a new contract (with the CCP).

18. The responses of some respondents reflect a view that novation is 'merely' a change in a contractual term. We note however that the IASB's conclusion is supported by the legal definition of novation[5]:

> Novation is a means of discharging a debt. A new contract is substituted for an existing contract, between either the same parties or different parties, the consideration usually being the discharge of the old contract. Thus, with novation, a new legal basis is created for contractual rights and obligations. (…)

[4] Refer to the agenda paper 21 for the January 2013 IFRS Interpretations Committee meeting (http://www.ifrs.org/Meetings/Pages/InterpretationsJanuary2013).

[5] Paragraph 5.1 of "Derivatives clearing, central counterparties and novation: The economic implications" written by R. Bliss, C. Papathanassiou (http://www.ecb.int/events/pdf/conferences/ccp/BlissPapathanassiou_final.pdf),

19. Novation is used in the context of the new requirements to contract with CCPs because it is essential that the original contract is extinguished (to prevent continued exposure to the credit risk of the original counterparty). Consequently, the novation of a derivative to a CCP would be accounted for as the derecognition of the existing derivative and the recognition of the (new) novated derivative.

20. The IASB also noted that if the derivative that was designated as a hedging instrument is derecognised and the (new) novated derivative should be recognised, the hedging instrument in the original hedging relationship no longer exists. Consequently, the second point in paragraph 15(b) would not be relevant.

21. With regard to the third point in paragraph 15(c), we note that the respondent's argument is based on the grounds that a change in counterparty is a much less significant change in circumstances than changes involving a replacement or rollover; consequently, the novation to a CCP should also be permitted for continuation of hedge accounting. However, we note that this exception relates to "[a] replacement or rollover [that] is part of the entity's documented hedging strategy" (IAS 39.91(a) and 101(a)). We question whether replacement of a contract as a result of unforeseen legislative changes fits the description of a replacement that is part of a 'documented hedging strategy'.

22. Consequently, we recommend that the IASB should proceed with the proposal to provide a relief from discontinuing hedge accounting in respect of novations (the scope of the relief will be addressed in later questions).

Question 1
Does the IASB agree to proceed with the proposal to provide a specific amendment to address novations?

Analysis of comments received with regard to the three criteria proposed in the Exposure Draft

23. The proposed amendments suggest that a relief from discontinuing the hedge relationship be provided only if the novation to a CCP meets three criteria (please refer to paragraph 2 in this paper).

24. We therefore performed an analysis of comments on each criterion as follows:

    (a) novation required by laws or regulations (**Criterion 1**);

    (b) novation to a CCP (**Criterion 2**); and

    (c) acceptable changes to the terms of the novated derivative (**Criterion 3**)

25. We discuss significant concerns raised by stakeholders regarding each of the proposed criteria.

Novation required by laws or regulations (Criterion 1)

26. The Exposure Draft limits the scope of the proposed amendments to novation that is required by laws or regulations. In determining this scope, the IASB noted that the amendments should be as narrow as possible, but at the same time, should be applicable regardless of jurisdiction. We note the following staff recommendation in the agenda paper for January 2013 IASB meeting [emphasis added]:

> 11. Consistently with this, we think that the amendment to IAS 39 and IFRS 9:
>
> (a) should be applied only to a novation required as a result of legislation, regulation or similar statutory requirement. This means that **voluntary novation to a CCP would not be included within the scope of the exception because such a novation does not arise as a result of laws and regulations**;
>
> (b) (…)

27. Consequently, the Exposure Draft suggests that voluntary novation to a CCP should be excluded from the scope of the proposed amendments. The Exposure Draft however invited comments on whether stakeholders agree with the scope of the proposed amendments noting that the objective was to address novations arising from current changes in legislation or regulation requiring the greater use of central counterparties (as Question 2 of the invitation to comment on the proposed amendments).

Feedback received

28. Some respondents agreed with the scope of the proposed amendments. However, the vast majority of respondents expressed opposition to them. Specifically, they disagreed with Criterion 1, requesting that it be removed from the criteria. Major concerns raised by these respondents are as follows.

    (a) an entity could voluntarily novate its derivatives in anticipation of new regulatory change, because of operational ease, or for compliance with best practice in terms of risk management;

    (b) voluntary novation to central counterparties should not be penalised or disincentivised;

    (c) an entity could novate its derivative when it is not required by laws or regulations if it would otherwise incur an additional regulatory capital charge;

    (d) the effects of the amendments, as drafted in the Exposure Draft, would be minimal because most jurisdictions would not require novation for existing contracts;

    (e) this criterion is not consistent with the position of the US SEC[6]; and

    (f) the objective of the proposed amendments would be achieved without this criterion.

[6] The following are the circumstances in which the US SEC letter mentioned that the existing hedge relationship is continued:

> "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 that is not insured by the FDIC and does not have access to Federal Reserve credit facilities."

Staff analysis

Voluntary novation to the CCP

29. We note that the objective of the proposed amendments is to accommodate new laws or regulations that mandate central clearing for derivatives. We also note that the IASB considered that accounting effects due to the new laws or regulations would be widespread because such laws or regulations were prompted by a G20 commitment.

30. In terms of the G20 commitment, we observe a suggestion made by the Financial Stability Board (FSB) in its report *Implementing OTC Derivatives Market Reforms* published on 25 October 2010:

> **3.2.3 Phase-in considerations for historical contracts**
>
> To ensure the G-20 commitment that all standardised OTC derivatives should be centrally cleared is fully met, the existing stock of outstanding historical contracts must also be considered. While new products subject to mandatory clearing requirements would be cleared through CCPs, consideration should be given to moving the existing stock of historical contracts (backloading) to CCPs where practicable. (…)

31. As described in the FSB's suggestion above, jurisdictions were encouraged to require existing derivatives to be novated to central counterparties (CCPs) (that is, backloading). However, it seems that almost all jurisdictions would not require backloading; even though some jurisdictions require 'backloading' the scope of it is very limited.

32. However, we think that novation to CCPs could be prevalent in the following circumstances:

    (a) novation in anticipation of regulatory changes (we note that a few respondents stated that many financial institutions have already begun the process of novation to central counterparties in anticipation of forthcoming legislation);

    (b) operational ease was cited as a reason for voluntary novation. One bank mentioned that it is operationally easier to have all derivatives of the same type being cleared with the same CCP (so novation may occur for existing derivatives to align them with new ones although not required); and

(c) novation to the CCP may be induced rather than required by laws or regulations, for example as a result of the imposition of charges or penalties.

33. In this regard, we think that expanding the scope of the proposed amendments to include voluntary novation to the CCP would correspond to the objective of the G20 commitment and consequently, to the objective of the new related laws or regulations, even if the novation to the CCP is not required by such new laws or regulations.

Staff recommendation

34. On the basis of the analysis above, we recommend that the IASB should include voluntary novation to a CCP in the scope of the proposed final amendments, by removing Criterion 1 from the criteria. Voluntary novation to the CCP is in line with the objective of the proposed amendments.

Novation to a CCP (Criterion 2)

35. In the Exposure Draft, Criterion 2 was proposed as follows:

> the novation results in a central counterparty (sometimes called a 'clearing organisation' or 'clearing agency') becoming the new counterparty to each of the parties to the novated derivative

Feedback received

36. Some respondents agreed with Criterion 2. However, many respondents expressed concern about Criterion 2 and requested that other situations also be considered.

37. Some respondents commented that in some jurisdictions, only entities that are 'clearing members' of the CCP may enter into derivatives with the CCP as counterparty and therefore, entities who are not clearing members would be required to **novate derivatives to a clearing member** rather than directly to the CCP.

38. Furthermore, they mentioned that some jurisdictions are introducing **'indirect clearing'** arrangements, where an entity transacts with another entity who in turn transacts with a clearing member who transacts with the CCP.

39. In addition, some of the respondents among those who expressed the concern suggested that **intragroup novation** should be included in the scope of the amendments. In particular, they pointed out that intragroup novation needs to be

considered as being the continuation of the existing hedging relationship if it is compelled by new laws or regulations relating to mandating central clearing of derivatives. Some of them cited a case mentioned in the US SEC letter published on 11 May 2012[6].

40. Some respondents commented that the scope of the proposed amendments needs to be expanded to **novation to any counterparty**. They argued that accounting should not be dependent on the status of the counterparty to a novation.

Staff analysis

Novation to a clearing member of a CCP

41. We note that there is a case where a CCP has a contractual relationship only with its 'clearing members', and therefore some entities have to have a contractual relationship with the clearing members which then transact with the CCP. Consequently, entities which are not clearing members would be required to novate derivatives to a clearing member of the CCP.

42. We note that the current wording in Criterion 2 would not accommodate such novation to a clearing member of the CCP because the current wording of Criterion 2 only prescribes that a CCP becomes the new counterparty to the new derivative as a result of the novation.

43. We think that novation to a clearing member of the CCP is no different from novation to the CCP in terms of the objective of the proposed amendments, because the novated derivative would be cleared through the CCP as well. Consequently, we think that this type of novation should also be included in the scope of the amendments and Criterion 2 should therefore be reworded to accommodate it.

Novation to a client of a clearing member of the CCP

44. We note that as respondents commented, a so-called 'indirect clearing' arrangement is being introduced in the laws or regulations of some jurisdictions. The 'indirect clearing' arrangement basically means that a client of a clearing member of the CCP provides a (indirect) clearing service to its client just as a clearing member of the CCP provides a clearing service to its client. According to a consultation paper published

by an organisation in one jurisdiction[7], the 'indirect clearing' is also explained in a way that the structure of a CCP, a clearing member and a client of a clearing member is replicated as that of a clearing member, a client of a clearing member and a client of a client of a clearing member. We think that in this 'indirect clearing' scheme, an existing derivative may be novated to a client of a clearing member.

45. We note that in one jurisdiction, indirect clearing is not uncommon and has been adopted by some smaller institutions, for example, in order to access third country CCPs. Consequently, considering these facts that indirect clearing would not be uncommon and it is an intermediary mechanism to access a CCP, we think that we need to accommodate indirect clearing in our amendments.

46. Consequently, we think that Criterion 2 should be reworded to permit novation that involves indirect clearing (ie to accommodate novation to clearing intermediaries) as described above.

Intragroup novation

47. Another variant raised was where in order to effect the move to a CCP, an intragroup novation also occurs (for example, because only particular group entities can transact with a CCP). We think that such intragroup novation is consistent with the objective of the proposal because it results in clearing through a CCP.

48. Consequently, we think that such novation should be considered a form of 'indirect clearing' and also scoped into the amendment.

Novation to any counterparty

49. We note that a few respondents suggested expanding the scope of the proposed amendments to the novation to a counterparty other than a CCP and unrelated to an ultimate transaction with a CCP; for example, one respondent requested that the scope of the amendments should include any novation resulting from increased credit risk of the counterparty; an entity seeks to reduce counterparty credit risk by novating to a counterparty that has a lower credit risk. They did not see why the status of the counterparty to a novation should be relevant for deciding whether accounting for the

[7] Paragraph 22 of Consultation Paper "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories" published in June 2012 by European Securities and Markets Authority (http://www.esma.europa.eu/system/files/2012-379.pdf)

novation as a continuation of an existing hedge relationship provides more useful information to users of financial statements.

50. We think that expanding the scope of the proposed amendments to novation to any other counterparty other than a CCP does not meet the objective of this narrow-scope amendment. As mentioned above, we note that the objective of this proposal is to accommodate the new regulatory changes and these changes relate to mandating central clearing of derivatives. Considering the effect of novation more broadly would require extensive analysis in respect of derecognition. This is beyond the scope of what the IASB has considered (and what has been exposed for (expedited) comment). Consequently, we believe that it is appropriate only to consider novation related to CCPs in this amendment.

Staff recommendation

51. On the basis of the analysis above, we recommend expanding the scope of the final amendment to include novation to a clearing member of the CCP and novation as part of an 'indirect clearing' arrangement by rephrasing Criterion 2.

Acceptable changes to the terms of the novated derivative (Criterion 3)

52. In the Exposure Draft, Criterion 3 consists of three sentences as follows:

    (a) the changes to the terms of the novated derivative arising from the novation of the contract to a central counterparty are limited to those that are necessary to effect the terms of the novated derivative;

    (b) 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; and

    (c) these changes include 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 central counterparty; and charges levied by the central counterparty.

Feedback received

53. Although a few respondents opposed Criterion 3, many respondents agreed with it: a few respondents agreed with Criterion 3 without condition; however, several respondents agreed with Criterion 3 on the condition that the current wording is rephrased so that it could clarify the meaning of Criterion 3.

54. The most common concern from the respondents was that the current wording can be read as though an entity were required to retroactively determine what the terms of the contract with the CCP would have been in order to decide whether the entity meets Criterion 3.

55. Some respondents also stated that the current wording is confusing because it is not clear whether the examples of acceptable changes to the terms of the contract cited in Criterion 3 are exhaustive or if there is a circular nature to the first sentence of Criterion 3.

Staff analysis and recommendation

Purpose of Criterion 3

56. The IASB acknowledged that novation to the CCP inevitably entails some changes to the terms of the original contract in addition to the change of counterparty to the CCP, which are incidental in nature. Consequently, the IASB noted that entities would not benefit from the proposed amendments without accommodating this practical aspect. Consequently, the proposed amendments included Criterion 3 to reflect that aspect.

57. We note that the first sentence of Criterion 3 is basically intended to describe the fact that changes to the terms of the original contract other than the change of counterparty to the CCP are **'directly attributable'** and **'incidental'** to the novation to the CCP; the second sentence of Criterion 3 intends to clarify what 'directly attributable' means; and the third sentence provides some (non-exhaustive) examples of changes that are 'directly attributable' and 'incidental' to the novation to the CCP.

58. We note that only one respondent requested removal of Criterion 3, arguing the other two sentences are sufficient. Consequently, we think that most respondents who expressed concern about the current wording of Criterion 3 did not object to the purpose of Criterion 3. We think that any changes to the current wording can be considered without reconsidering the purpose of Criterion 3.

First sentence of Criterion 3

59. We note that only a few respondents raised a concern over the first sentence of Criterion 3: one respondent commented that it is circular in nature; and another respondent suggested a wording that uses ‘incidental’ and ‘direct consequences of laws’.

60. We think that although we did not receive many comments regarding the first sentence of Criterion 3, it is necessary to clarify what this sentence means because the sentence can be confusing because of the use of ‘the terms of the novated derivative’ twice in this sentence.

Second sentence of Criterion 3

61. We note that the most of the concerns relating to Criterion 3 focus on the second sentence: some respondents commented that Criterion 3 can achieve its purpose without the second sentence; some other respondents pointed out that it can be read as though an entity were required to carry out a retrospective assessment going back to the original contract date of the derivative.

62. We think that removing the second sentence in entirety would not improve the understanding of Criterion 3 because the second sentence intends to clarify the meaning of the first sentence by specifying what ‘directly attributable’ means, as analysed above. We however think that it needs to be reworded to reduce confusion about whether this sentence requires a retrospective examination by the entity.

Third sentence of Criterion 3

63. We note that one respondent suggested a removal of the third sentence because there could be other cases in addition to the list of the examples described in this sentence and another respondent requested clarification of whether the list of the examples is exhaustive.

64. We think that the current wording is clear enough to indicate that the list of the examples is not exhaustive because the phrase ‘these changes include’ would not be read as the list of the examples being exhaustive. Consequently, we think that it is appropriate to maintain the third sentence as it stands.

65. On the basis of the analysis regarding Criterion 3, the proposed wording of Criterion 3 is as follows:

any other changes to the hedging instrument on novation are limited to those that are necessary to effect the replacement of the respective original counterparty with a central counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally entered into with the central counterparty. These changes include changes in the contractual collateral requirements, rights to offset receivables and payables balances with the central counterparty and charges levied by the central counterparty.

Question 2

Does the IASB agree that:

(a) Criterion 1 should be removed and therefore the scope of the amendments be expanded to voluntary novation to the CCP;

(b) the scope of the amendments should include novation to a party as part of indirect clearing to a CCP and

(c) Criterion 3 should be maintained with rewording as set out in paragraph 65?

Analysis of comments received with regard to transition requirements and first-time adoption

66. The Exposure Draft included a proposed requirement for effective date and transition as follows:

> Novation of Derivatives and Continuation of Hedge Accounting (Amendments to IAS 39), issued in xxx 20xx, amended paragraphs 91 and 101 and added paragraph AG113A. An entity shall apply those paragraphs for annual periods beginning on or after 1 January 20xx. Earlier application is permitted.

67. In the absence of specific words, the amendments as proposed would be applied retrospectively consistent with the 'default' approach to transition in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Feedback received

68. Some respondents commented on the proposed requirement for effective date and transition in the Exposure Draft. Many of the respondents who commented on this point expressed support for the option of early application. However, some respondents requested that transition relief should be provided so that novations entered into prior to the finalisation of the amendments can be exempt from the application of the amendments; prospective application (with a consequential amendment to IFRS 1) was suggested as a way of providing transition relief.

Staff analysis and recommendation

69. The proposed amendments provide relief in the sense that they enable hedge accounting to continue in the event of novation to a CCP when it otherwise would not be possible.

70. By allowing retrospective application, following the amendments, entities' financial statements would be as if hedge accounting had continued even when there were novations to CCPs in the past. Prospective application would mean that the amendments and associated relief would only be available for novations to CCPs occurring in the future.

71. Responses indicate that in fact relief is desired. Retrospective application provides the greatest relief. It means that once the amendments are finalised entities would be able to continue hedge accounting retrospectively where there were novations to CCPs in the past. (This could be particularly relevant for novations occurring just prior to the finalisation of these amendments).

72. If application is retrospective and early application is permitted, then the greatest possible relief is provided.

73. We note that some respondents are concerned with the effect of the proposed amendment on hedge accounting for novations occurred in the past. We think that the question implicit in that concern is what happens with the *historical* accounting for such novations.

74. However, neither retrospective nor prospective application changes the IFRS that was applicable at the time the old accounting actually occurred (ie as reported in past

financial statements). Thus the old accounting is unaffected by the decision made about whether the amendments are retrospective.

75. We recommend that the amendments apply retrospectively and that early application be allowed as was proposed in the Exposure Draft. Retrospective relief means that in [2014] an entity's financial statements would reflect continued hedge accounting when a novation to a CCP occurred prior to these amendments.

Question 3
Does the IASB agree that the amendments should apply retrospectively and early application should be allowed as was proposed in the Exposure Draft?

Analysis of comments received with regard to wording of the proposed amendments

76. Respondents raised concerns about the current wording of the proposed amendments. The following are the major concerns:

(a) the term 'novation';

(b) the phrase 'if and only if'; and

(c) other comments.

The term 'novation'

Feedback received

77. A few respondents commented that using the term 'novation' may be confusing. They indicated that novation is used in a wide range of situations and some of these do not involve a change in counterparty (only involving changes such as maturity, price or collateral arrangements).

Staff analysis and recommendation

78. We observe that 'novation' is a legal term, which is not commonly used in plain English. We think that if the IASB decides to remove Criterion 1 (that is, novation is required by laws or regulations) as we recommended in this paper, it would be more

appropriate to rephrase the term ‘novation’ by using plainer English because ‘novation’ would not need to be understood in terms of a legal context.

79. Consequently, we recommend that ‘novation’, as was used in the Exposure Draft, should be replaced by the wording that does not rely on a legal definition; for example, it can be explained in a descriptive way, such as, ‘substitution of the original counterparty to the contract for a new counterparty’.

The phrase ‘if and only if’

Feedback received

80. Some respondents raised a concern about using the phrase ‘if and only if’ because it might cause conflict with current accounting practice, by which certain types of novation, regardless of whether the new counterparty is a CCP or any other third party, have been accounted for as continuation of the hedge relationship.

Staff analysis and recommendation

81. As noted above, an amendment to IFRS cannot change the accounting in the past for transactions that occurred using IFRS prior to that amendment. However, we note that the Exposure Draft was intended to address a narrow issue – novation to CCPs. For that reason, we are of the view that it may be better to reword the amendment to say the relief is provided ‘if’ the criteria are met. That would have the effect of requiring an analysis of whether the general conditions for continuation of hedge accounting are satisfied in other cases (for example, in determining the effect of intragroup novations in consolidated financial statements which was raised by some respondents) and would target the amendment to the fact pattern the IASB sought to address. Consequently, we recommend rewording the amendment to ‘if’.

Other comments

Feedback received

82. Respondents commented on several parts of the proposed amendments with regard to the current wording in the Exposure Draft. Major comments are as follows:

    (a) the first paragraph of the Introduction and paragraph BC10 of the Exposure draft state that the proposed amendments would ‘require’ an entity to continue

hedge accounting. The word 'require' is potentially confusing because paragraph 91 and 101 of IAS 39 do not 'require' an entity to continue hedge accounting;

(b) paragraph AG113 is unnecessary because there is no serious doubt that the fair value changes of the hedging instrument that arise from the novation of the hedging instrument shall be reflected in the measurement of the novated derivative and therefore in the measurement of hedge effectiveness;

(c) when Paragraph 91 and 101 of IAS 39 refer to the fact that novation is not an expiration or termination, they need to explicitly state the phrase 'for this purpose' as consistently as these paragraphs refer to for the 'replacement' or 'rollover' of derivatives; and

(d) more clarification is needed to explain why the novation of an existing hedging instrument to a CCP results in the derecognition of the hedging instrument.

Staff analysis and recommendation

Usage of word 'require'

83. Respondents mentioned that the word 'require' is potentially confusing when explaining that the proposed amendments would 'require' an entity to continue hedge accounting because the current paragraph 91 and 101 of IAS 39 do not 'require' an entity to continue hedge accounting.

84. We note that this issue was discussed at the January 2013 IASB meeting. The IASB discussed whether the words 'require' or 'allow' would be more appropriate in describing the circumstances of the proposed amendments in the Exposure Draft. The IASB noted that even if the entity is 'required' to continue the hedge accounting when it meets the conditions proposed in the Exposure Draft, it is able to discontinue the hedge accounting in accordance with paragraph 91 or paragraph 101 of IAS 39. Consequently, the IASB decided to use the word 'require' in the proposed amendments.

85. Consequently, we recommend that the IASB maintain its decision as in the Exposure Draft.

Deletion of paragraph AG113A

86. Respondents stated that paragraph AG113A proposed in the Exposure draft is unnecessary because the requirement is obvious.

87. The proposed paragraph AG 113A is cited as follows:

> For the avoidance of doubt, any fair value changes of the hedging instrument that arise from the novation of the hedging instrument in the circumstances described in paragraphs 91(a) or 101(a) shall be reflected in the measurement of the novated derivative and therefore in the measurement of hedge effectiveness.

88. We note that this proposed paragraph is not intended to change any existing requirements, but to clarify the current accounting to avoid confusion as a consequence of the proposed amendments. We think that this purpose of paragraph AG 113A is clearly explained by the phrase 'for the avoidance of doubt' in the first sentence of the paragraph. Consequently, although this paragraph may be regarded as unnecessary by some stakeholders, we think that it could be useful to other stakeholders.

89. Consequently, we recommend that the IASB should maintain this proposed paragraph as in the Exposure Draft.

Addition of 'for this purpose'

90. Respondents pointed out that paragraph 91 and 101 of IAS 39 state the phrase 'for this purpose' when prescribing that 'replacement' or 'rollover' is not an expiration or termination of an hedging instrument, while the propose amendments do not use the phrase 'for this purpose' when prescribing that novation is not an expiration or termination of an hedging instrument.

91. The current wording of the proposed amendments in the Exposure Draft related to this issue is as follows [new text is underlined and deleted text is struck through]:

> **Fair value changes**
>
> An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:
>
> (a) the hedging instrument expires or is sold, terminated or exercised. ~~(~~<u>F</u>or this purpose, 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~~);~~ Additionally, the novation of a hedging instrument is not an expiration or termination if and only if:

(i) …

92. We think that adding the phrase 'for this purpose' when amending this paragraph would achieve consistency with the existing previous sentence that describes the case of 'replacement' or 'rollover'. Consequently, adding this phrase would clarify the meaning of the proposed amendments.

93. Consequently, we recommend that the IASB should add this phrase 'for this purpose' when considering the wording for the proposed final amendments.

Clarification on why the amendments meet derecognition requirements

94. Respondents suggested that more clarification is needed to explain why the novation of an existing hedging instrument to a CCP results in the derecognition of the hedging instrument.

95. We note that paragraphs BC4 and BC5 in the Exposure Draft describe the IASB's discussion and conclusion in terms of the derecognition requirements in IAS 39. The paragraphs are cited as follows:

> BC4 The IASB considered the derecognition requirements in IAS 39 to determine whether the novation in such a circumstance leads to the derecognition of an existing OTC derivative that is designated as a hedging instrument. The consequence of concluding that the OTC derivative should be derecognised is that hedge accounting would have to be discontinued because the hedging instrument in the existing hedging relationship no longer exists.
>
> BC5 The IASB concluded that the novation to a CCP would meet the derecognition requirements both for financial assets and financial liabilities in IAS 39. Consequently, the IASB concluded that an entity is required to discontinue the hedge accounting for an OTC derivative that has been designated as a hedging instrument in the existing hedging relationship if the OTC derivative is novated to a CCP. The new derivatives, with a counterparty being the CCP, are to be recognised at the time of the novation.

96. We acknowledge that the description in these paragraphs might not be sufficient for some stakeholders to understand in detail the basis for the IASB's conclusion although the related agenda paper and recording (for January 2013 IASB meeting) are publicly available on the IFRS Foundation website. We think that more clarification on this matter would provide useful information to some stakeholders.

97. Consequently, we recommend that the IASB should provide in more detail the reason why it concluded that novation of an existing hedging instrument to a CCP results in the derecognition of the hedging instrument in the of Basis for Conclusions.

Question 4
Does the IASB agree with the staff analysis and recommendation regarding the respondents' comment on the wording of the proposed amendments?

Analysis of comments received with regard to equivalent amendments to IFRS 9

Feedback received

98. We did not receive any comment that opposes equivalent amendments to those proposed to IAS 39 being made to the forthcoming chapter on hedge accounting that will be incorporated in IFRS 9; many respondents expressed support for the equivalent amendments.

Staff analysis and recommendation

99. On the basis of the comments from respondents, we recommend that the IASB should make equivalent amendments to IFRS 9.

Question 5
Does the IASB agree that equivalent amendments to those for IAS 39 be made to the forthcoming chapter on hedge accounting that will be incorporated in IFRS 9?

Analysis of comments received with regard to disclosure requirements

100. The IASB decided not to require an entity to disclose information with regard to the proposal. The reason for the decision was explained in the Basis for Conclusions in the Exposure Draft as follows:

> BC13 The IASB discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposed amendments to IAS 39 and IFRS 9. The IASB decided that it was not appropriate to mandate specific disclosure in this situation as from the perspective of a user of financial statements, the hedge accounting would be on-going.

Feedback received

101. The vast majority of respondents agreed with the proposal not to require additional disclosure requirements. However, a few respondents viewed that additional disclosures would provide useful information. One respondent suggested that the IASB might consider requiring an entity to disclose: that novation has occurred; whether the novation occurred prior to the novation deadline, and if so when the novation deadline was and why the entity elected to novate earlier than required; the law/regulation requiring the novation; which central counterparties (CCP(s)) the instrument(s) have been novated to; a summary of the terms and conditions imposed by the CCP that differ from the original terms, and any financial impact (including hedge ineffectiveness). Another respondent expressed a view that since the change of the counterparty risk profile is useful information, such information needs to be reported in accordance with IFRS 7.

Staff analysis and recommendation

102. We note that although the Exposure Draft does not require additional disclosures as to the proposed amendments, an entity may consider disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures,* which requires qualitative and quantitative disclosures with regard to credit risk. We also note the fact that only a few respondents suggested additional disclosures, while the vast majority of respondents agreed with the proposal.

103. Consequently, we recommend that the IASB should maintain its decision not to require additional disclosures as in the Exposure Draft.

Question 6
Does the IASB agree that additional disclosure should not be required?

Summary and staff recommendation

104. We performed an analysis on comment letters and recommended that:

(a) Criterion 1 (ie 'novation required by laws or regulations') should be removed and therefore the scope of the proposed amendments be expanded to voluntary novation to the CCP;

(b) the scope of the amendments should include novation to a party as part of indirect clearing to a CCP by rewording Criterion 2;

(c) Criterion 3 (ie acceptable changes to the term of the novated derivative) should be maintained with some rewording to reduce confusion;

(d) retrospective application with permission of early application be maintained as proposed in the Exposure Draft;

(e) equivalent amendments to IAS 39 be made to the forthcoming chapter on hedge accounting that will be incorporated in IFRS 9, as proposed in the Exposure Draft;

(f) no additional disclosure should be required, as proposed in the Exposure Draft;

(g) the term 'novation' should be replaced with a non-legal term;

(h) the phrase 'if and only if' should be reworded to 'if';

(i) the phrase 'for this purpose' should be added as in the same manner for the existing requirements for 'replacement' and 'rollover' when finalising the amendments; and

(j) more explanation should be provided in the Basis for Conclusions as to why the novation of an existing hedging instrument to a CCP results in the derecognition of the hedging instrument about this proposed amendment.

Due process consideration

Re-exposure

105. Paragraph 6.25 of the IASB and IFRS Interpretations Committee *Due Process Handbook (*the *Due Process Handbook)* sets out the following guidance on determining whether re-exposure is necessary:

> In considering whether there is a need for re-exposure, the IASB:
>
> (a) identifies substantial issues that emerged during the comment period on the Exposure Draft and that it had not previously considered;
>
> (b) assesses the evidence that it has considered;
>
> (c) determines whether it has sufficiently understood the issues, implications and likely effects of the new requirements and actively sought the views of interested parties; and
>
> (d) considers whether the various viewpoints were appropriately aired in the Exposure Draft and adequately discussed and reviewed in the Basis for Conclusions.

106. We note that the significant issue that respondents on the Exposure Draft raised is related to expansion of the scope of the proposed amendments. We also note that this issue was considered by the IASB during the deliberation for issuing the Exposure Draft and therefore the Exposure Draft included a specific question to invite comments on the scope of the proposed amendments. Our analysis of the comments received is set out in this paper. Our recommendation is that the scope should be broadened only to include voluntary novations to CCPs, and indirect novations to CCPs, reflecting the comments received.

107. Having considered the re-exposure criteria, we do not think that re-exposure is necessary.

Effective date

108. The IASB's due process requirement states that "the mandatory effective date is set so that jurisdictions have sufficient time to incorporate the new requirements into their

legal systems and those applying IFRS have sufficient time to prepare for the new requirements".[8]

109. We note that the objective of the proposed amendments is to accommodate new laws or regulations that mandate central clearing for derivatives and that such laws or regulations have already been, or will shortly, come into force in some jurisdictions.

110. Consequently, we think that the mandatory effective date should be set as early as possible, while considering the fact that jurisdictions have sufficient time to prepare for the new requirements.

111. In this respect, we recommend that the mandatory effective date is set at 1 January 2014 if the final amendments are published by the end of the 2nd quarter of 2013.

Balloting

112. The *Due Process Handbook* states the process with regard to consideration of comments received and consultations:

> 6.19 After the comment period ends, the IASB reviews the comment letters and the results of the other consultations, such as the investor consultation. The technical staff provides a summary of the comment letters, giving a general overview of the comments received and the major points raised in the letters. The analysis helps the IASB to identify the areas on which they are most likely to need to focus their efforts during the deliberations—or whether the IASB should even proceed with the project.
>
> 6.20 The development of a Standard is carried out during IASB meetings.
>
> 6.21 As a means of exploring the issues further, and seeking further comments and suggestions, the IASB may conduct fieldwork, or arrange public hearings and round-table meetings. The IASB is required to consult the Advisory Council and maintains contact with its consultative groups.

113. According to paragraph 6.21 of the *Due Process Handbook*, the IASB may conduct fieldwork, or arrange public hearings and round-table meeting. However, since the

[8] Paragraph 6.35 of IASB and IFRS Interpretations Committee *Due Process Handbook*

proposed amendments are narrow-scope amendments, we think that such consultations need not to be followed.

114. Consequently, we recommend that the IASB begins balloting process following the IASB's deliberation at its May 2013 meeting.

Question 7

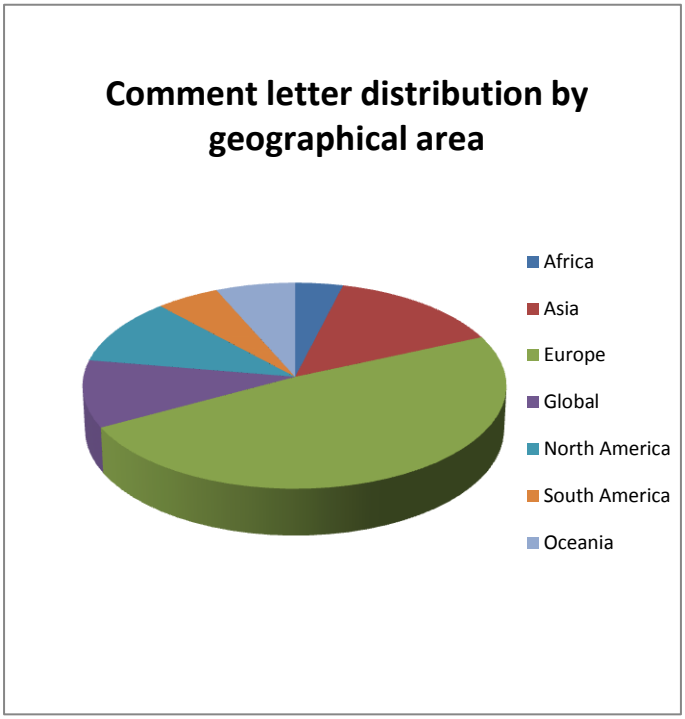
Does the IASB agree that:

a) re-exposure is not necessary;

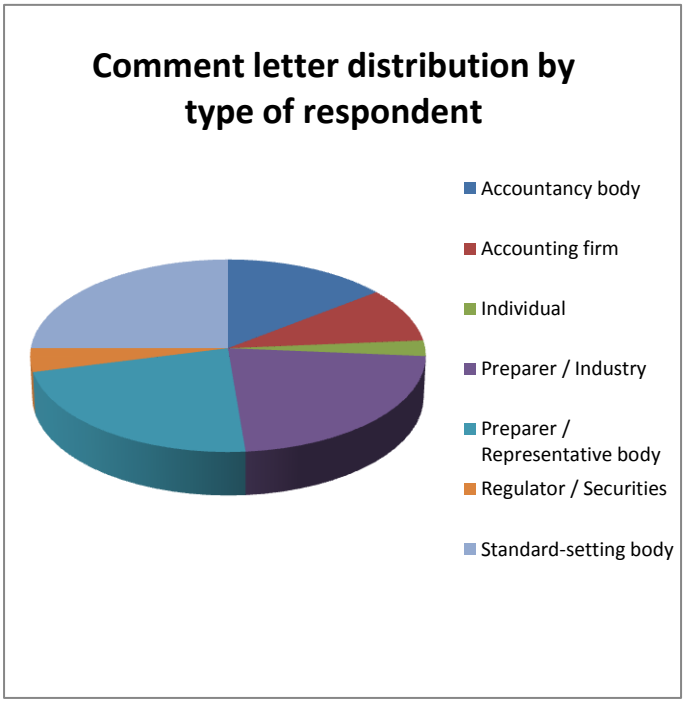
b) the mandatory effective date is set at 1 January 2014; and

c) balloting process begins following the IASB's May 2013 meeting?

Appendix A—Summary of characteristics of respondents



Comment letter distribution by geographical area		
Africa	3	4%
Asia	11	14%
Europe	37	49%
Global	8	11%
North America	8	11%
South America	4	5%
Oceania	5	6%
	76	**100%**



Comment letter distribution by type of respondent		
Accountancy body	11	15%
Accounting firm	7	9%
Individual	2	3%
Preparer / Industry	17	22%
Preparer / Representative body	17	22%
Regulator / Securities	3	4%
Standard-setting body	19	25%
	76	**100%**