AASB Exposure Draft **ED 236**
March 2013

Novation of Derivatives and Continuation of Hedge Accounting

(proposed amendments to AASB 9 and AASB 139)

Comments to the AASB by 25 March 2013

Australian Government

Australian Accounting Standards Board

Commenting on this AASB Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 25 March 2013. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 2 April 2013. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Respondents to the IASB are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Comment on a proposal' page.

All submissions on possible, proposed or existing financial reporting requirements, or on the standard-setting process, will be placed on the public record unless the Chairman of the AASB agrees to submissions being treated as confidential. The latter will occur only if the public interest warrants such treatment.

Obtaining a Copy of this AASB Exposure Draft

This AASB Exposure Draft is available on the AASB website: www.aasb.gov.au. Alternatively, printed copies of this AASB Exposure Draft are available by contacting:

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AASB REQUEST FOR COMMENTS

The main proposal in this Exposure Draft is to amend AASB 9 *Financial Instruments* and AASB 139 *Financial Instruments: Recognition and Measurement* to introduce an exception to the requirements for the discontinuation of hedge accounting. In particular, this amendment would permit the continuation of hedge accounting in circumstances where a derivative, which has been designated as a hedging instrument, is novated from one counterparty to a central counterparty as a consequence of laws or regulations.

In light of the Australian Accounting Standards Board's (AASB's) policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(a) any of the proposals in the attached International Accounting Standards Board (IASB) Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft; and

(b) the 'AASB Specific Matters for Comment' listed below.

Submissions play an important role in the decisions that the AASB will make in regard to a Standard. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 25 March 2013. This will enable AASB members to consider those comments in the process of formulating the AASB's comments to the IASB within the 30-day comment period the IASB has allowed for this ED. Constituents are also strongly encouraged to send their response to the IASB.

Reduced Disclosure Requirements

AASB 1053 *Application of Tiers of Australian Accounting Standards* establishes a differential reporting framework consisting of two tiers of reporting requirements for preparing general purpose financial statements:

(a) Tier 1: Australian Accounting Standards; and

(b) Tier 2: Australian Accounting Standards – Reduced Disclosure Requirements.

Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1 and substantially reduced disclosures corresponding to those requirements.

The proposals in this Exposure Draft would not amend the disclosure requirements in AASB 7 *Financial Instruments: Disclosures*. Accordingly, this Exposure Draft does not give rise to any particular implications for Tier 2 disclosures.

AASB Specific Matters for Comment

The AASB would particularly value comments on the following:

1. whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

    (a) not-for-profit entities; and

    (b) public sector entities, including GAAP/GFS implications;

2. whether, overall, the proposals would result in financial statements that would be useful to users;

3. whether the proposals are in the best interests of the Australian economy; and

4. unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

February 2013

Exposure Draft ED/2013/2

Novation of Derivatives and Continuation of Hedge Accounting

Proposed amendments to IAS 39 and IFRS 9

Comments to be received by 2 April 2013

IFRS®

Novation of Derivatives and Continuation of Hedge Accounting

(Proposed Amendments to IAS 39 and IFRS 9)

Comments to be received by 2 April 2013

Novation of Derivatives and Continuation of Hedge Accounting (Proposed Amendments to IAS 39 and IFRS 9) is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to Standards. Comments on the Exposure Draft, the Basis for Conclusions and the Illustrative Examples should be submitted in writing so as to be received by **2 April 2013**. Respondents are asked to send their comments electronically to the IASB website (www.ifrs.org), using the 'Comment on a proposal' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Introduction

The International Accounting Standards Board (IASB) has published this Exposure Draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement* to require an entity to continue hedge accounting in a circumstance in which a derivative, which has been designated as a hedging instrument, is novated from one counterparty to a central counterparty as a consequence of laws or regulations.

The proposals introduce an exception to the requirements for the discontinuation of hedge accounting in IAS 39. The IASB proposes that the requirements for the discontinuation of hedge accounting in IAS 39 would not apply to the hedging instrument, if specific conditions are met.

Equivalent requirements are proposed to be included in the forthcoming hedge accounting chapter in IFRS 9 *Financial Instruments*.

Invitation to comment

The IASB invites comments on the proposals in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated;

(b) indicate the specific paragraph or group of paragraphs to which they relate;

(c) contain a clear rationale; and

(d) include any alternative that the IASB should consider, if applicable.

The IASB is not requesting comments on matters in IAS 39 or the forthcoming hedge accounting chapter in IFRS 9 that are not addressed in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than 2 April 2013.

Questions for respondents

Question 1

The IASB proposes to amend IAS 39 so that the novation of a hedging instrument does not cause an entity to discontinue hedge accounting if, and only if, the following conditions are met:

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

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

(iii) 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 would be limited to those that are consistent with the terms that would have been expected if the contract had originally been entered into with the central counterparty. These changes include changes in the 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.

Do you agree with this proposal? If not, why? What criteria would you propose instead, and why?

Question 2

The IASB proposes to address those novations arising from current changes in legislation or regulation requiring the greater use of central counterparties. To do this it has limited the scope of the proposed amendments to a novation that is *required* by such laws or regulations. Do you agree that the scope of the proposed amendment will provide relief for all novations arising from such legislation or regulations? If not, why not and how would you propose to define the scope?

Question 3

The IASB also proposes that equivalent amendments to those proposed for IAS 39 be made to the forthcoming chapter on hedge accounting which will be incorporated in IFRS 9 Financial Instruments. The proposed requirements to be included in IFRS 9 are based on the draft requirements of the chapter on hedge accounting, which is published on the IASB's website[a]

Do you agree? Why or why not?

(a) See the draft of the forthcoming hedge accounting requirements posted on the IASB website on 7 September 2012 (http://go.ifrs.org/Draft-of-forthcoming-IFRS-general-hedge-accounting)

Question 4

The IASB considered requiring disclosures when an entity does not discontinue hedge accounting as a result of a novation that meets the criteria of these proposed amendments to IAS 39. However, the IASB decided not to do so in this circumstance for the reason set out in paragraph BC13 of this proposal.

Do you agree? Why or why not?

[Draft] Amendments to IAS 39
Financial Instruments: Recognition and Measurement

Paragraphs 91 and 101 are amended. New text is underlined and deleted text is struck through.

Fair value hedges

91 An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:

(a) the hedging instrument expires or is sold, terminated or exercised. ~~(~~F~~f~~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) the novation is required by laws or regulations;

(ii) 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

(iii) 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.

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 88; or

(c) the entity revokes the designation.

Cash flow hedges

101 In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95–100:

(a) the hedging instrument expires or is sold, terminated or exercised ~~(for 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)~~. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies. For the purpose of this sub-paragraph, 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) the novation is required by laws or regulations;

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

(iii) 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.

(b) ...

Paragraph 108D and AG113A are added. New text is underlined.

Effective date and transition

108D *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.

Appendix A

Application Guidance

AG113A 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.

[Draft] Amendments to the draft requirements of the chapter on hedge accounting that will be incorporated in IFRS 9 *Financial Instruments*

Paragraph 6.5.6 is amended, a heading is added after paragraph B6.5.21 and paragraph B6.5.21A is added. New text is underlined and deleted text is struck through.

6.5 Accounting for qualifying hedging relationship

6.5.6 An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes when the hedging instrument expires or is sold, terminated or exercised. ~~(~~F~~f~~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, and consistent with, the entity's documented risk management objective~~)~~. Additionally, the novation of a hedging instrument is not an expiration or termination if and only if:

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

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

(iii) 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.

Discontinuing hedge accounting can affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship).

Novation of hedging instrument as a requirement of laws or regulations

B6.5.21A For the avoidance of doubt, any fair value changes of the hedging instrument that arise from the novation of the hedging instrument in the circumstance described in paragraph 6.5.6 shall be reflected in the measurement of the novated derivative and therefore in the measurement of hedge effectiveness.

Approval by the Board of *Novation of derivatives and continuation of hedge accounting* (Proposed amendments to IAS 39 and IFRS 9) published in xxx 2013

The Exposure Draft *Novation of derivatives and continuation of hedge accounting* was approved for publication by the fifteen members of the International Accounting Standards Board.

Hans Hoogervorst	Chairman
Ian Mackintosh	Vice-Chairman
Stephen Cooper	
Philippe Danjou	
Martin Edelmann	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Patricia McConnell	
Takatsugu Ochi	
Darrel Scott	
Chungwoo Suh	
Mary Tokar	
Wei-Guo Zhang	

Basis for Conclusions on the proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft *Novation of derivatives and continuation of hedge accounting*. Individual IASB members gave greater weight to some factors than to others.

Background

BC2 IAS 39 *Financial Instruments: Recognition and Measurement* requires hedge accounting to be discontinued when the hedging instrument expires or is sold, terminated or exercised (unless the replacement or rollover of a hedging instrument into another hedging instrument is part of the entity's documented hedging strategy).

BC3 The IASB received an urgent request to clarify whether an entity is required to discontinue hedge accounting for hedging relationships in which an over-the-counter (OTC) derivative has been designated as a hedging instrument in accordance with IAS 39 in a circumstance where that OTC derivative is novated to a central counterparty (CCP) following the introduction of a new law or regulation.

Proposed amendments

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.

BC6 The IASB, however, was concerned about the financial reporting effects that would arise from the novation as a result of new laws or regulations. The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this would result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different from a new derivative, ie it would not be 'at-market' (for example, the derivative would have a non-zero fair value if it is a non-option derivative, such as swap or forward) at the time of the novation. The IASB also noted that there would be an increased risk that the hedging relationship would fail to meet the 80 per cent – 125 per cent hedge effectiveness range required by IAS 39.

BC7 The IASB, taking note of these financial reporting effects, was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship in this specific situation would provide more useful information to users of financial statements. The IASB also considered the result of outreach that involved the members of the International Forum of Accounting Standard Setters (IFASS) and securities regulators and noted that this issue is not limited to a specific jurisdiction because many jurisdictions have introduced, or are expected to mandate, laws or regulations that require the novation of OTC derivatives to a CCP.

BC8 The IASB noted that the widespread legislative changes across jurisdictions were prompted by a G20 commitment to improve transparency and regulatory oversight of OTC derivatives in an internationally consistent and non-discriminatory way; specifically, the G20 agreed to improve OTC derivatives markets so that all standardised OTC derivatives contracts are cleared through a CCP.

BC9 Consequently, the IASB decided to propose a limited scope amendment to provide relief from discontinuing hedge accounting when the novation to a CCP is required by new laws or regulations and meets certain criteria. While the IASB tentatively decided that the terms of the novated derivative should be unchanged other than the change in counterparty, however, the IASB noted that, in practice, other changes may arise as a direct consequence of the novation. For example, in order to enter into a derivative with a CCP it may be necessary to make adjustments to the collateral arrangements. Such narrow changes that are a direct consequence or are incidental to the novation are acknowledged in the proposed amendments. This would not include changes such as to the maturity of the derivatives, the payment dates or to the contractual cashflows or the basis of their calculation (except for charges that may arise as a consequence of transacting with a CCP).

BC10 The IASB decided to propose that in the context of both IAS 39 and IFRS 9 *Financial Instruments*, hedge accounting should be required to continue when this narrow category of novation occurs. The IASB noted in the case of IAS 39 an entity can elect to discontinue hedge accounting at any time.

BC11 The IASB also noted that although the proposals would prevent de-designation of a hedging relationship from being required as a result of novation to a CCP, IAS 39 (or IFRS 9 as relevant) would otherwise be applied as usual to the accounting for the derivative and the hedge accounting relationship. For example, any changes in the fair value of the hedging instrument resulting from a change in the credit quality of the counterparty or as a result of changes in the contractual collateral requirements would be reflected in the fair value of the novated derivative and in the measurement of hedge ineffectiveness.

Other considerations

BC12 The IASB also took the following issues into account in reaching its conclusions.

Disclosure

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.

Consideration of IFRS 9

BC14 The IASB also considered the draft requirements of the forthcoming hedge accounting chapter that will be incorporated into IFRS 9. The IASB noted that those draft requirements would also require hedge accounting to be discontinued if the novation to a CCP occurs. Consequently, the IASB concluded amendments that are equivalent to the proposed amendments to IAS 39 should also be proposed to be included in IFRS 9.

Reduced comment period on the proposed amendments

BC15 The IASB noted that it is necessary to complete the amendments urgently as the new laws or regulations to mandate CCP clearing of OTC derivatives would come into force within a short period. The IASB also noted that the contents of the proposed amendments are short and there is likely to be a broad consensus on the topic. Consequently, the IASB decided to reduce the comment period for these proposed amendments to 30 days.

