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The Chairman
Australian Accounting Standards Board
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30 May 2013

Dear Mr Stevenson

Ernst & Young's global submission to the IASB on the Exposure Draft ED/2013/2 *Novation of Derivatives and Continuation of Hedge Accounting (Proposed amendments to IAS 39 and IFRS 9)*

Please find enclosed Ernst & Young's global submission to the IASB on the above Exposure Draft.

Yours sincerely

Ernst & Young

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3 April 2013

Dear IASB members

Invitation to comment – Exposure Draft ED/2013/2 - *Novation of Derivatives and Continuation of Hedge Accounting* (proposed amendments to IAS 39 and IFRS 9)

The global organisation of Ernst & Young is pleased to submit its comments on the above Exposure Draft (ED). In Appendix 1 we respond to the specific questions the Board raised in the invitation to comment.

We broadly agree with the Board's objective to provide more useful financial reporting information to users about hedging relationships, by requiring hedge accounting to continue when a derivative counterparty has been replaced by a central counterparty (CCP). However, we have three main concerns:

First, given that, for the most part, the new clearing requirements are only prospective in application, and that it is expected that many entities who are not required to novate existing derivatives to a CCP will voluntarily elect to do so, we recommend that the scope of the amendment be broadened, to include voluntary novations to CCPs.

Second, we believe the Board's decision, that a novation of a derivative to a CCP results in the discontinuation of hedge accounting, to be an interpretation of the derecognition and hedge discontinuation requirements of IAS 39. As we describe in more detail in our response to Question 1, many constituents have applied the requirements differently in the past and have not discontinued hedge accounting when derivatives were voluntarily novated to CCPs. We request that the Board provides transition relief so that the accounting treatment of these past novations would not need to be amended. This could be achieved either:

a) by making the 'interpretation' prospective, so that both it and the relief proposed by the amendments would only apply to future novations to CCPs, or

b) by extending the relief to voluntary novations and making it clear that it can be applied retrospectively to past novations to CCPs.

Establishing a requirement to de-designate and then re-designate hedging relationships, rather than continue hedge accounting, is no more useful for past and present hedging relationships than for future ones for which relief is proposed. Similarly, whether novations

are voluntary or mandatory is not relevant for the usefulness of discontinuing hedge accounting as the economic effect is the same.

Third, given the wide range of uses of the term 'novation', we believe that the amendment should refer only to replacements of a counterparty with a CCP (or a clearing member of a CCP) and so not opine on the accounting consequences of other forms of novation. We believe that this would more accurately reflect the Board's objectives in proposing these amendments.

Should you wish to discuss the contents of this letter with us, please contact Tony Clifford on +44 20 7951 2250.

Yours faithfully

Ernst & Young

APPENDIX 1 - Answers to the specific questions

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?

We are concerned about four aspects of the proposed amendments.

First, we believe the scope of the proposed exception from discontinuing hedge accounting to be too narrow. Certain regulations, for example the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, must be applied prospectively, meaning that only new derivatives will have to be novated to a CCP. Hence, the proposed exception would not provide a solution for such existing derivatives. Also, many end users, while not required by law to clear their derivative trades, are expected to elect to have their derivative trades cleared to benefit from a central counterparty. It is expected that this will be largely true also for the European Market Infrastructure Regulation (EMIR) and laws and regulations in some other jurisdictions. We expect some entities will choose to voluntarily novate existing derivatives to make use of the standardised processes of a CCP and benefit from credit risk mitigation. Also, increased capital requirements will give financial institutions a significant economic incentive to voluntarily novate OTC derivatives to a CCP, rather than being required to do so.

Consequently, we recommend extending the scope of the exception from discontinuing hedge accounting to *any novation to a CCP*, irrespective of whether required or voluntary. This means the first criterion proposed in the ED should be omitted.

Second, paragraphs BC4 and BC 5 of the Basis for Conclusions for the ED state that "*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 the OTC derivative that has been designated as a hedging instrument in the existing hedging relationship if the OTC derivative is novated to a CCP* ". However, the BC does not state the reason why the IASB believes the derecognition and discontinuation criteria to be met. We recommend that the reasons should be documented in the BC. Also, while we do not necessarily disagree with the conclusion as it applies to novations to a CCP, we believe it to be an interpretation of the requirements of IAS 39.

In the past, many entities in different jurisdictions have applied a different accounting treatment and, as a result, did not discontinue hedge accounting when derivatives designated in hedging relationships were voluntarily novated to a CCP. In some cases, the view was taken that the introduction of an intermediary between the two parties to a derivative, without in any other way changing or interrupting the contractual cash flows, did not result in a termination or expiry of the original contract, nor a discharge or extinguishment of the entity's obligations. As a result, the novation was not regarded as a derecognition. In other cases, entities did not regard a novation, in which all the terms of the hedging instrument were otherwise maintained except the identity of the counterparty, to be critical for assessing whether hedge accounting should be discontinued.

In order to treat past novations consistently with those in the future, we request that the Board provides transition relief. This could be provided either:

a) by making the 'interpretation' prospective, so that both it and the relief proposed by the amendments would only apply to future novations to CCPs, or

b) by extending the relief to voluntary novations and making it clear that it can be applied retrospectively to past novations to CCPs.

Third, under the new regulations, not all derivatives will be novated to a CCP, but in many cases to a clearing member of a CCP (which will, in turn, novate them to a CCP). Therefore the wording in ii) should be broadened to include such novations.

Fourth, the term "novation" is used in a wide range of situations. Some of these do not involve a change in counterparty, but only an amendment of terms such as maturity, price or collateral arrangements. Meanwhile, derivatives may be novated from one company within a group to another, without significantly affecting the economics of the transaction from the point of view of the counterparty to the trade. Also, the term and its legal consequences, e.g. whether the original contract is extinguished and replaced by a new one, are also closely linked to the respective legal environment. Therefore, we do not believe that the assessment of whether a financial instrument has to be derecognised or hedge accounting should be discontinued can be made simply by reference to "novation".

The proposed amendments—as drafted—could be taken to imply that *any form* of novation that does not meet the proposed criteria would result in discontinuation of hedge accounting *because* the hedging instrument would have to be derecognised. We do not think such a general assertion would be appropriate or that it would be needed to achieve the Board's objective. We believe that the amendments should be restricted to those situations where the original counterparty to a contract is replaced by a CCP (or a clearing member of a CCP). This would avoid opining more generally on the accounting consequences of other novations.

We support condition (iii) in the proposed amendments to paragraphs 91(a) and 101(a): we agree that a relief from discontinuing hedge accounting as a result of a novation should be limited to situations in which the terms of the novated derivative are not changed other than changes directly attributable to the novation itself. We also support adding paragraph AG113A to the Application Guidance as it clarifies that any such permitted change in terms would have to be considered when assessing and measuring hedge ineffectiveness.

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?

For the reasons outlined in our response to Question 1:

i) we believe that the scope should include voluntary novations to a CCP (or to a clearing member of a CCP);

ii) the amendment—as worded—would apply more broadly than just to novations as a result of changes in legislation or regulation, since it would suggest an interpretation that any other form of novation always involves a derecognition of the hedging instrument and discontinuation of hedge accounting. We believe that the amendments should deal only with novations to a CCP (or a clearing member of a CCP) and should not address other forms of novation. This would mean deleting the 'and only if' wording of the amendments.

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

Question 3:
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.

Do you agree? Why or why not?

We agree that equivalent amendments should also be made to the forthcoming chapter on hedge accounting which will be incorporated into IFRS 9 *Financial Instruments*.

However, we also highlight that the concerns raised in our response to Question 1 are equally applicable to the amendments to be made to IFRS 9.

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?

We agree that no additional disclosures need to be introduced as a consequence of the proposed amendments because the existing disclosure requirements in IFRS 7 are adequate.