



22 March 2013

Our ref: ICAEW Rep 49/13

Your ref: ED/2013/2

Hans Hoogervorst  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

Dear Hans

**ED/2013/2 *Novation of Derivatives and Continuation of Hedge Accounting***

ICAEW is pleased to respond to your request for comments on ED/2013/2 *Novation of Derivatives and Continuation of Hedge Accounting*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Eddy James FCA  
Technical Manager  
Financial Reporting Faculty

**T** +44 (0)20 7920 8701  
**E** eddy.james@icaew.com



## ICAEW REPRESENTATION

### **ED/2013/2 NOVATION OF DERIVATIVES AND CONTINUATION OF HEDGE ACCOUNTING**

**Memorandum of comment submitted in March 2013 by ICAEW, in response to IASB's exposure draft ED/2013/2 *Novation of Derivatives and Continuation of Hedge Accounting* published in February 2013.**

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## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft ED/2013/2 *Novation of Derivatives and Continuation of Hedge Accounting* published by the IASB on 28 February 2013, a copy of which is available from this [link](#).

## WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

## MAJOR POINTS

### Change is needed

5. We are pleased that the IASB is acting quickly in response to the widespread legislative changes that are taking place in the wake of the G20's commitment to improve transparency and oversight in over-the-counter derivative markets. We agree that IAS 39 *Financial Instruments: Recognition and Measurement* should be amended in order to prevent hedge accounting being discontinued when derivatives that are designated hedging instruments are novated to a central counterparty as doing so will provide users of the financial statements with more useful information.

### The exception is drafted too narrowly

6. We do, however, have some concerns about the scope of the proposed amendment. In our view, the exception to the requirement to discontinue hedge accounting is drafted too narrowly as derivatives that are novated in advance of the mandatory date of any new law or regulation or which are otherwise voluntarily novated (for example because not novating the derivative would incur an additional regulatory capital cost) would not be within scope of the exception. These concerns are discussed further in our answers to question 1-2 below.
7. We therefore recommend that the Board deletes paragraph 91(a)(i) and 101(a)(i) in order to allow the exception to apply whenever derivatives are novated to a central counterparty.

### The exception is too rules-based

8. From a conceptual perspective, it is difficult to argue that a novation to a central counterparty is any different from any other novation. In practice, there could be other good reasons why a derivative might be novated to another counterparty. Therefore, a case can be made for extending the exemption to all novations where only 'limited changes' to the terms occur, regardless of whether such novations are to a central counterparty or any other counterparty.

### The transition requirements are not clear

9. The exposure draft states that the amendments will apply for annual periods beginning on or after 1 January 20xx with early application permitted. However, the impetus for the change in this case is not an accounting period but when the legal changes occur. Therefore, in our view, the amendment should apply immediately.
10. If the scope is unchanged, immediately would be as soon as the law requires. If the scope is widened as we suggest, immediately would be whenever novations are done to a central counterparty. Application relative to the start of an accounting period with the ability to apply voluntarily to an earlier accounting period if that is the period in which the law changes is less straightforward.

### EU endorsement

11. Given the urgency of the proposed changes, it may be helpful for the IASB to encourage the EU to endorse the amendment via a fast track mechanism.

## RESPONSES TO 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?

12. We agree that IAS 39 should be amended in order to prevent hedge accounting being discontinued when derivatives that are designated hedging instruments are novated to a central counterparty as doing so will provide users of the financial statements with more useful information. We do, however, have some concerns about the scope of the proposed amendment. In our view, the exception to the requirement to discontinue hedge accounting is drafted too narrowly.
13. Our primary concern is that derivatives that are novated in advance of the mandatory date of any new law or regulation would not be within scope of the exception. Many entities have already begun to novate derivatives to central counterparties in anticipation of impending legislation to avoid the administrative and legal burden of having to novate all derivatives on a single date. The wording of the exposure draft (ie, 'if and only if') suggests that such novations must be treated as discontinuations because they were not 'required by law or regulations' at the time they were undertaken. We believe that all novations to central counterparties should benefit from the exception provided there are only 'limited changes' to the terms of the novated derivative of the nature outlined in the exposure draft.

14. Another concern is that in some jurisdictions we understand that laws are being drafted that will effectively 'grandfather' older derivatives so that they do not have to be novated to central counterparties. Many entities are likely, nonetheless, to want to novate all of their derivatives, in many cases because not doing so would incur an additional regulatory capital charge. Again, by allowing all novations to central counterparties to benefit from the exception inconsistencies would be avoided.
15. We therefore recommend that the Board deletes paragraph 91(a)(i) and 101(a)(i) in order to allow the exception to apply whenever derivatives are novated to a central counterparty.
16. From a conceptual perspective, it is difficult to argue that a novation to a central counterparty is any different from any other novation. In practice, there could be other good reasons why a derivative might be novated to another counterparty. Therefore, a case can be made for extending the exemption to all novations where only 'limited changes' to the terms occur, regardless of whether such novations are to a central counterparty or any other counterparty. The Board may therefore wish to consider amending its proposals further so that all such novations cease to be deemed discontinuation events.
17. We note that paragraph BC 5 states that, under IAS 39's current requirements, a novation is a discontinuation event. Including such a categorical statement may lead to unexpected consequences as, in the absence of such guidance to date, current market practice may vary.

## 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?**

18. Many entities will novate their derivatives in advance of the mandatory date of any new law or regulation. Indeed, some have already begun this process. Others will voluntarily choose to novate derivatives that are outside of the scope of the relevant legislation. Therefore, as noted above, we believe that the IASB should clarify that novations that take place to meet the requirements of pending laws or regulations or which are otherwise undertaken on a voluntary basis will fall within the scope of the proposed amendment.

## 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.**

**Do you agree? Why or why not?**

19. Yes. The proposed relief is just as relevant under IFRS 9 *Financial Instruments* as it is under IAS 39. Therefore both standards should be amended.

#### 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?

20. We agree that no additional disclosures are necessary as no disclosures are required in relation to other on-going hedge relationships. In our view, requiring one-off disclosures about novations is unnecessary and would offer little benefit to users of financial statements.

E [eddy.james@icaew.com](mailto:eddy.james@icaew.com)

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