

Amendments to IAS 39: continuing hedge accounting after novation

What you need to know

- ▶ The IASB has amended IAS 39 to provide relief from discontinuing hedge accounting when, as a consequence of laws or regulations or their introduction, an entity changes the immediate counterparty of a hedging instrument to achieve clearing with a central counterparty.
- ▶ The amendment covers novations to central counterparties, as well as to intermediaries such as clearing members, or clients of the latter that are themselves intermediaries.
- ▶ The relief does *not* apply to *all* novations.
- ▶ The effective date is 1 January 2014 with early application permitted.
- ▶ The forthcoming hedge accounting requirements of IFRS 9 will include a similar relief.

Overview

On 27 June 2013, the International Accounting Standards Board (IASB, the Board) issued *Novation of Derivatives and Continuation of Hedge Accounting - Amendments to IAS 39*. This amendment to IAS 39 *Financial Instruments: Recognition and Measurement* provides an exception to the requirement to discontinue hedge accounting in situations where over-the-counter (OTC) derivatives designated in hedging relationships are directly or indirectly, novated to a central counterparty (CCP) as a consequence of laws or regulations, or the introduction of laws or regulations.

The amendment

The IASB made a narrow-scope amendment to IAS 39 to permit the continuation of hedge accounting in certain circumstances in which the counterparty to a hedging instrument changes in order to achieve clearing for that instrument. The amendment covers novations:

- ▶ That arise as a consequence of laws or regulations, or the introduction of laws or regulations
- ▶ Where the parties to the hedging instrument agree that one or more *clearing counterparties* replace their original counterparty to become the new counterparty to each of the parties
- ▶ That did not result in changes to the terms of the original derivative other than changes directly attributable to the change in counterparty to achieve clearing

All of the above criteria must be met to continue hedge accounting under this exception.

The use of clearing counterparties in the second criterion above is intended to extend the relief to both direct and indirect clearing arrangements. Direct clearing refers to an arrangement in which the parties to the hedging instrument agree that a CCP replaces their original counterparty and becomes the new counterparty to the hedging instrument. In contrast, indirect clearing refers to an arrangement where, instead of a CCP, an intermediary entity (or entities) acting as a counterparty (or counterparties) replaces the original counterparty in order to eventually effect clearing by a CCP. Intermediaries may include a clearing member of a CCP or a client of a clearing member of a CCP (i.e., financial intermediaries that are not themselves clearing members). In the case of indirect clearing, when the clearing counterparties designated by the original counterparties to the hedging instrument are different, the relief would only apply if those clearing counterparties execute the clearing with the *same* CCP.

Changes to the terms of the original derivative that are directly attributable to the novation are limited to those that are consistent with the terms that would be expected if the novated derivative were originally cleared with the CCP (e.g., changes in the collateral requirements, rights to offset receivables and payables balances and charges levied).

Central clearing of OTC derivatives in response to the financial crisis

The collapse of some financial institutions during the financial crisis exposed the impact that credit risk can have on the global derivatives markets. In response to this, the G20 agreed at its Pittsburgh Summit in September 2009 that standardised OTC derivatives should be cleared through a CCP. The CCP would usually require the derivatives to be collateralised, thereby (potentially) significantly reducing the counterparty credit risk.

As a result, several jurisdictions have introduced, or are in the process of introducing, legal or regulatory requirements that OTC derivatives have to be novated to a CCP. Examples include the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in the United States and the European Market Infrastructure Regulation (EMIR) in the European Union.

For novations that do not meet the criteria for the exception, entities must assess the change to the hedging instrument against the derecognition criteria for financial instruments.

Novations outside the scope of the exception

The scope of the exception includes only those novations that occur as a consequence of laws or regulations, or their introduction (as opposed to the mere possibility of laws and regulations being introduced), and in the context of direct or indirect clearing. This means that, for all other novations, entities have to assess the changes to the hedging instrument against the derecognition criteria for financial instruments and the general conditions for continuation of hedge accounting. In some countries, novation also involves changes in the contract other than a change of counterparty. For that reason, the text of the amendment and its application guidance do not refer to novation, but describes the particular type of change that the amendment seeks to address (i.e., replacing the original counterparty in order to achieve direct or indirect clearing).

Effect on hedge effectiveness

The application guidance clarifies that the change in the fair value of the hedging instrument that results from the changes to the contract in connection with the novation (e.g., a change in the collateral arrangements and the counterparty's credit standing) must be included in measurement of hedge ineffectiveness. This would also affect the hedge effectiveness assessment (i.e., one of the qualifying criteria for hedge accounting).

Documentation of replacement or rollover of the hedging instrument

Some held the view that discontinuation of hedge accounting as a result of novation might be prevented by including in the documentation of the hedging relationship a replacement or rollover that is envisaged by IAS 39, paragraphs 91(a) and 101(a). However, such a replacement or rollover must be part of the entity's documented *hedging strategy*. In the Basis for Conclusions, the IASB questions whether the replacement of a contract as a result of unforeseen legislative changes (even if documented) fits the definition of a replacement that is part of a 'documented hedging strategy'.

Transition and effective date

The amendment has an effective date of 1 January 2014, with earlier application permitted. If an entity decides to early adopt the interpretation, disclosure of that fact is required. Retrospective application of this amendment is required, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, entities that discontinued hedge accounting in the past because of a novation that would be in the scope of the amendment cannot reinstate that previous hedging relationship. This is because those entities did not meet the qualifying criteria for hedge accounting after discontinuing that hedging relationship and IAS 39 does not allow entities to retrospectively revive those hedging relationships (as if they had not been discontinued).

IFRS 9

The forthcoming hedge accounting requirements of IFRS 9 *Financial Instruments* will include similar relief from discontinuation of hedge accounting.

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