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28 March, 2013

Dear Françoise,

Novation of Derivatives and Continuation of Hedge Accounting (Proposed Amendments to IAS 39 and IFRS 9)

Thank you for providing the Financial Reporting Council (FRC) with the opportunity to comment on your draft comment letter (DCL) to the International Accounting Standards Board's Exposure Draft on Novation of Derivatives.

We agree with EFRAG's broad support of the content of the proposals. We also share EFRAG's concern to ensure that the conditions are not excessively limiting, although our suggestions to the IASB do not go as far as EFRAG's in recommending that "the scope of the amendments be extended to novations that arise from statutory requirements that are similar to laws and regulations" as this may inadvertently admit too many arrangements into the scope.

We have not provided specific responses to the questions in the DCL as we believe that practitioners will be better placed to give informative responses. We do, however, attach our response to the International Accounting Standards Board for your information.

If you would like to discuss these comments, please contact Deepa Raval on 020 7492 2424.

Yours sincerely

A handwritten signature in black ink that reads "Roger Marshall".

Roger Marshall
Chair of the Accounting Council
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Michael Stewart
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

28 March 2013

Dear Michael,

Novation of Derivatives and Continuation of Hedge Accounting

The Financial Reporting Council is pleased to have the opportunity to comment on the IASB's Exposure Draft ED/2013/2 "Novation of Derivatives and Continuation of Hedge Accounting".

Our responses to the specific questions appear in the Appendix to this letter.

In general, we support the content of the Exposure Draft, and agree that this type of novation of derivatives should not result in the discontinuance of hedge accounting. We understand that novation of derivatives are common and in practice do not generally result in the discontinuation of a hedging relationship. This means that a change which is designed to avoid discontinuation arising from a change in legislation must be drafted with extreme care to ensure it does not introduce any unintended constraints. This is discussed further in our responses to questions 1 and 2.

In addition, we suggest that early adoption should be permitted, to ensure that there is no time gap after any relevant legislation is passed that would result in discontinuance of a hedge relationship.

If you would like to discuss these comments, please contact myself or Deepa Raval on 020 7492 2424.

Yours sincerely

A handwritten signature in black ink that reads "Roger Marshall".

Roger Marshall
Chair of the Accounting Council
DDI: 020 7492 2434
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Appendix – responses to detailed 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 agree with this proposal.

Entities that are required by law to novate their hedging instruments to a central counterparty are required by IAS 39 to discontinue hedge accounting. This would be an undesirable consequence as it fails to reflect the commercial reality of the situation.

The criteria proposed here seem reasonable, although point (iii) could be more tightly drafted. The phrase "necessary to effect the terms of the novated derivative" appears to have a narrower scope than "consistent with the terms that would have been expected if the contract had originally been entered into with the central counterparty", although it seems that the second version is the intended meaning. It might be possible to address this issue by simply removing the first phrase, so the paragraph reads

(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 consistent with the terms that would have been expected...

It may also be worth clarifying whether the examples of changes are intended to be an exhaustive list (and, if not, whether there are any limits on the type of change that could be so classified).

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?

We agree with the intention behind this proposed limitation, but would suggest changes in its implementation.

It may be the case that entities will act in advance of legislation they expect to see passed, by novating derivatives "voluntarily". We believe that the scope should allow for this type of voluntary novations.

It may also be possible to draw in parallel situations where an entity is outside the scope of specific laws or regulations, but is under an economic compulsion to behave similarly to its peers, and therefore will novate its derivatives despite not being legally required to do so. If the IASB wishes to extend the exemption from discontinuance of hedge accounting to this type of situation, the drafting will need to ensure that it only captures situations where there is no substantive change to the arrangement beyond the change in counterparty, to ensure that an economic compulsion argument does not become more widely applied than had been intended.

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?

We agree that equivalent changes should also be made to IFRS 9, to ensure that the treatment proposed here can be continued when IAS 39 is withdrawn.

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 it would not be appropriate to require additional disclosures in this situation. From the user's perspective, there is simply a continuing hedging relationship, and since this is maintaining the status quo, there are no triggers for additional disclosures.