Straight away
IFRS bulletin from PwC

1 March 2013

IASB publishes exposure draft on novation of derivatives

What is the issue?

The IASB has issued an exposure draft (ED) proposing a limited scope amendment to IAS 39, 'Financial instruments: Recognition and measurement', and to the forthcoming chapter on hedge accounting in IFRS 9, 'Financial instruments'. The ED proposes some relief to the hedge accounting requirements when a derivative is novated to a central counterparty (CCP) such as a central clearing organisation under certain circumstances.

Regulations have been introduced (based on the G20 commitments arising out of the financial crisis) that will require 'over the counter' (OTC) derivatives to be transacted with a CCP to improve transparency, consistency and regulatory oversight of OTC derivatives. This will result in the novation (that is, replacing one party of the derivative contract with a new party, in this case the CCP) of existing OTC derivative contracts.

IAS 39 requires an entity to stop hedge accounting when such a novation occurs; this is because the original derivative no longer exists. The derivative with the CCP might be designated in a new hedging relationship, but this would result in more hedge ineffectiveness (because the new derivative has a non-zero fair value) and also increases the risk that the hedging relationship might fail to meet the 80%-125% hedge effectiveness requirements in IAS 39.

Steps have already been taken by the Securities and Exchange Commission (SEC) in the US to address this issue for hedge accounting under US GAAP.

Key amendment

The ED proposes to allow the continuation of hedge accounting when a hedging derivative is novated to a CCP and the following conditions are met:

- the novation is required by laws or regulations (so it is not applicable for voluntary novations),
- the novation results in a CCP becoming the new counterparty, and
- the changes to the terms arising from the novation are consistent with the terms that would have existed if the novated derivative had originally been entered into with the CCP. For example, there can be changes in terms such as collateral, rights to offset receivables and payables, and charges levied by the CCP, but there can be no changes to maturity dates, payment dates, contractual cash flows or the basis of their calculation.

Any changes to the derivative's fair value that arise from the novation will be reflected in its measurement and therefore in the measurement of hedge effectiveness.

pwc

Am I affected?

The limited scope amendment will be beneficial to all entities applying hedge accounting that are subject to mandatory novation of OTC derivatives as described above.

What do I need to do?

The comment period ends on 2 April 2013. Entities should consider responding to the proposals so that their views can be considered by the IASB in its finalisation of the amendment.

If you have questions about this issue, please contact your PwC engagement partner. Engagement teams that have questions should contact their Global Accounting Consulting Services contact.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. It does not take into account any objectives, financial situation or needs of any recipient; any recipient should not act upon the information contained in this publication without obtaining independent professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2013 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.