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HKFRS / IFRS UPDATE 2013/12

NOVATION OF DERIVATIVES AND CONTINUATION OF HEDGE ACCOUNTING

Overview

As part of actions taken following the global financial crisis, the G20 made a commitment to improve transparency and regulatory oversight of over-the-counter (OTC) derivatives. It was agreed that all standard OTC derivative contracts should be cleared through a central counter party. A regulation was implemented in Europe which requires certain OTC derivatives to be cleared centrally through an independent central counterparty (CCP).

However, under IAS 39 *Financial Instruments: Recognition and Measurement* this change in counterparty would have required the discontinuation of hedge accounting (unless the novation had been contemplated in the original hedging documentation).

While both the International Accounting Standards Board (IASB) and IFRS Interpretations Committee agreed with the above application of IAS 39 as currently drafted, they were sympathetic to concerns raised by constituents that the imposed legislation did not fundamentally change the underlying economic nature of an entity's hedging activities, and therefore it would be inappropriate to require a change to the accounting of these novated derivatives.

Accordingly, on 27 June 2013 the IASB issued *Novation of Derivatives* and *Continuation of Hedge Accounting (Amendments to IAS 39)* (the amendments) which would allow the continuation of hedge accounting (subject to meeting certain criteria) in instances where a derivative is required by law or regulation to be novated to a CCP or an entity acting in a similar capacity.

The amendment will also be incorporated into the forthcoming chapter of hedge accounting in IFRS 9 *Financial Instruments*.

Entities are required to apply the amendments retrospectively for annual periods beginning on or after 1 January 2014. Earlier application is permitted.

On 16 July 2013 HKICPA published the equivalent amendments to HKAS 39 *Financial Instruments: Recognition and Measurement* with the same effective date and transition requirement.

STATUS
Final

EFFECTIVE DATE
1 January 2014 with earlier application permitted

ACCOUNTING IMPACT
Significant for entities that have designated over-the-counter (OTC) derivatives as hedging instruments where those derivatives are required to be novated to a central clearing counterparty by law or regulation

Summary of the amendment

The amendments introduce a narrow scope exception that would allow the continuation of hedge accounting under IAS 39 (and IFRS 9) when a derivative is novated, subject to the following criteria:

a) The novation comes as a consequence of laws or regulations (or the introduction of laws or regulations)

b) The parties to the hedging instrument agree that one or more *clearing counterparties* replace their original counterparty to become the new counterparty of each party.

Note: A *clearing counterparty* is either:

- A central counterparty (or a 'clearing organisation' or 'clearing agency'), or
- An entity or entities that are acting as counterparty in order to effect clearing by a *central counterparty* (eg a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation).

Note: When the parties replace their original counterparties with **different** clearing counterparties the exception will **only apply** if each of those clearing counterparties ultimately clears with the same central counterparty.

c) Any changes to the hedging instrument are limited only to those that are necessary to effect such a replacement of the counterparty.

These changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty, and include:

- Changes in the collateral requirements
- Rights to offset receivables and payables balances
- Charges levied.

BDO Comments

The final amendment is less restrictive than the original exposure draft (ED) in respect to the above criteria.

*The criteria of the original ED required that the novation be made **directly** with a CCP.*

However based on feedback from constituents, it was highlighted that in practice in certain jurisdictions there may not be a direct relationship with the CCP (ie there may be clearing members that act as intermediaries between the CCP and the parties of the novated derivative, including intragroup novations).

Based on this, the IASB expanded the scope of the amendments beyond that of just a direct relationship between a CCP and the parties of the novated derivative.

Also, the amendment only applies to those derivatives that are novated as a consequence of laws or regulations (or the introduction of laws or regulations).

Therefore any derivatives that are novated voluntarily are not within the scope of the amendment and would therefore the discontinuation of hedge accounting would be required in accordance with HKAS 39 (and HKFRS 9).

Disclosure requirements

The amendment does not propose any additional disclosure requirements in relation to novated derivatives.

Effective date and transition

The amendment is to be applied retrospectively in accordance with IAS 8 *Accounting policies, Changes in Accounting Estimates and Errors*, for periods beginning on or after 1 January 2014. Early application is permitted.

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