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Continuing hedge accounting after derivative novations

Limited exception provides relief

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IN THE HEADLINES

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> "The amendments provide some welcome relief on a widespread issue."
>
> – Andrew Vials
> KPMG's global IFRS financial instruments leader

Regulatory changes may lead to novations

Laws and regulations on over-the-counter (OTC) derivatives are changing in several jurisdictions, requiring or providing incentives for entities to novate many OTC derivatives to a clearing counterparty – i.e. a central counterparty, or an entity (or entities) acting as counterparty in order to effect clearing by a central counterparty. Many derivatives that are, or may be, subject to these requirements have been designated in hedging relationships by one or both counterparties.

For example, suppose that Company X and Company Y have entered into an OTC derivative contract. Novation to a clearing counterparty involves cancelling the original derivative contract between X and Y and replacing it with two new derivative contracts: a new contract between X and the clearing counterparty, and a new contract between Y and the clearing counterparty. Either or both of X and Y may have designated the old OTC derivative contract as a hedging instrument.

IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to discontinue hedge accounting if the derivative hedging instrument is novated to a clearing counterparty – unless the hedging instrument is being replaced as part of the entity's original documented hedging strategy. This is because novation involves a termination or expiration of the original hedging instrument, and this requires the cessation of hedge accounting.

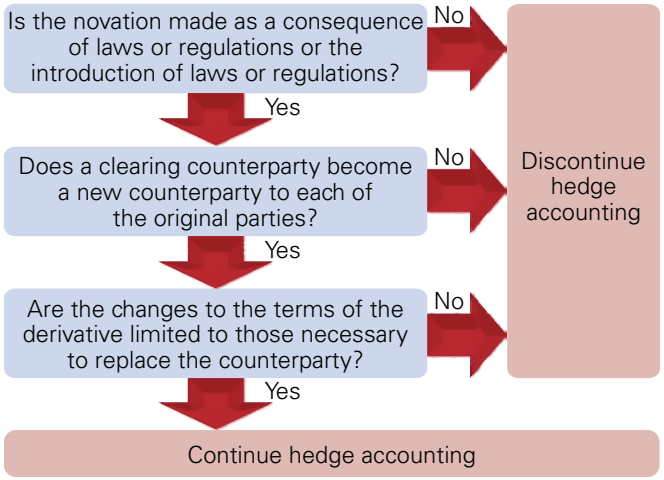
Novations may create issues

Although the new derivative with the clearing counterparty may be designated in a new hedging relationship, it would often have a non-zero fair value at inception of the new hedging relationship; this could lead to significant ineffectiveness, which could potentially cause the hedging relationship not to qualify for hedge accounting.

While the IASB believed that the analysis under IAS 39 was clear, it did not believe that the outcome was desirable. Therefore, on 27 June 2013 it issued *Novation of Derivatives and Continuation of Hedge Accounting (Amendments to IAS 39)* (the amendments) to provide relief.

A limited exception has been provided

The amendments add a limited exception to IAS 39, to provide relief from discontinuing an existing hedging relationship when a novation that was not contemplated in the original hedging documentation meets specific criteria.



Not all novations receive relief

The amendments provide relief when a novation meets the specific criteria. However, there may be other situations in which a derivative is novated that will not be eligible under the amendments – e.g. an entity agrees to a counterparty novating an OTC derivative to a third party as a consequence of laws or regulations, and no clearing counterparty is introduced.

Adoption

The amendments are effective for annual periods beginning on or after 1 January 2014. Early application is permitted. However, if an entity applies the amendments for an earlier period, then it should disclose that fact. Although the amendments are applied retrospectively, if an entity had previously discontinued hedge accounting as a result of a novation, then the previous hedge accounting (pre-novation) for that relationship cannot be reinstated.

Next steps

Constituents should consider whether the amendments provide relief for the scenarios that they may experience.

The IASB plans to include similar requirements in its forthcoming standard on general hedge accounting under IFRS 9 *Financial Instruments*.

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