ISDA | Safe, Efficient Markets

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28 November 2012

Reference: Novation of Derivatives under EMIR legislation

Dear Sirs,

We are writing to express our concerns about a matter that has arisen as a result of the interaction between IAS 39 and the new European legislation concerning the European Market Infrastructure Regulation (EMIR). Specifically, we would like to highlight our concern over the 'novation of derivatives' to a Clearing House under the EMIR legislation, which is expected to become effective by the middle of 2013, and its impact on hedge accounting.

ISDA's[1] European Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry that rely on over-the-counter (OTC) derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

Over the next year, in response to the reforms of the derivatives market, many OTC derivatives will be required to be novated to central clearing houses. The effect of this is that a clearing house will become the new counterparty to two new derivative contracts, one with each of the original parties to the original derivative, instead of the original parties remaining counterparties to each other via the original bilateral contract. There is an additional possibility that, as part of these reforms, some of the derivatives will need to be transferred to different entities within the same group.

These reforms have led to a concern as to whether it is possible to continue the designation of novated derivatives in a hedge relationship, or whether the process of novation forces a dedesignation of the existing relationship and the designation of a new one. The main significance is that, for cash flow hedges, a redesignation of a derivative that already has an

[1] Since its founding in 1985, ISDA has worked to make over-the-counter (OTC) derivatives markets safe and efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. ISDA has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has more than 800 members from 55 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on OTC derivatives to efficiently manage the financial market risks inherent in their core economic activities. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of ISDA toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

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accumulated fair value will result in future hedge ineffectiveness to be recorded in profit or loss. Such ineffectiveness may result even though the derivative's terms and cash flows are unaffected and the clearing house now merely stand between the original two counterparties. Recognising ineffectiveness in such a scenario would not result in meaningful information being presented in the accounts. Further, in the case of collateralised swaps there won't be significant fair value differences and this effect might be pervasive if the entire industry would start recognising ineffectiveness on their cash flow hedges due to the novation where none such ineffectiveness exists.

Paragraph 101 of IAS 39, for cash flow hedges, states that "In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95-100" and sub-paragraph (a) lists as one of the circumstances, "The hedging instrument expires or is sold, terminated or exercised." (There is similar wording for fair value hedges in paragraph 91). It does not say whether a novation of a derivative to a new counterparty would constitute an expiry, and we note that paragraph 88, that specifies the designation and documentation requirements of a hedging relationship, does not specify the counterparty as one of the key elements of the designation. However, we are aware that some audit firms have not fully formed a view about whether the novation of derivative, resulting in the replacement of one original contact with two, to which the clearing house is counterparty, would trigger a requirement to discontinue a hedging relationship.

We also note that paragraph 101 (a) for cash flow hedges (and similarly paragraph 91 for fair value hedges) specifies that "the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy." This has been taken to mean that, if a novation would not result in the discontinuation of a hedge relationship, as long as the novation had been anticipated at the time the hedge was first designated. However, we believe that a novation in these circumstances would not be a discontinuation and therefore there would be no need for the hedge accounting documentation to anticipate such a situation, consistent with the statements below.

ISDA raised the same concerns to the Chief Accountant of the Securities and Exchange Commission (SEC), with respect to U.S. GAAP. His response set out in his letter to ISDA of May 11 2012, was as follows:

> "The Staff of OCA would not object to a conclusion for accounting purposes that the original derivative has not been terminated and replaced with a new derivative contract, nor would the staff object to the continuation of existing hedge relationships when there is a novation of a derivative contract to effect a change in counterparties to the underlying contract, provided that other terms of the contract has not been changed, in any of the following circumstances:
>
> "For an OTC derivative transaction entered into prior to the application of the mandatory clearing requirements, an entity voluntarily clears the underlying OTC derivative contract through a central counterparty, even though the counterparties had not agreed in advance (ie at the time of entering in the transaction) that the contract would be novated to effect central clearing.
>
> "For an OTC derivative transaction entered into subsequent to the application of the mandatory clearing requirements, the counterparties to the underlying contact agree in advance that the contract will be cleared through a central counterparty in accordance with standard market terms and conventions and hedging documentation describes the counterparties' expectation that the contract will be novated to the central counterparty.

> "A counterparty to an OTC derivative transaction who is prohibited by Section 716 of the Act (or expected to be so prohibited) from engaging in certain types of derivative transactions novates the underlying contract to a consolidated affiliate..."

The Chief Accountant goes on to say that the FASB has been requested to "consider the accounting for a change in counterparties when a derivative contract is designated as a hedging instrument as part of their existing project on financial instruments." This has been read to mean that the Chief Accountant's confirmation that 'the Staff wouldn't object' is an exception from the normal requirements of U.S. GAAP. However, the letter nowhere says that the confirmation constitutes an exception and the request to the FASB can be read as a request for more formal clarification.

For these reasons, our members strongly urge the IASB to follow the FASB's example and provide a formal clarification on this matter with respect to IFRS as it would be confusing for users if changes to derivative contracts arising from structural / regulatory changes to financial markets were accounted for on significantly different basis by IFRS preparers compared with U.S. GAAP preparers. In addition, the effect of forcing a redesignation would not result in meaningful information, as contemplated above.

We hope you find ISDA's comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

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Chair of European Accounting Policy Committee

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