IAS 39: Implications on Hedging Relationships of Novation of Derivatives

Excerpt, IFRS Discussion Group Report on Meeting – July 19, 2012

Globally, there is a push to require financial institutions to enter into derivatives that are cleared through derivative-clearing organizations rather than continuing with over-the-counter (OTC) or bilateral trades. This push is intended to eliminate counterparty credit risks that are inherent when two counterparties enter into a derivative such as an interest rate swap.

This push raises questions about the potential implications on pre-existing hedging relationships for certain financial institutions when a derivative contract in a valid hedging relationship is required by regulation to be "novated" and transferred to a central clearing house for settlement.

Fact Pattern

- Bank A and Bank B enter into an interest rate swap in which Bank A agrees to pay Bank B a variable rate, and Bank B agrees to pay Bank A a fixed rate. As result, Bank A is exposed to Bank B's credit risk and vice versa.
- Bank A and Bank B are required to clear the derivative through a clearing organization. As a result, each of Bank A's and Bank B's credit risk exposure is replaced with that of the clearing organization.
- Interposition of a clearing organization results in novation of the over-the-counter derivatives and the central counterparty (i.e., a clearing organization) becomes the new counterparty to each of the original parties via two new contracts. As a result, Bank B is no longer the counterparty to Bank A and vice versa. The clearing organization becomes each of Bank A's and Bank B's counterparty.

The issue considered by the Group was whether hedge accounting under IFRSs should be terminated (*View A*) or can be continued (*View B*) if a derivative that is designated as a hedging instrument is novated to a different counterparty when all other terms and conditions of the original derivative remain the same.

View A – Hedge accounting should be terminated

Proponents of this view argue that a critical term of a hedging derivative is its counterparty. Regardless of which risk is designated as the hedged risk in a qualifying hedging relationship, the assessment and measurement of effectiveness and ineffectiveness, respectively, is driven partially by counterparty credit risk. If a counterparty to a hedging derivative changes, it necessitates a change in counterparty credit risk (even when the ratings of the original and replacement counterparties may be the same). As a result, proponents of this view argue that hedge accounting should be terminated.

Source: www.frascanada.ca/ifrs-discussion-group

View B – Hedge accounting can be continued

Proponents of this view argue that a framework exists within IAS 39 *Financial Instruments: Recognition and Measurement* that doesn't require dedesignation and, as a result, novation does not cause termination of hedge accounting. If fully collateralized, novation does not represent a substantive change if the hedge remains effective. Further, IAS 39 does not explicitly state that a change in counterparty causes dedesignation. As a result, proponents of this view argue that if the change in credit risk does not affect hedge effectiveness, hedge accounting should be continued.

The Group's Discussion

The Group observed that the International Swaps and Derivatives Association, Inc. had requested that the U.S. Securities and Exchanges Commission (SEC) staff address this issue under U.S. GAAP. The SEC staff recently released a response[1] indicating that it would not object to the continuation of hedge accounting for the existing hedging relationship under certain specified circumstances and when all other terms and conditions remain the same. Group members noted that the International Swaps and Derivatives Association, Inc. may submit a similar request to the IASB.

The Group observed that Canada is not the only country facing this issue, which is being discussed in other jurisdictions including Europe. As a result, the issue is evolving in several arenas and some time is needed to allow the international discussions to play out. Group members observed that any action the AcSB may take should not conflict with or slow down the evolution of the international discussions.

Group members expressed concern that if the Dodd-Frank Wall Street Reform and Consumer Protection Act legislation becomes effective later this year, this issue will arise for practically an entire derivatives portfolio rather than just a few isolated transactions. As a result, there is a pressing need to resolve this issue before any significant diversity in practice emerges.

Group members observed that one of the reasons the issue was tabled was to seek Group members' views on whether the AcSB should wait and see what transpires globally or be more proactive and take some more immediate action.

Group members noted that View B is currently not sufficiently developed and needs further articulation prior to raising this issue with the IASB or the IFRS Interpretations Committee. As a result, the Group agreed that there is no immediate action to recommend to the AcSB. However, Canadian stakeholders in the banking industry should consider working to develop and articulate View B sufficiently so that any necessary action can be taken when appropriate.

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[1] The SEC staff's response is available on the SEC's website at: http://www.sec.gov/info/accountants/staffletters/isda051112.pdf.