2 April 2013

International Accounting Standard Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON THE EXPOSURE DRAFT ON NOVATION OF DERIVATIVES AND CONTINUATION OF HEDGE ACCOUNTING - PROPOSED AMENDMENTS TO IAS 39 - *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT* AND IFRS 9 - *FINANCIAL INSTRUMENTS*

The International Accounting Standards Board (IASB and Board) has requested commentary on the exposure draft on Novation of Derivatives and Continuation of Hedge Accounting - Proposed Amendments to IAS 39 - *Financial Instruments: Recognition and Measurement* and IFRS 9 - *Financial Instruments*, attached is the comment letter prepared by Accounting Practices Committee (APC) of The South African Institute of Chartered Accountants (SAICA). This comment letter results from deliberations of the APC, which comprises members from reporting organisations, regulators, auditors, IFRS specialists and academics.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours faithfully,

Sue Ludolph
Project Director – Financial Reporting

cc: Paul O'Flaherty (Chairman of the Accounting Practices Committee)

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SAICA SUBMISSION ON NOVATION OF DERIVATIVES AND CONTINUATION OF HEDGE ACCOUNTING - PROPOSED AMENDMENTS TO IAS 39 - *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT* AND IFRS 9 - *FINANCIAL INSTRUMENTS*

GENERAL COMMENTS

We disagree with the proposal contained in the Exposure Draft (ED). We believe that the novation of a derivative financial instrument, in itself, should not result in the discontinuance of hedge accounting, whether prescribed by laws and regulations or not. We have noted below areas which we recommend that greater clarity should be provided as well as recommendations to the ED's final wording to affect our recommendations.

SPECIFIC COMMENTS

Question 1

The IASB proposes to amend IAS 39 so that the novation of a hedging instrument does not cause an entity to discontinue hedge accounting if, and only if, the following conditions are met:

(i) the novation is required by laws or regulations;
(ii) the novation results in a central counterparty (sometimes called 'clearing organisation' or 'clearing agency') becoming the new counterparty to each of the parties to the novated derivative; and
(iii) the changes to the terms of the novated derivative arising from the novation of the contract to a central counterparty are limited to those that are necessary to effect the terms of the novated derivative.

Such changes would be limited to those that are consistent with the terms that would have been expected if the contract had originally been entered into with the central counterparty. These changes include changes in the collateral requirements of the novated derivative as a result of the novation; rights to offset receivables and payables balances with the central counterparty; and charges levied by the central counterparty.

Do you agree with this proposal? If not, why? What criteria would you propose instead, and why?

We do not agree with the IASB's proposal. Our rationale and recommendations have been set out below:

- The term novation has not been defined in the ED. The IASB's press release, as issued on 28 February 2013, defines novation as "*the substitution of the original counterparty to the contract for a new counterparty*". If this is the Board's intended definition for novation, it should be included in the final amendment.

- We note that the ED's Basis for Conclusion (BC), with specific reference to BC 4 and 5, states that *"The IASB considered the derecognition requirements in IAS 39 to determine whether the novation in such a circumstance leads to the derecognition of an existing OTC derivative that is designated as a hedging instrument…..have to be discontinued because the hedging instrument in the existing hedging relationship no longer exists. The IASB concluded that the* *novation to a CCP would meet the derecognition requirements both for financial assets and financial liabilities in IAS 39. Consequently, the new derivatives, with a counterparty being the CCP, are to be recognised at the time of the novation."*

We do not believe that the novation of a derivative, in itself, for the 'non-novating[1] counterparty, meets the derecognition requirements of IAS 39, *Financial Instruments: Recognition and Measurement* (IAS 39) and IFRS 9: *Financial Instruments* (IFRS 9). IAS 39 and IFRS 9 states that a financial asset shall be derecognised *'when, and only when':*

a) the contractual rights to the cash flows from the financial asset expire; or
b) it transfers the financial asset ... and the transfer qualifies for derecognition ...''

We do not believe that the novation, in itself, results in the cash flows from the financial asset expiring nor is there a transfer arrangement. Hence, we do not believe that the derecognition of the financial asset, in terms of IFRS, is appropriate.

Noting that derivatives can also be financial liabilities, it would be necessary for a derivative to also comply with the derecognition requirements for financial liabilities in order for it to be derecognised. IAS 39 and IFRS 9 requires a financial liability to be derecognised *''when, and only when, it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires.''* IAS 39 and IFRS 9 also states that: *''An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.''* Using arguments similar to that for the derecognition of financial assets noted above, we do not believe that the derecognition requirements for financial liabilities are met since the financial liabilities' obligation has neither been discharged, cancelled or expired, nor are the terms of the derivative substantially different as a result of the novation.

We hence recommend the deletion of BC 4 and 5 from the ED. The analysis of whether the derivative instrument is required to be derecognised or not requires a full analysis taking into account all terms and conditions of the novation of the derivative instrument.

- In reaching our conclusion above we compared the novation of a derivative financial instrument to the following scenario:

[1] In this comment letter references are made to the 'non-novating' or 'other counterparty'. Such a counterparty is the party that is not a party to the terms of a novation agreement such as counterparty A in the following example: A enters into an interest rate swap with B. At a later date, B novates the derivative to C.

Company A obtains funding from bank B. Bank B and C are part of the same group of companies. If bank B decides to novate its loan asset to bank C, the novation will result in derecognition of the loan asset from bank B's statement of financial position (assuming all of the IFRS requirements for derecognition are met) and result in the recognition of a loan asset in bank C's statement of financial position. However the novation between bank B and C does not affect the accounting treatment for Company A's financial obligation as its financial obligations established at inception remain unaltered, with the exception of the counterparty to which such cash flows are required to be made. Therefore, regardless of the change in counterparty, the obligation has not been extinguished and hence the liability should not be derecognised and then re-recognised. The conclusion here would be the same where company A's obligation is a negotiable instrument.

Implying that novation amounts to derecognition, as in the case of the ED, would require company A to derecognise the financial liability to B in its balance sheet and recognise a new financial liability to C, notwithstanding the fact that company A's financial obligations in terms of the original agreement have not changed.

We believe that there could be several unintended consequences as a result of the IASB maintaining its view that the novation of a derivative financial instrument results in derecognition especially since the novation and sale/acquisition of debt instruments, whereby the obligations/ rights to cash flows remain unaltered, are presently (in terms of market practice) not accounted for as derecognition events by the non-novating or other counterparty.

- We note that the derecognition principles of IAS 39 and IFRS 9, in so far as they relate to derivative financial instruments are not applicable since derivatives are always recognised at fair value. Derecognition does however affect whether a hedge accounting relationship is required to be discontinued in terms of IFRS.

- Noting our responses above, we recommend that the mere novation of a derivative should not result in the discontinuance of a hedge accounting relationship but that a hedge effectiveness assessment should be undertaken following the novation in terms of the hedge documentation (and it be at least at each and every reporting date). Where the hedge relationship is no longer determined to be effective, then the existing relationship shall end and shall be accounted for in terms of IAS 39/ IFRS 9. A new hedge relationship may be established thereafter subject to the qualification requirements of IAS 39/IFRS 9 being met.

- We believe that the scope of the ED is too narrow in terms of it only being required, amongst other requirements, by laws and regulations. Many of constituents have noted instances where novation of derivative financial instruments has arisen in groups of entities (e.g. from one bank to another bank in a group company). We therefore believe that the novation of a derivative from one counter-party to another should not result in the discontinuation of hedge accounting and limiting the amendment only to where there are changes in laws and regulations that would not result in consistent accounting treatment of all transactions across entities.

- Guidance regarding the specific definition of a central counterparty (CCP) has not been provided in the ED. Our constituents questioned whether a CCP would be a country, a specified counterparty with reference to a specific derivative, or a specific counterparty for all types of derivatives. In line with our recommendations above, we believe that the reference to a CCP should be deleted and hence allow for the novation to take place between any counterparty without affecting the application of hedge accounting.

- Based on our recommendations above, we recommend that the wording of the ED change as follows:
  ~~(i) the novation is required by laws or regulations;~~
  *~~(ii)~~**(i)** the novation results in a ~~central counterparty~~ **third party** (~~sometimes called~~ which may include 'clearing ~~organisation~~ **organisations**' or 'clearing ~~agency~~ **agencies**') becoming the new counterparty to ~~each of the parties to the novated derivative;~~ the novated derivative and*
  *~~(iii)~~**(ii)** the changes to the terms of the novated derivative arising from the novation of the contract to a ~~central counterparty~~ **third party** are limited to those that are necessary to effect the terms of the novated derivative.*

  *Such changes would be limited to those that are consistent with the terms that would have been expected if the contract had originally been entered into with the ~~central counterparty~~ **third party**. These changes include changes in the collateral requirements of the novated derivative as a result of the novation; rights to offset receivables and payables balances with the ~~central counterparty~~ **third party**; and charges levied by the ~~central counterparty~~ **third party**.*

Question 2
The IASB proposes to address those novations arising from current changes in legislation or regulation requiring the greater use of central counterparties. To do this it has limited the scope of the proposed amendments to a novation that is required by such laws or regulations. Do you agree that the scope of the proposed amendment will provide relief for all novations arising from such legislation or regulations? If not, why not and how would you propose to define the scope?

Our response to question 1 above provides our reasons for not agreeing with the limited scope of the proposed amendments. In summary, we believe that the requirements, subject to meeting the derecognition requirements, should apply to all instances in which derivatives are novated by one party to another.

Question 3
The IASB also proposes that equivalent amendments to those proposed for IAS 39 be made to the forthcoming chapter on hedge accounting which will be incorporated in

IFRS 9 Financial Instruments. The proposed requirements to be included in IFRS 9 are based on the draft requirements of the chapter on hedge accounting, which is published on the IASB's website

Do you agree? Why or why not?

We agree with the proposal. Please refer to our response in question 1 for further details.

Question 4

The IASB considered requiring disclosures when an entity does not discontinue hedge accounting as a result of a novation that meets the criteria of these proposed amendments to IAS 39. However, the IASB decided not to do so in this circumstance for the reason set out in paragraph BC13 of this proposal.

Do you agree? Why or why not?

Yes we agree with the IASB's decision on not requiring further disclosure. We do not believe that such disclosures would add decision useful information to the users of financial statements. We also believe that this is consistent with IFRS 7, *Financial Instruments: Disclosures* (IFRS 7) not requiring disclosures for de-designated hedge relationships or other reasons as to why hedge relationships are discontinued.

OTHER COMMENTS

Although the ED did not request comments on other areas of hedge accounting, a related question that we have relates to IAS 39 and IFRS 9's near-final draft requirements as follows: *''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, and consistent with, the entity's documented risk management objective* (NFD[2])/ *hedging strategy* (IAS 39)''.

It is unclear what the intention of this statement is. To illustrate the above by means of an example:

- An entity has a cash flow exposure that will arise in 1.5 years' time;
- The entity is only able to enter into an appropriate derivative with a 1 year or less maturity (the market only trades up to a 1 year maturity); and
- The entity initially enters into a 1 year derivative and intends to roll over the hedging instrument in 1 year's time for a further 6 months.

In this instance:

a. Would the fact that the entity has indicated that it will roll over the hedging instrument require it to measure hedge effectiveness of the 1 year derivative against the change in cash flows of a 1 year hedged item?; or

[2] Near final draft on hedge accounting as published by the IASB for which comments were provided in November 2012.

b. Would the determination of hedge ineffectiveness be computed by comparing the change in fair value of the 1 year derivative to the change in cash flows of the 1.5 year hedged exposure (both on a discounted basis) which would result in hedge effectiveness?

We hence recommend that the Board clarify its reference to *''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, and consistent with, the entity's documented risk management objective* (NFD)/ *hedging strategy* (IAS 39)''. Clarification through the use of an example, such as that noted above, i.e. either (a) or (b) is also recommended.

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