

International Accounting Standards Board  
30 Cannon Street  
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United Kingdom

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By email to: [director@fasb.org](mailto:director@fasb.org) (File Reference No. 2011-100)

### **IASB ED/20011/1 – Offsetting Financial Assets and Financial Liabilities**

Dear Sirs

I am writing on behalf of AFME (the Association for Financial Markets in Europe) to respond to the IASB's 28 January Exposure Draft ED/20011/1 – Offsetting Financial Assets and Financial Liabilities (“the ED”). AFME is, as you know, the principal UK trade association for firms active in investment banking and securities trading; it was established in November 2009 as a result of the merger of LIBA (the London Investment Banking Association) and the European Branch of SIFMA (the US-based Securities Industry and Financial Markets Association), and thus represents the shared interests of a broad range of participants in the wholesale financial markets. We appreciate the opportunity to comment on this ED, which has significant implications for many of our members.

#### **General Comments**

Before turning to the specific questions set out in the ED, we have a number of high-level comments on the proposed approach.

We continue to welcome the work performed by the IASB and the FASB to address areas of differences in their respective accounting frameworks. While AFME/LIBA has been a long-standing supporter of convergence, we feel strongly that a necessary condition for moving to any new converged standard must be that it represents the best possible solution. In particular, in the current case, we do not think the principle articulated in the ED results in a statement of financial position that provides users with the most relevant information.

The ED proposals will result in most derivative and repurchase agreements, including those cleared through central counterparties such as clearinghouses, being presented gross. We feel this may be misleading to users of the financial statements since, for any sizeable institution, it will lead

to very large numbers on the balance sheet, which may obscure meaningful information on the true exposures of the reporting entity. In particular, it will not provide users of the financial statements with any information about the credit exposure, liquidity or solvency risk of the reporting entity.

We believe the existing requirements in US GAAP provide a superior framework for reporting, as they result in the presentation of meaningful, well understood and comprehensive balance sheet information, supported by the required disclosures. The experience of our members who currently report net balances under US GAAP is that they do not receive requests or demands for gross presentation in the balance sheet. Indeed, many members who are IFRS reporters already disclose on a voluntary basis what would be the impact of applying the US GAAP netting principles. As noted in Paragraph BC7 of the ED, users have not specified whether gross or net presentation in the balance sheet is preferable as long as the detailed information is provided in the notes to the financial statements. We therefore believe that there is insufficient demand from users for gross presentation, and that any requests for additional granularity of information can be adequately met through appropriate enhanced disclosure.

We would also highlight a number of key concerns from our responses to the specific questions set out in the ED:

- Our members continue to believe strongly that individual derivative transactions subject to an enforceable master netting agreement should be reported net on the balance sheet. We believe gross presentation does not represent the resources available to creditors of an entity in default, given that the execution of an enforceable master netting agreement legally creates a single contract between the counterparties incorporating all individual transactions under that agreement, that each entity is exposed to the net credit risk across all the individual transactions, and that all transactions will be settled net in the event of a close out. Furthermore, we believe that gross presentation of derivatives overstates the resources available to creditors of the entity in the normal course of business, given the existence of collateral agreements that result in cash settlement payments on derivatives being returned (often the following day) as margin.
- We are concerned that the requirement that settlement occurs simultaneously (defined as “only when the settlements are executed at the same moment”) is particularly onerous, and could lead to unforeseen circumstances, in that certain commonly used settlement mechanisms may no longer qualify for netting. For example, certain clearing houses, for operational reasons, may not have one single settlement of all trades at the same moment, but may rather settle trades in batches. We do not believe this leads to any measurable increase in risk, and consider that netting should be allowed in these situations, where a settlement mechanism can be considered to be the functional equivalent of net settlement.

- We do not agree with the wording in Paragraph C14 of the ED that states that collateral should not be offset. On the contrary, in our view, there are many instances where transactions are fully margined every day, resulting in the entity being in the same economic position as if the trade had settled that day. In addition, if collateral assets or liabilities meet the requirements of the ED then we believe that offsetting should be permitted. This would change current practice in certain cases, such as the treatment of the margin on futures contracts.
- We are very unclear as to how the requirements of the exposure draft should be applied in a case where some, but not all, cashflows due between two entities are payable on the same date. We are particularly concerned that the ED could be read to require an entity to look through to the underlying cashflows within a single instrument and to net only those cashflows that occur on the same day. This could result in larger balance sheet numbers after applying the netting rules, which is clearly wrong.
- The operational impact of the criteria in the ED and the enhanced disclosure requirements will be significant even for existing IFRS reporters. Therefore, we request that adequate time be allowed for implementation of the standard: this should be no sooner than 1 January 2016, particularly if retrospective transition is required.

In summary, we urge the IASB and FASB to reconsider the ED: we believe it leads to a less relevant, and potentially misleading, presentation on the balance sheet.

Our responses to the questions set out on pages 7-8 of the ED are as follows:

**Q1 *Offsetting criteria: unconditional right and intention to settle net or simultaneously***

*The proposals would require an entity to offset a recognised financial asset and a recognised financial liability when the entity has an unconditional and legally enforceable right to set off the financial asset and financial liability and intends either:*

- (a) to settle the financial asset and financial liability on a net basis or*
- (b) to realise the financial asset and settle the financial liability simultaneously.*

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

- A. Our members continue to support the current US GAAP offsetting principles in FIN 39 and FIN 41, which we believe result in a better representation of an entity's credit, liquidity and solvency risk for both derivatives and repurchase agreements.

For derivatives (whether exchange traded, centrally cleared or bilateral), there is little information value in gross positions as they do not represent future cash movements, being fair value amounts and hence the net present value of a contract. As a result, criteria based on the intent to net cash flows or the legal ability to net cash flows are not meaningful.

Derivatives transacted under master netting agreements are often fully collateralized as outlined under the Credit Support Annex that often accompanies these agreements, mitigating credit and liquidity risk.

For other positions, although we agree with the basic objective and requirements, they are in our view applied in an overly restrictive and form-driven manner. We believe the principle should be that, where transactions are settled or managed in such a way that the risks are substantially those of net settled transactions, they should be offset on the balance sheet.

As such we would specifically note:

- Many clearing houses and exchanges have settlement processes which, whilst not being exactly simultaneous, reduce the liquidity risk and credit risk of settlement failures to be in substance that of simultaneous settlement and hence net settlement. This would, for example, include repo trades settled on the London Clearing House.
- The provision of collateral and margin mitigates gross settlement risk significantly. In many cases the margin acts as de facto settlement: it is never returned to the owner, cannot be used by the owner, and is legally transferred to the counterparty on termination. It would be inappropriate (and contrary to the conceptual framework) for this to be recognised as an asset. More importantly, to show the positions gross would be to mislead users as to the potential outflows and inflows of resources, and hence as to the risk position of the entity. We believe the appropriate treatment of collateralised transactions is to assess the substance of the arrangement.

We would highlight also that the changes proposed in the ED represent a step change from IAS 32, which allows a more principle/substance based approach. Our members are, for example, currently able to achieve netting for repos settled on certain securities transfer systems, which under the ED would not meet the simultaneous criteria as they do not settle at the same moment. Similarly members review centrally cleared derivatives when fully collateralised and in many cases conclude that they are either in substance settled or in substance net settled.

We are not clear how the ED proposes to deal with “intention” in the context of derivatives. Paragraph C9 indicates that entering into a contract/master netting agreement which provides for payment netting is sufficient. This would appear to be independent of whether contracts under the master agreement actually have payments on the same day.

This however is not consistent with the Basis of Conclusions, or indeed with conversations we have had with IASB staff.

We believe it would be helpful to outline some scenarios whereby payment netting may be applicable. A number of members of our Accounting Committee have been involved in preparing the ISDA response to this ED, which highlights the possible interpretations. We believe these should be considered and inserted into the standard or application guidance where appropriate.

As previously discussed, our members do not believe that netting on the basis of intention to net is appropriate for derivatives, preferring instead to follow the existing US GAAP netting requirements of FIN 39. If this is to be retained, however, we would support payment netting in line with Paragraph C9; this would mean that, where an entity had elected payment netting in a master netting agreement, and hence had the right and obligation to net settle when payments coincide, this would be sufficient to allow all transactions conducted under that agreement to be presented net. We believe any other approach would be difficult to implement operationally. In particular, we do not believe it would be consistent with generally accepted accounting practice if we were required to look at every individual payment and net if and only if they occurred on the same day: this could involve splitting individual transactions and effectively ignoring the unit of account, which would be both conceptually unsound and non-operational.

## **Q2 Unconditional right of set-off must be enforceable in all circumstances**

*It is proposed that financial assets and financial liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of set-off. The proposals specify that an unconditional and legally enforceable right of set-off is enforceable in all circumstances (ie it is enforceable in the normal course of business and on the default, insolvency or bankruptcy of a counterparty) and its exercisability is not contingent on a future event. Do you agree with this proposed requirement? If not, why? What would you propose instead, and why?*

- A. We do not agree with the proposed requirement that the right to set-off must be unconditional. The definition of “unconditional” is not clear in the ED. An unconditional right to set-off is considered to be too broad, making it near impossible to obtain a clean legal opinion in all circumstances. For instance, a change in law or tax may preclude the net settlement of a financial asset and a financial liability. We strongly recommend that the Board reconsider the definition of “unconditional” to ensure that it can be applied in a reasonable and practical manner.

As described above, our members continue to support the current US GAAP offsetting requirements for derivatives, in particular the requirement that derivatives can be presented net if transacted with the same counterparty under a master netting agreement that provides for

net settlement through a single payment in a single currency in the event of default. In these cases the legal ability to net is enforceable in the event of a default rather than on a continuing basis. For derivatives, our members believe that only the close out position is relevant as this gives appropriate information on an entity's derivative risk exposure.

### **Q3 Multilateral set-off arrangements**

*The proposals would require offsetting for both bilateral and multilateral set-off arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of set-off may be present?*

- A. We agree with the proposal to require an entity to offset financial assets and financial liabilities when the offsetting criteria are met, irrespective of whether the set-off arrangements are bilateral or multilateral.

We do not see any strong reason to explicitly limit the offsetting requirement to bilateral set-off arrangements. On the contrary, we believe that in the multilateral arrangement specified in IAS 32.45, an entity should offset an amount due from a third party against an amount due to a creditor, provided the agreement among the three parties clearly satisfies the offsetting criteria. Such multilateral arrangements could arise not only within a group context (as illustrated in paragraphs 7-8 of IASB Agenda Paper 4A/FASB Agenda Paper 9A for the December 2010 joint meeting), but also outside a group context for structured transactions involving multiple counterparties where there are established terms requiring direct settlement between counterparties.

### **Q4 Disclosures**

*Do you agree with the proposed disclosure requirements in paragraphs 11-15? If not, why? How would you propose to amend those requirements, and why?*

- A. Financial instruments disclosures having become progressively more burdensome with each new accounting standard, we propose that the breadth of disclosure requirements should be more widely revisited and rationalised as part of a cohesive revision of IFRS 7 and other financial instrument related disclosures.

Our members believe the proposed disclosure requirements to be excessive, and question their utility to the primary users of financial statements. We find the proposed approach to be very prescriptive and rules-based, and not reflective of the way an entity's key managers view and control the business. For example, collateral is calculated on a net, cross-product basis. Allocating collateral on a gross basis, by class of financial instrument, would be arbitrary at best. Members note that

quantitative disclosures on the nature and extent of risks arising from financial instruments under IFRS 7 are based on information provided to key managers, and believe that a similar principles-based approach would be beneficial, in that it would provide more relevant and decision-useful information to users. If a prescriptive approach is considered essential, we would prefer to provide disclosure by rating of counterparty rather than by class of financial instrument, as this would more accurately reflect the collateral and credit management processes of the entity.

Specific concerns have been expressed about the requirements in Paragraphs 12(c) and 12(d) covering amounts with rights of set-off both conditional and unconditional that the entity is unable to offset. It is not possible to execute the requirement to track such legal rights in financial systems by the level of granularity required, given that the separate disclosures relate to the same amounts in derivative contracts. Specifically, payment netting and close out netting clauses are provisions within the same contract. Payment netting exists throughout the life of the transactions, but ceases to exist upon termination of the transactions, to be replaced by close out netting. The rationale for requiring this level of disclosure is also unclear. We propose that these requirements be removed from the ED.

#### **Q5 Effective Date and Transition**

*(a) Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements, and why?*

*(b) Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.*

- A.** We have a number of concerns regarding the transition requirements and the effective date.

As described above, the ED proposal represent a significant change, both for IFRS and US GAAP reporters. In order to maintain existing netting, or indeed to assess the impact, entities will be required to review thoroughly all the settlement procedures surrounding derivatives, securities and repos. This will necessitate a review of all clearing house processes and may lead to a change in those processes and systems. Legal opinions will need to be obtained and transaction documentation reviewed and amended. Absent any presentation change, the disclosure requirements have a significant impact on systems requirements and capability.

As described in our 31 January 2011 response to the IASB's October 2010 Request for Views on Effective Dates ("the RfV"), we are generally supportive of retrospective application for new standards, as this improves comparability in financial reporting. However, the consequence of this is that the "true" effective date of any new standard is, for entities presenting a single comparative period, one year prior to the actual effective date. Accordingly, retrospective application extends the timeline

required for implementation of the standards and thus must be taken into account in setting the effective dates for the standards.

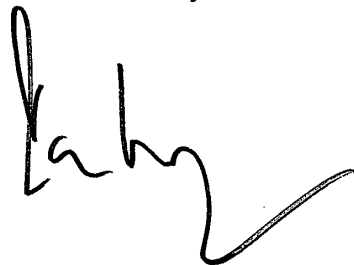
As noted in our response to the RfV, we suggest that a practical alternative to alleviate the problem of retrospective adoption would be to extend the scope of IFRS 9 Para 8.1.12, which would exempt entities from the need to restate comparative amounts.

We believe the ED should ideally be implemented alongside the other standards affecting Financial Instruments. For the reasons set out in our response to the RfV (see particularly our response to Question 5, on the overall implementation plan), given the scale of the review and changes needed, and the fact that it is not solely restricted to accounting systems we believe that, under a single date approach, the mandatory effective date should be no earlier than for accounting periods beginning on or after 1 January 2016, assuming that the key convergence projects are completed, as is now planned, by the end of 2011.

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I hope the above comments are helpful. We would of course, as always, be pleased to discuss any points which you may find unclear, or where you believe AFME members might be able to assist in other ways.

Yours faithfully



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