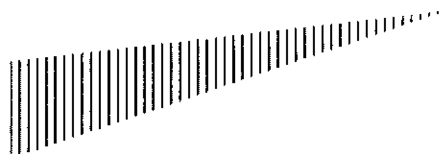

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27 April 2011

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Dear Board Members

Invitation to comment - Exposure Draft *Offsetting Financial Assets and Financial Liabilities*

The global organization of Ernst & Young is pleased to respond to the International Accounting Standards Board's (IASB) and the Financial Accounting Standards Board's (FASB) Exposure Draft (ED) *Offsetting Financial Assets and Financial Liabilities*.

Overall, we continue to support the move to a single set of high-quality global financial reporting standards. Financial statement users around the world would benefit from comparable financial information that is useful for decision making. Converging the offsetting requirements for financial assets and financial liabilities would further promote this goal. In considering the Boards' proposal, on the one hand, we appreciate the technical merits of the Boards' proposal and acknowledge that the gross presentation of financial assets and financial liabilities aligns with the Boards' conceptual framework for financial reporting and faithfully reflects the unit of account. We also acknowledge that the application of the Boards' proposal would improve comparability of financial reporting.

On the other hand, we believe that offsetting derivative assets and liabilities (and any related cash collateral) that are executed with the same counterparty and subject to a legally enforceable master netting arrangement provides financial statement users with more useful information about the entity's exposure to credit risk. We also believe that same day transfers of gross amounts associated with repurchase (repo) and reverse repurchase (reverse repo) agreements may be considered the functional equivalent of net settlement (and therefore balance sheet offsetting should be permitted) when transactions are settled through a centralized settlement mechanism that minimizes credit and liquidity risk.

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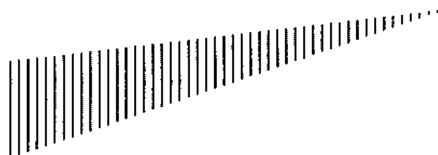


Indeed, the Boards have already heard that many financial statement users would continue to support the current US GAAP requirements, but with improved disclosure. This indicates to us that the Boards' proposal isn't the only way to address this issue. In addition, preparers have significant concerns with the Boards' proposal because it would require assets and liabilities to be presented in a manner that is inconsistent with how they are managed.

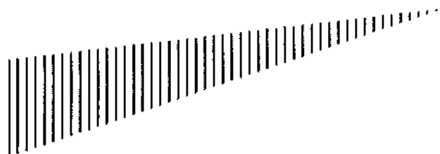
On balance, given the varying user preferences, the legitimate concerns expressed by preparers and the view that gross presentation does not provide more useful information about the credit and liquidity risks of financial instruments subject to master netting arrangements, we believe the Boards should consider adopting a model that retains the existing exceptions in US GAAP for repo and reverse repo agreements and certain derivative contracts subject to master netting arrangements. We believe that adoption of the US GAAP exceptions would be a pragmatic solution to achieve convergence in offsetting that would avoid some of the practical issues arising from the Boards' proposal.

To address the varying information needs of users of financial statements, we believe that both the gross amounts of eligible assets and eligible liabilities and the net amount resulting from offsetting should be disclosed in the notes accompanying the financial statements. Additionally, to improve comparability between entities, we believe that netting on the balance sheet should be required when the conditions for offsetting have been met.

If the Boards are not persuaded by our views and decide to move forward with their proposal we believe certain changes to the proposed standard are needed. First, as more fully described in the responses to the Boards' questions, we believe the Boards should provide an exception for financial assets and financial liabilities that are realized and settled on the same day, in the same currency and through a central clearing organization that sufficiently limits both intra-day credit and settlement risk.

Second, with respect to cash collateral that is provided/obtained in connection with over the counter derivatives and certain exchange traded derivatives, we believe that the Boards should clarify and differentiate between margin payments that represent collateral, which are available for setoff only in the event of counterparty default, and those which not only act as collateral but also, in effect, represent settlements or advance payments for eventual settlement of the derivative cash flows. We believe that in the latter case the margin and the fair values of the derivatives should be offset as the proposed criteria for offsetting are met.

These recommendations are more fully discussed in the Appendix to this letter along with our other responses to the specific questions posed in the ED.



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We would be pleased to discuss our comments further with the Boards or their respective staffs at your convenience. Please contact either Michiel van der Lof at +31 88 407 1030 or Joseph Cascio at +1 212 773 8151.

Yours faithfully,

Ernst & Young

Appendix - Responses to the questions in the Exposure Draft *Offsetting Financial Assets and Liabilities*

Question 1–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?

As mentioned in our cover letter, to improve comparability between entities, we believe that netting on the balance sheet should be required when the conditions for offsetting have been met. However, we recommend that the Boards consider adopting the following existing exceptions under US GAAP that permit the netting of repo and reverse repo agreements and certain derivative contracts subject to master netting arrangements:

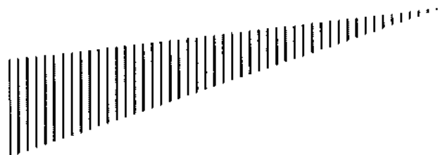
Repurchase and reverse repurchase agreements

Under US GAAP, same day transfers of gross amounts may be considered the functional equivalent of net settlement when transactions are settled in a manner that meets all of the conditions specified in ASC 210-20-45-11 (or paragraph 3 of FASB Interpretation No.41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (FIN 41)). Some of the key requirements of FIN 41 that support the offsetting exception include:

(a) the existence of a master netting arrangement,

(b) cash settlements under established banking arrangements that require the entity to have cash on deposit only for any net amounts that are due at the end of the business day, and

(c) an entity's intent to use the same account at the clearing bank at the settlement date to transact the cash inflows and outflows resulting from the settlement of the offsetting financial instruments.



Derivative contracts

When FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts, an interpretation of APB Opinion No. 10 and FASB Statement No. 105* ((FIN 39) codified in ASC 210-20)), was issued in March 1992 the then FASB decided to permit offsetting of the fair value of recognized derivatives and other conditional or exchange contracts if they were executed with the same counterparty under a master netting arrangement because the net presentation discloses the amount of credit risk exposure under that arrangement. Additionally, the previous FASB decided that, given a master netting arrangement, presentation of the aggregate fair values of the individual contracts executed under that arrangement would not provide more information about the uncertainty of future cash flows from those contracts than net amounts would. We are not aware of past practices or recent events that would call those decisions into question. Moreover, net presentation is consistent with how preparers manage their credit risk and how fair value is measured for portfolios of derivative instruments that are subject to a master netting arrangement.

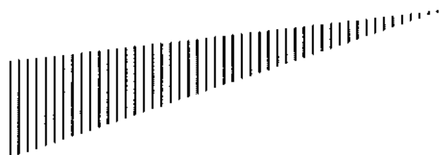
Offsetting the fair values of derivative contracts and related amounts of cash collateral transacted under a master netting arrangement reflects the exposure in the event of default or bankruptcy of the entity or a derivative counterparty, and so better presents the credit risks of the entity. Also, as derivatives are increasingly subject to cash margining arrangements, whether settled through clearing houses or bilaterally, the offset amounts also provide a better indication of future cash flows. Meanwhile, the gross fair values of most derivatives do not provide useful information about future cash flows, even when the derivatives are not cash margined, since the fair value of each derivative is itself a net number.

If the Boards choose not to retain the exceptions permitted by US GAAP, we recommend the following two amendments to the proposal.

(i) Requirement to simultaneously settle at the exact same moment will affect transactions entered into with a clearing house

Paragraph 10 (f) of the ED states that realization of a financial asset and settlement of a financial liability are treated as simultaneous only when the settlements are executed at the same moment. A literal interpretation of this requirement would mean that a financial asset and a financial liability can only be offset if they are realized/settled at the exact same second in all circumstances (assuming that an unconditional and legally enforceable right to set off exists).

Under the proposed offsetting requirements an entity that executes, for instance, repos and reverse repos through a clearing house that mature on the same day (denominated in the same currency and subject to a legal right of set-off) will not be able to net such transactions on the balance sheet if, for example, they are cleared in batches during the day.



The proposed change will therefore result in the grossing up of financial assets and financial liabilities on the balance sheet, especially for banks, which could have a knock on effect on leverage and (potentially) solvency ratios.

Conceptually, we understand that a financial asset and a financial liability should only be offset if they are settled at the same moment. However, we believe that the exception in paragraph 48 of IAS 32 for transactions executed with a clearing house should be retained. This is because a clearing house has underlying arrangements in place that serve to mitigate intra-day credit and liquidity risk. The presence of such intra-day risk mitigation arrangements could be used as a principle to justify such an exception.

Even though the IASB may not have intended all transactions with clearing houses to be treated as an exception to the simultaneous settlement principle under IAS 32, we are not aware of any disadvantages of such a practice nor have we come across any circumstances which would lead us to believe that there is a need to change this practice.

In addition, given the integral role of a clearing house in the stability of the financial system coupled with the regulatory drive towards increased central clearing of more financial instruments, we believe that the benefits of such an exception are well founded.

(ii) Offsetting of cash collateral against underlying derivative financial instruments

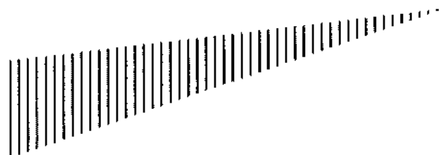
Paragraphs 9 and C14 of the ED state that an entity shall not offset collateral pledged or the obligation to return collateral against an associated financial instrument. Paragraph C14 is explicit that such collateral should be accounted for as separate assets and liabilities.

This proposed requirement would impact the treatment of certain "over the counter" and "exchange traded" derivatives novated to, and cleared by, a central clearing house, which calls for cash collateral in the form of variation margin to cover the fluctuations in the market value of the derivatives.

Under the rules of certain exchanges, variation margin is considered the legal settlement of a net position. Certain other clearing houses that do not consider variation margin to be "settlement," custody the margin payments received with a third-party and ultimately use the collateral to settle the cash flows on the derivatives as they fall due.

At present, many preparers offset the market values of the derivatives and the cash collateral, on the basis that all payments on the derivatives will be made net using the cash collateral already provided. In effect, the collateral represents an advance payment for eventual settlement of the cash flows arising on the derivatives and the intention is to always net settle the derivatives and the cash collateral.

For example, in the case of interest rate swaps, separate payments are not made on the swaps on the interest due dates as this is already imputed in the daily margin call based on their mark to market value. That is, the provision of cash collateral provides the funds for the future settlement of amounts due. If there is no further movement in market prices and



no new trades then, apart from the unwind of the time value reflected in the mark to market valuation, no further cash will be paid or received. Hence, the swaps and the cash collateral will be settled net.

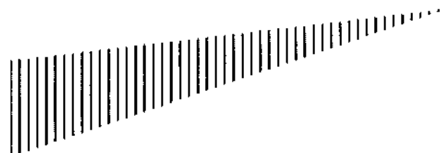
While our analysis of the issue refers to derivative arrangements transacted through a clearing house, this issue would also be applicable to bilateral derivative trades where the terms (including collateral) and settlement mechanism for the trades are similar to derivative transactions executed with a clearing house.

Based on the wording in paragraphs 9 and C14 of the ED, it is unclear if offsetting the cash collateral against the market value of the derivative would be possible in such circumstances if the proposed criteria for offsetting are met. If the Boards agree that such an offset should be possible, we would recommend that the Boards add the words "*unless the criteria for offsetting as stipulated in paragraph 6 are met*" at the end of paragraphs 9 and C14.

Other matters for consideration - Offsetting non-financial derivatives against financial derivatives

The Boards' proposal states that an entity shall offset an eligible recognized asset and liability when (a) the entity has an unconditional and legally enforceable right to set off the asset and liability and, (b) intends to either settle net or realize the asset and settle the liability simultaneously. The proposal is not explicit as to whether non-financial derivatives, which can either be net physically settled or net cash settled, may be offset against financial derivatives when the conditions in paragraph 6 of the proposals are met, and clarification by the Boards in that regard would be helpful.

In addition, with regard to scope, the FASB's exposure draft clearly states that it would apply to financial assets, financial liabilities, and all derivatives (financial and non-financial). In comparison, the IASB's exposure draft states that its provisions would apply only to those assets and liabilities that are within the scope of IAS 39. Given the difference in the manner in which the Boards phrased their respective scope, we recommend that the Boards conform the language of both ED's in order to avoid any unintended consequences that would result in certain instruments falling in scope for IFRS and out of scope for US GAAP (or vice versa).



Question 2–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?

Apart from our preference to adopt the existing exceptions in US GAAP for derivative contracts and repos and reverse repos subject to master netting arrangements, we agree with the proposed requirement.

Question 3–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?

We agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements. We do not believe that there is a conceptual accounting basis to prohibit set-off in such arrangements but understand that there are legal impediments in certain jurisdictions.

Question 4- 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?

Overall, we agree that the proposed disclosures would provide most users with the information that they require for their respective purposes. However, we have the following comments regarding the scope and extent of the proposed disclosure requirements:

(i) Some entities believe that the proposal requires the quantitative information discussed in paragraph 12 of the ED to be presented in a single note for all eligible assets and eligible liabilities and are concerned that there are elements of the proposed disclosures that are already required by existing US GAAP and IFRS. For example, both US GAAP and IFRS currently require disclosure of gross fair value amounts by class of financial instruments and information about collateral pledged/obtained. Others believe that paragraph 14 of the ED specifically permits entities to disclose the information in more than one note with cross references to the other notes in which the information required by paragraphs 11 and 13 is disclosed.

If the Boards intend, as we believe, to permit entities to disclose the required information in more than one note we recommend that the Boards add the words *"in one or more notes"* after the word *"disclose"* in the first sentence of paragraph 12. Additionally, examples should be provided to supplement the single example shown in paragraph IE1 that would further illustrate this option. For example, the Boards could illustrate how the existing gross fair value disclosures required by ASC 815, *Derivatives and Hedging*, and IFRS 7, *Financial Instruments: Disclosures*, could be enhanced to include the supplementary information required by this proposal. Similarly, the repurchase agreement, securities lending and collateral disclosures required by ASC 860, *Transfers and Servicing*, and IFRS 7 could also be modified to present an alternative illustrative example.

(ii) Paragraph 15 of the ED requires the disclosures even if there are no financial assets or financial liabilities that are subject to offsetting. The ED states that the disclosures are required if an entity has provided or obtained cash or other financial instrument collateral in respect of its financial assets and liabilities. In light of the fact that the main purpose for this project is to address the differences in the offsetting requirements between IFRS and US GAAP, we do not agree that these disclosures should be required for financial assets and financial liabilities that are not subject to offsetting on the balance sheet. If the Boards' intention was to enhance the existing disclosures in respect of credit risk and liquidity risk, this should be carried out as a separate project.

Likewise, we do not believe that the Boards should require companies to separately disclose the amount of any portfolio-level adjustments for credit risk associated with eligible assets and liabilities. Such adjustments are only a component of the overall fair value measurement considerations, which is beyond the scope of this project.

Question 5—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) Yes, we support full retrospective application.

(b) We are unable to comment on the estimated time required to implement the Boards' proposal, however, given the significant differences between existing standards and the proposal, we believe that such an undertaking may be burdensome, especially for US GAAP preparers that currently elect not to offset eligible assets and liabilities but would meet the criteria for netting. In addition, as a result of the proposed deletion of ASC 940-320-45-3, US broker dealers that currently present net payables and receivables arising from unsettled regular-way trades may need to modify systems and reporting processes to capture the information required in the proposal. Furthermore, entities will have to deal with the consequential effects such as managing investor relations, assessing the potential capital implications, renegotiating loan covenants and possibly disclosures.

Accordingly, we encourage the Boards' to consider the feedback received from all preparers and the time and effort necessary to address other standard setting projects when determining an effective date for this proposal. Similarly, it is important that the Boards continue their ongoing discussions with regulatory authorities to better understand the implications on regulatory capital and liquidity ratios and to provide the regulators with sufficient time to address such implications before the accounting requirements become effective.