

April 28, 2011

Ms. Leslie Seidman Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-05116

Sir David Tweedie Chairman International Accounting Standards Board 30 Cannon Street London EC 4M 6XH United Kingdom

Re: FASB File Reference No. 2011-100, Proposed ASU, Balance Sheet (Topic 210), Offsetting; IASB ED/2011/1, Exposure Draft, Offsetting Financial Assets and Financial Liabilities

Dear Ms. Seidman and Sir David:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks, appreciates the opportunity to comment on the above-referenced document (the "Proposal").

# **Executive Summary**

The Clearing House supports the efforts of the Financial Accounting Standards Board (the "FASB") and the International Accounting Standards Board (the "IASB") (collectively, the

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<sup>&</sup>lt;sup>1</sup> Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

"Boards") to improve the quality and comparability of financial statements. In particular, The Clearing House acknowledges the need to develop a common model for offsetting, but does not believe that the proposed model would result in an improvement to financial reporting.

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In summary, The Clearing House:

- Strongly believes that net presentation is more relevant than gross presentation for derivatives and certain securities financing contracts<sup>2</sup> in that it provides a superior presentation of an enterprise's liquidity and credit risk;
- Believes that there is no compelling reason to further limit the availability of net
  presentation in favor of gross presentation, given that analysts have not expressed a
  clear preference for gross presentation and that any additional information that is
  required can instead be provided in the footnote disclosures;
- Believes that the Boards should consider the effect of the Proposal on financial ratios and other charges that are based on total assets and total liabilities, including those commonly used by banking regulators, especially in the U.S.; and
- Strongly encourages the Boards to consider the significant operational costs of compliance with this Proposal, as well as the two alternative approaches suggested below, before proceeding further with this Proposal.

We elaborate on these points below.

#### A. Net Presentation is More Relevant than Gross Presentation

The Proposal states that the objective in issuing the ASU is to "provide information about assets and liabilities that is useful for assessing the following:

- The entity's ability to generate cash in the future (the prospects for future net cash flows)
- The nature and amounts of the entity's economic resources and claims against the entity
- The entity's liquidity and solvency."<sup>3</sup>

We do not believe that the proposed ASU accomplishes these objectives for the following reasons:

<sup>2</sup> Securities financing contracts that currently are netted under ASC 210-20, Offsetting.

<sup>&</sup>lt;sup>3</sup> Proposed ASU, page 6 and ED/2011/1, page 6.

## 1. Net Presentation is a Superior Presentation of Liquidity Risk

We disagree with the Boards' assertion that "gross amounts of derivative assets and liabilities are more relevant to users of financial statements than net amounts for assessing the liquidity and solvency of an entity." The Boards appear to base this conclusion on the reasoning that the derivative can be settled or sold at any time for an amount equal to its fair value. In practice, with the exception of exchange traded products, derivatives generally are not sold or settled. Accordingly, the liquidity impact of derivatives has little to do with today's fair value. As noted in the dissenting views, the fair value of the derivative reflects the expected *net* cash inflows and outflows of the contract. Even for a single derivative contract, therefore, actual payments on the derivative contract will likely occur at different amounts, at different times, and in different directions than the fair market value of the derivative contract would suggest.

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In contrast, we believe that net presentation for derivatives and certain securities financing contracts<sup>6</sup> is a superior depiction of an enterprise's actual liquidity risk. This is because in the normal course of business for secured or collateralized derivatives that are executed under a master netting arrangement, liquidity risk is driven by the cash collateral and ongoing margining requirements which are calculated on a net basis, not a gross basis.

To illustrate: Assume Bank A has a derivative receivable of \$200 due in 5 years and a derivative payable of \$100 due tomorrow with the same counterparty, Bank B; Bank A already holds cash collateral posted by Bank B of \$100. When Bank A makes a payment of \$100 to settle the payable tomorrow, Bank B will be required to return \$100 to post additional cash collateral on Bank A's net open receivable balance. Thus, there is effectively no net movement of cash. Accordingly, we struggle to see how gross presentation would facilitate a user's ability to predict cash flows and understand liquidity. In fact, separating these balances from each other could mislead investors, as viewing the balances in isolation may result in cash flow expectations that are invalid.

We are aware that cash collateral posting may occur on a one-day lag. Thus, in the example above, Bank A will bear liquidity risk for one day, which we believe is nominal and could be addressed by appropriate disclosure. Moreover, gross balance sheet presentation of the derivative receivable and payable would not capture this nominal inter-day liquidity risk, because Bank A would initially record a derivative payable of \$100 and then replace that balance with a \$100 collateral payable the next day.

<sup>&</sup>lt;sup>4</sup> Proposed ASU, paragraph BC21.

<sup>&</sup>lt;sup>5</sup> Proposed ASU, paragraph BC82.

<sup>&</sup>lt;sup>6</sup> See footnote 2.

Finally, during times of market stress, the relevant measure of risk is the net risk amount by counterparty as that balance represents the credit risk. In a default event, credit risk and liquidity risk are the same amount for derivatives because any cash required to be settled is calculated on a net basis pursuant to the master netting arrangement. Ratings-contingent provisions that have liquidity implications are also primarily based on net exposures.

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# 2. Net Presentation is a Superior Presentation of Counterparty Credit Risk

Net presentation is also a superior presentation of an enterprise's credit risk, and is also consistent with how entities manage the business risks of their derivatives portfolios. Derivatives are executed under an ISDA master netting arrangement and, as a result, the enterprise's counterparty credit risk for these derivatives is equal to the net fair value across all positions with the respective counterparty. In this regard, we note that legal opinions have been obtained for over 50 jurisdictions, which confirm the enforceability of ISDA close-out netting. Furthermore, we are not aware of any instances in which the close-out netting provisions of the ISDA Master Agreement were found to be unenforceable.

The Boards seem to dismiss the relevance of credit risk to users of financial information.<sup>7</sup> Our understanding is that many financial statement users (*e.g.*, ratings agencies, lenders and other investors) prefer credit risk to be displayed prominently within the financial statements, as it assists them in making important decisions. Also, as explained above, the collateralization requirements for derivatives create a direct link between liquidity and credit risk.

Finally, we note that market risk information is essentially forward looking and is best conveyed via value-at-risk, stress tests and other similar risk metrics. Thus, there is no significant reason to change from net to gross presentation for reasons related to market risk.

In sum, gross presentation of derivatives contracts does not provide information regarding an entity's ability to generate cash in the future or about the claims against the entity. Net presentation, on the other hand, best reflects an entity's credit risk

<sup>&</sup>lt;sup>7</sup> "The Boards also concluded that offsetting based on a conditional right of setoff will result in financial statements that depict only the entity's exposure to credit risk. The Boards observed that the statement of financial position does not represent an aggregation of the credit risk of an entity; it is not its purpose to set out the rights or the obligations of an entity if counterparties fail or become bankrupt. Thus, the Boards concluded that offsetting on the basis of a conditional right of setoff would not result in financial statements that are representationally faithful." Paragraph BC36.

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profile and is consistent with how entities manage the risks of their portfolios. We believe it would be optimal if the accounting were aligned with the risk management of these instruments.

# 3. Net Presentation Results in the Same Accounting for Economically Equivalent Contracts

We also agree with the dissenting view that gross presentation is less preferable because it results in a different presentation for contracts that are economically equivalent, such as the example of the swap versus the two forward contracts. We believe that having the same accounting treatment for contracts that are economically equivalent is fundamental to ensure consistency and comparability of financial statements.

# 4. Analysts Have Indicated No Clear Preference for Net Presentation

As the Boards have noted, analysts and investors find both gross and net information useful. The user feedback also highlights the fact that current disclosures already provide a significant amount of information about gross and net fair value amounts. U.S. accounting standards currently require a reconciliation of gross fair value amounts to net amounts recorded on the balance sheet. Many tables presenting information about derivatives, such as fair values and credit exposures, disclose the impact of various netting adjustments. Under IFRS, most if not all financial institutions provide supplementary data that allows users to arrive at net amounts. Accordingly, we see no compelling need to change the current approach under U.S. accounting standards.

We understand the desire for additional information to facilitate a better understanding of the cash flow and liquidity impact of derivatives. To accomplish this, we believe net presentation could be supplemented by additional disclosure of items that are relevant to cash flow liquidity.

# 5. Gross Presentation Distorts Key Metrics and Results in Real Costs to Financial Institutions

From a regulatory perspective, we are concerned that a gross presentation will result in a highly distorted leverage ratio. We believe that in order to be useful, leverage also must consider the impact of risk mitigants. In the case of derivatives, risk mitigants include enforceable netting provisions and cash collateral margining provisions. Thus, we believe that where such provisions are in place, net presentation on the balance

<sup>&</sup>lt;sup>8</sup> Proposed ASU, paragraph BC83.

sheet presents a truer picture of economic leverage; gross presentation, in contrast, could be misleading.

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A gross presentation will also result in real economic costs to regulated entities where other charges, such as FDIC assessments, SIPC fees and some state and local taxes<sup>9</sup> are calculated on the basis of total U.S. GAAP assets. We are concerned that enterprises will be subjected to increased costs as a result of a change in an accounting standard, despite the fact that from an economic perspective, nothing has changed.

In summary, we strongly believe that net presentation of derivatives and certain securities financing contracts<sup>10</sup> is superior in presenting both liquidity and credit risks, and fairly presents market risk and settlement risk. In addition, we believe sufficient information already is disclosed to allow for comparability across entities. Accordingly, we do not believe there are benefits to the proposed changes that would justify the large operational costs of the changes involved as described further below. As a result, we strongly urge the Board to not proceed with the Proposal.

## B. Gross Presentation Will Create a Significant Operational Burden for Financial Institutions

The Proposal presents a significant operational burden for financial institutions that currently report under U.S. GAAP and will likely impact those that report under IFRS as well. In order to implement the Proposal, financial institutions will need to make changes to cash settlement systems, which will be extensive given the number and variety of types of contracts, counterparty preferences, clearing house practices, collateral maintenance requirements, and margin calculations and applications. Organizations also will need to identify not only those items that can no longer be netted, but also those items that are currently reported gross but need to be presented net.

Moreover, the population of contracts requiring analysis may be much bigger than originally anticipated by the Boards, extending to, for example, clearing and settlement arrangements with organizations such as Visa and other credit card merchants, merchant processing, interbank ATM settlement and other transactions. The Proposal also would require a significant change in practice and operational procedures for brokerage payables and receivables. Under current practices, receivables and payables relating to trade date/settlement date differences are recorded on a net basis. Presenting on a gross basis will require significant effort, so financial institutions may need additional time to implement the Proposal.

<sup>&</sup>lt;sup>9</sup> See, e.g., N.Y. Tax Law § 1455; 20 N.Y.C.R.R. §18-5; N.Y.C. Admin. Code §11-643-5.

<sup>&</sup>lt;sup>10</sup> See footnote 2.

We are concerned that such a large effort may take resources away from other priorities, such as implementation of the anticipated new standards on credit impairment, leasing, revenue recognition and the many regulatory, capital and liquidity changes being introduced pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and Basel III capital and liquidity framework.

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In summary, the complexity and scale involved in these changes must be considered and taken into account by the Boards as we strongly believe that the costs of implementing this Proposal far outweigh the benefits.

#### C. Alternatives for Consideration

As an alternative to the Boards' Proposal, we suggest that the Boards continue to permit netting for collateralized derivatives and for derivatives that are traded on or cleared through a central exchange, where netting is contractually provided and legally enforceable. In the case of collateralized derivatives under an ISDA Master Agreement, the collateral may be used to offset a counterparty's liability in the event of default and the margining provisions ensure that sufficient collateral will be available at all times to settle the contract. In the case of a derivative traded on a central exchange or clearing house, the exchange or clearing house stands in the place of the counterparty, thus mitigating the entity's counterparty exposure. We believe this approach is consistent with how financial institutions manage risk and best reflects the credit, liquidity and market risks of these contracts.

A second alternative we would support would be a linked presentation approach whereby eligible financial instruments (derivatives and repurchase agreements where there is either a conditional or unconditional and legally enforceable right to net) would be presented in the statement of financial position on both a gross as well as a net basis, with the classification as an asset or liability based on the net carrying value of the group. The net amount would be aggregated based on other relevant accounting guidance for the transactions. This approach would seem to satisfy the preference expressed by many analysts to see both gross and net amounts on the face of the financial statements.

## D. Suggestions for Improvement

Should the Boards decide to proceed with the Proposal, we have the following comments:

We believe more clarification is needed to interpret the term "simultaneous" as it could be
viewed as only requiring instantaneous settlement, thereby precluding intra-day settlement
netting practices. We understand that many major exchanges have intra-day settlements,
which would not meet a stringent definition of "simultaneous" settlement. Accordingly, we
encourage the Boards to require "same day" settlement rather than "simultaneous"
settlement.

- We believe the scope of the Proposal should be clarified to exclude arrangements involving
  multiple bank accounts wherein an entity is permitted to offset an overdraft amount in one
  account with a positive balance in another account. We believe in this situation the unit of
  account is clearly at the level of the account holder as opposed to the individual bank
  account, as the accounts are all in the same party's name.
- We believe that the requirement in paragraph 12.a.2. to disclose separately for eligible
  liabilities the portfolio-level adjustments made in the fair value measurement to reflect the
  effect of the entity's net credit risk is essentially meaningless as, de facto, there is only one
  net exposure amount of an entity's own credit risk. Accordingly we recommend that this
  Proposal be eliminated.
- We believe that the disclosures required by paragraph 12.f. regarding collateral arrangements are largely duplicative with existing U.S. GAAP.<sup>11</sup> The Clearing House believes that analysts find these disclosures of little use. Accordingly, we believe that the incremental requirement to disclose information regarding cash and other financial instrument collateral *obtained* (as opposed to collateral that is able to be *sold or repledged* that is presently required) will similarly prove to be of little interest to investors. As a result, we recommend that the Boards eliminate this proposed requirement.
- We believe that the proposed requirement in paragraph 12.d. to disclose the amount of
  eligible assets and eligible liabilities that the entity has a conditional right to set off would
  encompass situations such as traditional lending arrangements where the lender has the
  right to claim non-cash collateral, such as real estate, from the borrower, in the event of the
  borrower's default. We question whether this is what the Boards intended as these
  arrangements are not presented net on the balance sheet today. We believe such a
  requirement would further add to the operational complexity of the Proposal. Accordingly,
  we recommend that it be eliminated.
- The Boards must provide for sufficient time to implement the standard due to the operational complexity and proposed transition requirement for retrospective application.

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<sup>11</sup> See, for example, the disclosures required by Topic 860-10-50-4 pertaining to arrangements where an entity has accepted collateral that it is permitted by contract or custom to sell or repledge.

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Thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org) or Gail Haas at (212) 612-9233 (email: gail.haas@theclearinghouse.org).

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Sincerely yours,

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Senior Vice President, Financial and Tax Affairs

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cc:

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