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11 November, 2010

Ms. Leslie Seidman  
FASB Acting Chairman  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856

Sir David Tweedie  
IASB Chairman  
30 Cannon Street  
London  
EC4M 6XH  
United Kingdom

Re: *Offsetting of Derivative Assets and Liabilities* – 17 November Joint Board Meeting

Dear Ms. Seidman and Sir David:

Goldman Sachs has been following the joint project on offsetting of derivative assets and liabilities with great interest. As you know, U.S. accounting standards currently allow offsetting while IFRS does not. The difference between the two treatments is material to the balance sheets of dealers. We therefore applaud your decision to seek convergence in this important area.

On 1 November we met with a subset of FASB and IASB Board members and Staff to present our views on derivatives netting. We presented the views of our senior risk managers charged with managing credit, liquidity and market risks on whether gross or net presentation of derivative fair values on the balance sheet better informs users about these risks. We also presented user perspectives based on outreach conducted by our investor relations department.

In summary, our risk managers stated that net presentation better informs than gross on credit risk because it is a vastly more relevant measure of current credit risk exposure when supported by a legally enforceable netting framework. We also stated that net presentation better informs than gross on liquidity risk because of the significant impact of collateralization agreements, which are based on net fair values and not gross fair values. Finally, we stated that neither gross nor net presentation informs on market risk, as market risk exposures are forward looking and consider all on and off-balance-sheet exposures, including cash instruments and derivatives. The key takeaway was net presentation of derivative fair value amounts on the balance sheet – although not perfect – provides significantly more relevant information than gross.

The key takeaway from the user perspectives is that sophisticated users already make netting adjustments. They view net presentation on the balance sheet as closer to economic reality while gross presentation is largely meaningless. Uniform convergence of netting adjustments would increase transparency and be a convenience for users from all backgrounds. A clear beneficiary of net presentation would be the less sophisticated financial statement user who doesn't have the knowledge base to make the necessary netting adjustments.

The user perspectives highlight that information about gross and net fair value amounts is already disclosed and is transparent to users. 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 which presents gross, most if not all financial institutions provide supplementary data that allows users to arrive at net amounts.

#### 17 November Joint Meeting; FASB Staff Paper 8C/IASB Staff Paper 3C

We have read the above-captioned Staff Paper and clearly support Alternative 1, which is consistent with current U.S. accounting standards. In our view, the decision to allow derivatives netting is a trade-off between adherence to the Conceptual Framework and relevant information. Along that continuum, we believe relevance – a key objective of financial reporting – should weigh heavily in the Boards thinking. Presenting derivative fair values other than on a net basis (Alternatives 2 and 3 in the Staff Paper) will greatly distort our balance sheet, provide no meaningful information on our true exposures, and will provide no incentive from a financial reporting perspective to pursue netting agreements (or potentially, other risk mitigants).

The Staff Paper contains several arguments opposing netting. In the paragraphs that follow, we provide our views on some of those arguments. For your convenience, we have included the relevant section of the Staff Paper, followed by our views.

**Paragraph 15:**

“A disadvantage of this [netting] approach is that offsetting based on credit risk could misrepresent the amounts by which the instruments being offset under master netting arrangements are actually settled. It is not common, other than in an event of default or bankruptcy, that the instruments offset under master netting arrangements actually settle net.”

Goldman Sachs' Views: Derivatives settling on different days are typically settled gross. However, daily fluctuations in derivative values typically result in daily cash collateral exchanged based on net values. Market convention is to recognize netting whenever feasible and appropriate.

More broadly, this argument suggests gross presentation better informs than net presentation on liquidity risk. At a fundamental level, the fair value of a single derivative contract generally does not provide relevant information about its liquidity profile, for example, because payments can occur at different amounts, at different times, and in different directions, which are then encapsulated into a single fair value measurement.

When a single contract is then combined with other contracts to create a portfolio of derivative contracts, gross presentation on the balance sheet does not inform about liquidity risk because the issues inherent in a single measurement are multiplied across the portfolio.

As we stated at our 1 November meeting, net presentation is a more relevant measure of liquidity risk. Dealers manage liquidity risk of derivatives on a net basis. Market movements generate direct and indirect liquidity flows based on net exposure. Ratings contingent provisions with liquidity implications are predominately based on net exposure. Client behavior that could impact a dealer's liquidity is driven by net exposure. A substantial amount of derivative transactions are collateralized. Funding requirements are driven by collateral held and posted and margining is done on a net basis.

**Paragraph 21:**

“The opponents of this [netting] view believe that aggregating the asset and liability positions of several of such instruments could further reduce users' ability to understand the risk exposures of an entity arising from such contracts. If these positions are aggregated, users cannot, for example, determine which side of contracts an entity holds and therefore the risks the contracts pose. Investors can better assess these risks if they know which side of such contracts an entity holds.”

Goldman Sachs' Views: This argument suggests gross presentation better informs than net presentation on market risk. As we stated at our 1 November meeting, presenting derivatives on a gross or net basis bears no relationship to a dealer's market risk exposures. A balance sheet analysis is not relevant, as market risk analysis is first and foremost based on net exposures, that is, positions in offsetting trades, regardless of their composition, for example, cash positions versus derivatives and other off-balance-sheet exposures. Value-at-risk, stress tests, and other disclosed risk metrics inform users on a net basis.

**Paragraph 23:**

“Opponents [of netting] also believe that net presentation (of the gross fair value of the outflows and the inflows) on the face of the statement of financial positions reduces users' ability to understand the implied economic leverage position of an entity.”

Goldman Sachs' Views: Leverage is a legitimate concern of users, although it is an imprecise and potentially misleading measure of risk if the analysis does not consider the underlying assets funded with leverage and any associated risk mitigants. In the context of derivatives, risk mitigants include enforceable netting provisions and cash collateral margining provisions. When the two are present in a master netting agreement, which is often the case, net presentation on the balance sheet presents a truer picture of economic leverage than gross, which can be misleading.

**Paragraph 25:**

“The opponents of this [netting] approach also reject the idea that the net balance (current exposure) represents the credit exposure of an entity. Although, current exposure provides a snapshot of credit exposure at a single point in time, there is a fundamental difference between derivatives and unconditional payables and receivables. The nature of derivative contracts is such that their market values can fluctuate substantially, even over relatively short periods of time. Because the credit exposure of derivatives can fluctuate dramatically, measuring exposure at a single point in time does not yield an accurate assessment of the credit exposure of a derivative portfolio. Thus, they argue that net fair value of derivative positions does not represent the net credit exposure of the entity. This view is consistent with how both market participants and supervisors measure credit risk - total credit exposure is calculated as the sum of current and potential exposure.”

Goldman Sachs' Views: Measuring credit exposure on a netted current exposure basis provides the most accurate and relevant point in time snapshot of credit exposure for a derivatives portfolio. It doesn't reflect the volatility of the exposure, but volatility and other asset characteristics are best described through disclosure similar to the way other potentially volatile assets are treated. Market participants and supervisors typically measure credit risk using several common metrics including current exposure, expected exposure and potential exposure. These metrics measure current risk, expected future risk and potential (e.g., two standard deviation) future risk. The one characteristic that

these metrics share is the use of netting (when supported by legal enforceability). When evaluating credit exposure at a specific point in time, market participants and supervisors typically refer to net current exposure.

**Paragraphs 26-29:**

“They [opponents of netting] also argue that, credit exposure (net fair value of derivative positions) does not take into account the probability that given that a particular institution fails to deliver, other institutions in the system would also fail to deliver (a major concern arising from the recent financial crises). This is based on the fact that financial institutions are usually linked, either directly, through the interbank deposit market and participations in syndicated loans, or indirectly, through lending to common sectors and proprietary trades.

Financial institution distress dependency tends to rise in times of distress since the fortunes of institutions decline concurrently through either contagion after idiosyncratic shocks or through negative systemic shocks.

Derivative markets are seen as particularly vulnerable to systemic shocks. The value of derivative positions can change rapidly. The huge volume of derivative trading and the enormous open positions misrepresent the true liquidity of the derivative markets when they are under stress. Moreover derivative markets are dominated by a few large firms. Thus the failure of one firm and the response of others can lead to endogenous adverse changes in asset values and to rapid changes in market liquidity.

Thus some argue that in presenting these positions gross most interconnections will show up in the balance sheet. They argue that gross presentation would thus give a better picture of the exposure of the bank itself to counterparty risk. For example, a bank has a large amount of derivatives contracts outstanding, but without any significant net exposure. It could still make very large losses in case important counterparties fail and netting arrangements do not work or the pricing of the contracts is distorted, as happens typically in a systemic crisis.”

*Goldman Sachs' Views:* The argument incorporated in paragraphs 26 – 29 essentially reduces to: “given that there are uncertainties associated with markets and operational processes that can be exacerbated during periods of stress, gross rather than net presentation should be used to ensure that exposures are not understated.” While this has some intuitive appeal, it is based on imperfect logic and leads to unintended, adverse consequences.

Paragraphs 26 and 27 appear to deal with settlement risks, specifically the risk that a distressed financial institution might fail to deliver; and, the observation that there is potential contagion risk across financial institutions. These are legitimate concerns.

However, neither gross nor net presentation of current exposures on the balance sheet accurately captures prospective settlement risks. For example, a \$100mm spot FX trade settled through a free delivery has \$100mm of settlement risk, while it may have anywhere between \$0 and \$100mm current exposure. Whether the current exposure is reported on the balance sheet net of other trades or gross (that is, only reflecting the current exposure of this trade), is not at all representative of the spot settlement risk. While it is true that gross exposures will be larger than net exposures, to conclude that one should use a larger (but largely uncorrelated) number as a proxy for this settlement risk is highly misleading.

Paragraph 28 asserts that because derivative fair values and liquidity can change rapidly (especially during periods of stress), one should be conservative and present fair values gross rather than net. This assertion also suffers from imperfect logic. While there may be increased price volatility during stressful times, it will affect all positions within a netted portfolio; the net impact on P&L may be positive, negative, or neither. Merely showing gross numbers gives no meaningful information about the true portfolio credit risk, at exactly the time it is most necessary.

Paragraph 29 asserts that given the risk of netting failure, positions should be reported gross. We concur that if there is a significant risk, positions should be reported gross; it is only where we are confident that there is a very high certainty of enforceability that exposures should be reported net. Our experience, and that of the industry generally, is that there is a substantial amount of information available on where netting is highly certain and where it is not. In addition, we are not aware of any situation where we believed we had enforceable netting rights and found out otherwise in a distressed circumstance.

In summary, there is no single presentation that is 100% accurate, 100% of the time. The only realistic objective is to choose methodologies which present exposures in the most informative manner. For representing credit risk, netted exposures are the most meaningful. As an example, our gross exposures to recently failed broker dealers, which whom we did substantial business, would have indicated extremely large levels of credit risk. In fact, our netted risk was well controlled, and the ultimate outcome reflected this.

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Thank you for the opportunity to provide our views. If you have any questions or comments regarding this letter, please do not hesitate to contact me.

Sincerely,

Matthew L. Schroeder