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— April 27, 2011

Re: IASB Exposure Draft ED/2011/1: Offsetting Financial Assets and Financial Liabilities

Dear Sir David,

— Commerzbank Aktiengesellschaft¹ appreciates the opportunity to comment on the IASB's Exposure Draft ED/2011/1 Offsetting Financial Assets and Financial Liabilities issued in January 2011 (the "ED").

The offsetting of financial assets and financial liabilities is one of the biggest differences between entities reporting under US GAAP and IFRS, i.e. whether over-the-counter derivatives should be reported on gross or net basis. We, therefore, acknowledge the need for convergence in this area. In this regard, we welcome and applaud the IASB and the FASB efforts to develop a common set of principles for the offsetting of instruments that would address the present differences in the offsetting requirements between IFRS and U.S. GAAP

— However, we are not supportive of the Boards' chosen approach in the ED to eliminate the offsetting differences between IFRS and U.S. GAAP, as we believe that the ED is driven more by the need to converge rather than to achieve an appropriate common set of offsetting principles. In this regard, we do not think that the proposed offsetting approach in the ED would provide financial statement users with the most relevant or decision-useful information, since the ED would result in most derivative instruments to be presented gross on the face of the balance sheet. We feel that such grossing-up of the balance sheet would obscure information and does not reflect the true economic exposures of the reporting entity, especially for the banking industry where derivative instruments are transacted in huge volumes that in most cases are fully collateralised either in the form of cash or security interests.

¹ Commerzbank Aktiengesellschaft is the second largest credit institution in Germany, and one of the leading financial institutions in Europe. Following the takeover of Dresdner Bank in 2009, Commerzbank is the leading bank for private and corporate banking in Germany. The bank serves approximately 15 million customers worldwide.

On the contrary, we believe that the existing offsetting framework under the U.S. GAAP, supported by adequate disclosures, provides a superior approach towards presenting meaningful and comprehensive information for users of financial statements that best reflect the credit exposure, liquidity or solvency risk of the reporting entity. As the IASB has noted in the ED, there is no clear consensus amongst financial statements users for either gross or net presentation in the balance sheet, as long as the appropriate information is provided in the notes to the financial statements. In the light of this, we question the Board's rationale for choosing an approach that could have far-reaching adverse effects on leverage ratios and regulatory requirements. This, in our view, will not result in an improvement to financial reporting. On the other hand, we would support a converged approach that is more towards the direction of the existing offsetting requirements in the U.S. GAAP, in particular the principles in FIN 39 and FIN 41 that allow net presentation for bilateral transactions executed under a master netting agreement such as that issued by ISDA. It is our view that derivatives transacted under master netting agreements should be reported net in the balance sheet as they are in most cases fully collateralised to mitigate credit and liquidity risk. Besides, we believe that a gross presentation does not reflect the true picture of an entity's available resources to its creditors in the event of a default, given that all transactions under an enforceable master netting agreement legally creates a single contract with the counterparty such that the entity is exposed to the net credit risk of all individual transactions, and hence constitutes a net settlement for all such transactions upon closeout. We, therefore, strongly urge the Boards to build an offsetting approach that includes the notion of reducing credit risk and liquidity risk, rather than solely on the basis of an entity's future cash flows expected from settling two or more separate financial instruments.

Although the ED generally retains the existing criteria in IAS 32 for offsetting financial assets and financial liabilities, there are proposed provisions in the ED that could potentially impact existing IFRS reporters in the banking industry. We highlight below 2 concerns we have where the new proposals could be interpreted to mean derivatives and repurchase agreements executed and cleared through central counterparties (CCPs) would not qualify for netting under the ED:

Inter-relationship between the intent to settle net and simultaneously

The inter-relationship between an entity's intent to settle net and simultaneously has never been in the focus in the current market practice to offset trades cleared through CCPs such as clearing houses. This is because of the provision contained in paragraph 48 of IAS 32 which indicates that the operating mechanisms of a clearing house is deemed to constitute simultaneous settlement as defined in IAS 32.

However, the language used in the ED for the application of the simultaneous settlement provision is now being interpreted by market practitioners to be more restrictive than that used in current IAS 32. Because of this, a debate on interpretation has arisen amongst market participants whether the strict simultaneous settlement provisions contained in the ED applies to CCP-cleared transactions especially for interest rate swaps and repurchase agreements. Our view is that this should not be the case. We remain convinced that the language used in the ED continues to require an entity to offset centrally cleared and settled arrangements since they result in an economic outcome that is in effect tantamount to a single net amount based on the fact that the settlement mechanisms in CCPs, in particular that of

clearing houses such as London Clearing House, give rise to no credit or liquidity risk exposures. We therefore recommend that the IASB provides clarification on this in the final standard.

Besides, we view the proposed simultaneous settlement requirement in the ED to be rule-based as it would predominantly excludes the possibility of netting even if the period between settlements is brief and there is no change in the value of the asset and liability. We therefore strongly recommend that the IASB re-formulate this requirement from a principle based perspective instead.

— **Collaterals and Margin Accounts**

Paragraph C14 in the ED states that margin accounts required by exchange-traded, centrally cleared and bilateral over-the-counter (OTC) derivative transactions are collaterals and hence they are to be accounted for separately as assets or liabilities. We have concerns with the rule-based formulation of this principle:

- Firstly, we do not see the rationale behind precluding financial collaterals from offsetting when an entity meets the offsetting requirements
- Secondly, if the Boards continue to scope out financial collaterals from the offsetting framework, we are concerned with the broad generalisation to treat variation margins as collaterals in the ED. Variation margins posted with certain exchanges or clearing houses constitute a legal form of settlement in that they remain with the exchanges or clearing houses (absent a change in the fair values of the transactions) to be used to close out and settle members' net position.

— We believe that the use of collaterals and margin accounts mitigates gross settlement risk significantly and not allowing their netting would ignore the economic substance of arrangements that involve the provision of collaterals and margin accounts by the counterparties. Moreover, in the light of the recent financial crisis, there has been a movement to put more bilateral OTC derivative trades to be settled through CCPs in order to reduce the credit exposure and liquidity risk of the counterparties. We are concerned that the CCP initiatives would experience a setback if transactions executed with CCPs are required to be presented gross in the balance sheet because the offsetting framework fails to recognise the netting eligibility of collaterals and margin accounts, including imposing the unnecessary and unreasonable requirement for settlements to occur at the same moment in time. We, therefore, urge the Board to develop a principle-based approach for determining the offsetting requirements for collaterals and margin accounts that provide the best reflection of the above-mentioned arrangements in the financial statements.

— Furthermore, we find the proposed disclosure requirements extensive and in certain instances duplicative, prescriptive and rules-based and even to some extent non-operational. They contradict the principle of the disclosure requirements under IFRS 7 where the focus is to provide information to users of financial statements that is based on information given to key management personnel. We question the usefulness of the proposed disclosure requirements while at the same time we are concerned with the significant operational impacts they would have for existing IFRS reporters. We therefore recommend that

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the Board develops more balanced disclosure requirements that take into account the existing disclosure requirements for financial instruments in IFRS 7.

Last but not least, we believe that the timetable for the implementation of the final standard on offsetting should be aligned with the effective dates for the entire IFRS 9. As we have stated in our comment letter on the Request for Views on Effective Dates and Transition Methods, the effective date of the final standard on offsetting should be 01.01.2015 (on the basis that we need at least 3 years implementation period after the finalisation of standards in 2011). In setting this effective date in our answer to the Request for Views on Effective Dates and Transition, we did not consider the onerous and complex level of disclosure requirements proposed in the ED since we do not have this knowledge at that point in time.

At the same time, we recommend to apply the final offsetting requirements prospectively. This is a consequence of our view that the whole IFRS 9 - classification and measurement, impairment and hedge accounting - should have the same transition requirement, i.e. prospective, in order not to confuse financial statements users.

Our detailed responses to the questions in the ED are included in the Appendix to this letter. Our views expressed in this comment letter may be subject to change at a later stage as and when we obtain a more complete picture of the entire project on the accounting for financial instruments to replace IAS 39 with IFRS 9.

We thank the Board for considering our comments and would be pleased to meet with the Board or its staff at your convenience to discuss our concerns raised in this comment letter.

Kind regards,

COMMERZBANK
Aktiengesellschaft



Hermann Rave
Head of Group Accounting



Dr. Patrick Kehm
Head of Accounting Principles

Appendix

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?

The proposal in the ED requires net presentation when an entity satisfies 2 criteria. The first criterion is an unconditional right of set-off that is legally enforceable in all circumstances. The second criterion is that the entity needs to have intent to settle on a net basis or simultaneously.

We acknowledge the need for convergence between US GAAP and IFRS for offsetting. However, we do not believe that the proposed principles as outlined above would result in an improvement in financial statements for users in the area of offsetting for transactions involving derivatives and repurchase agreements. For such transactions, regardless of whether they are centrally-cleared or bilateral based on master netting agreements, there is little decision-useful information to be obtained by presenting them on a gross basis. As a result, we would support a converged approach that is more towards the direction of the existing offsetting requirements under US GAAP, in particular the principles found in FIN 39 and FIN 41. This would result in a better representation of an entity's credit, liquidity and solvency risks. In this regard we do not support the first criterion that limits the set-off to only unconditional right as we believe that there are circumstances under which conditional right of set-off would merit the netting of a financial asset and financial liability in the balance sheet. Such circumstances could be found in the case of bilateral OTC transactions involving master netting agreements such as that issued by ISDA.

In the second criterion under the ED, the settlement of an asset and liability would only be considered simultaneous if it occurs at the same moment. Market practitioners have interpreted this proposed requirement on simultaneous settlement to be more restrictive than the current IFRS provision contained in paragraph 48 of IAS 32. This applies especially for trades cleared through central counterparties (CCPs), in particular interest rate swaps and repurchase agreements. Because of IAS 32.48, the current focus for such transactions has been on the first part of the second criterion, i.e. the entity's intent to settle on a net basis taking into consideration that there is only a single resulting amount to settle at the end. This is especially the case for London Clearing House (LCH) cleared transactions. However, this principle in current IAS 32 is not clearly articulated in the ED, and as a consequence a debate has arisen in the market on whether the simultaneous provision in the latter part of the second criterion applies to transactions executed with CCPs. This unclear interaction between the two criteria is all the more increased by the following paragraphs contained in the ED:

- In paragraph C7, the ED states that “the requirement for an intention to settle net or to settle simultaneously is assessed from the reporting entity’s perspective”. It follows therefore that there is no necessity to look into the clearing mechanism of each individual CCP.
- In paragraph C9, the ED states that the rules of a clearing house typically provide for automatic netting and cancellation of offsetting contracts and as such the entity’s intention to settle net is demonstrated.

We support the above statements as we do not see any conceptual reasons to impose upon the reporting entity the onus to ensure that its counterparty, the CCP, has set up clearing and settlement mechanisms that fulfil the simultaneous settlement provision. We find this an unreasonable demand for reporting entities as it would require tremendous efforts to undertake this task.

At the same time, we feel that the Board has failed to uphold the spirit of developing principle-based accounting standards when it comes to the proposed guidance on simultaneous settlement in the ED. We are of the opinion that this imposes a “rule” for the amount of time that could occur between the settlements of two or more transactions. We find this “rule” to be extremely strict as it does not take into consideration the operational constraints faced by entities.

On top of the above, we have some concerns about the language used within the ED that could have potential unintended consequences for transactions executed with CCPs:

- The provision in C14 states that an entity shall not offset collaterals and that margin accounts are collaterals and hence should be shown separately on the face of the balance sheet. We do not see any conceptual reasons to limit financial collaterals from offsetting in the financial statements. Furthermore, we view margin accounts maintained with exchanges or clearing houses to constitute a legal form of settlement as they remain with the exchanges or clearing houses (absent a change in the fair value of the transactions) to be used to close out and settle members’ net position. Hence, we do not agree with the ED’s broad generalisation to treat margin accounts as collaterals. In view that the provision of collaterals and margin accounts mitigates gross settlement risk significantly, we believe that they should be eligible for netting if the offsetting requirements are met. We therefore recommend that the Board replace the proposed provision on collaterals and margin accounts in the ED with principles that are based on their substance rather than on their legal form.
- As we have aforementioned, we support the above statements in C7 and C9 as they would lead to the conclusion that transactions executed with exchanges and clearing houses would meet the proposed offsetting requirements. However, an entity’s ability to net these transactions could be limited by BC 52 and BC 53 to only transactions that have the same maturities and payment dates. This would essentially preclude offsetting for most of the exchange-cleared or centrally-cleared transactions. Moreover, precluding centrally-cleared transactions from netting could cause a setback on the current ongoing initiatives to mandate an increased level of central clearing for bilateral OTC transactions in an effort to reduce the credit and liquidity risks of counterparties.

Taking all the above arguments into consideration, we strongly urge the Board to reconsider their proposals in the ED, and instead develop a robust offsetting framework that is based on principles that focus on the substance of the arrangements undertaken by entities and the reason for which entities enter into such arrangements to reduce liquidity and credit risk.

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 exercise ability is not contingent on a future event. Do you agree with this proposed requirement? If not, why? What would you propose instead, and why?

As we have described in our answer to Question 1, we do not agree with the proposed requirement that the right to set-off should be unconditional. We have also stated our support for the current US GAAP offsetting requirements in respect of derivatives and repurchase agreements. This is in particular to FIN 39 and FIN 41 where they are to be presented net if transacted with the same counterparty under a master netting agreement such as ISDA where it provides for net settlement through a single payment in the same currency in the event of default. Hence, we do not agree to the provision in the ED requiring the unconditional right to be enforceable in the normal course of business and on default, solvency or bankruptcy of a counterparty including that of the reporting entity. Instead, we view that the ability to offset only on the event of default, rather than in all circumstances, also provides useful appropriate risk information to users of financial information in the event of close-out positions.

Additionally, it is not clear how the proposed unconditional right to set off in all circumstances is to be applied as the provisions on "all circumstances" is far-reaching and virtually impossible to clearly obtain a definitive legal opinion on what could comprise all circumstances. We believe that there could be application issues which need to be addressed by the Board such as the existence of a right by a counterparty to early terminate the contracts when the arrangements satisfy the offsetting criteria. This inability is worsen by the fact that offsetting is mandatory and not an accounting policy choice. We believe that this would require significant change to existing operations in an entity to analyse and identify all contracts that meet the proposed requirement in the ED. We therefore request that the Board reconsiders the proposed "unconditional" criterion.

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 with the proposal to require offsetting for both bilateral and multilateral set-off arrangements when they meet the offsetting criteria.

— We do not see any reason to explicitly limit the offsetting requirement to only bilateral agreements. On the contrary, we believe that in the circumstances, as 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 paragraph 7 & 8 of the IASB Agenda Paper 4A / FASB Agenda Paper 9A in the December joint IASB / FASB Board Meeting), but also outside a group context for structured transactions involving multiple counterparties where there are established terms that require direct settlement amongst the counterparties.

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?

As we have described in our answers to the previous questions in the ED, we do not agree to the proposed offsetting requirements. In the light of this, we believe that this question could only be appropriately considered in the context of the final offsetting framework.

— However, independent of the above, we do not agree with the proposed disclosure requirements in the ED for the following reasons:

- They are expansive and would be costly and onerous for entities to apply. This is in particular to the disclosure proposal that requires an entity to carry out extensive search to identify contracts where there is a conditional right of set-off but is presented gross in the balance sheet under the ED, and therefore is required to give quantitative information of the amount of the conditional offset. We feel that the costs to implement the proposed disclosure do not justify the benefits received.
- They are prescriptive and very much rule dictated, especially the tabular format proposed by the ED to provide disclosure by class of financial instruments.
- They are in certain cases duplicative such as the information on credit quality of financial instruments that is also required under IFRS 7. In addition, we feel that the proposed disclosure requirements do not follow the same basis as in IFRS 7 where the focus is on the way an entity provides in-

formation to key management personnel. We feel that the foundation upon which IFRS 7 is built is better suited to provide decision-useful information to users of financial instruments.

- They include the disclosure of “portfolio-level adjustments in the fair value measurement of derivatives” for the financial assets and financial liabilities that are presented net in the balance sheet (refer to footnote on page 23 and 24 of the ED relating to the proposed prescribed format for disclosure). These portfolio-level adjustments are in the context of the fair value measurement disclosures for financial instruments and it is not clear what is the Board’s intention for including them in the offsetting disclosures. Additionally, we question the usefulness of providing such information by class of financial instruments.

In view of the above, we urge the Board to reconsider the depth of the proposed disclosure requirements and their usefulness in the ED. Considering the increasing amount of disclosures required by the Board recently, we advocate that the Board reviews the offsetting disclosure requirements in the context of IFRS 7 in order to ensure that the level of disclosure requirements is balanced and consistent across the entire accounting regime for financial instruments.

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.

As we have described in our answers to the previous questions in the ED, we generally do not agree to the proposed offsetting requirements. Similarly to Question 4, we believe that this question could only be appropriately considered in the context of the final offsetting framework.

However, we are of the opinion, as we have mentioned in our comment letter to the Request for Views on Effective Dates and Transition, that the effective date for offsetting should be aligned to the effective date for the entire IFRS 9 (classification and measurement, impairment and hedge accounting). Hence, the effective date should be 01.01.2015 (on the basis that we need at least 3 years implementation period after the finalisation of standards in 2011). In setting this effective date in our answer to the Request for Views on Effective Dates and Transition, we did not consider the onerous and complex level of disclosure requirements proposed in the ED since we do not have this knowledge at that point in time.

Similarly as described in our comment letter on the Request for Views on Effective Dates and Transition, we are in favour of a prospective application for the entire IFRS 9. We do not believe in having different transition requirements for different parts of IFRS 9. Doing a prospective application for the entire IFRS 9 would avoid confusing financial statement users.