

**David Schraa**  
*Director, Regulatory Affairs*



April 28, 2011

Sir David Tweedie,  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
EC4M 6XM London, United Kingdom

1333 H Street, NW, Suite 800E  
Washington, DC 20005-4770

TELEPHONE 202.857.3600

FAX 202.775.1430

WEB [iif.com](http://iif.com)

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

**Re: ED/2011/1 Offsetting Financial Assets and Financial Liabilities  
Proposed Accounting Standards Update, Balance Sheet- Offsetting  
(File ref: 2011-100)**

Dear Sir David and Ms. Seidman:

The Institute of International Finance (IIF) Senior Accounting Group appreciates the opportunity to comment on the boards' joint proposal on offsetting financial assets and financial liabilities. Today, differences between IFRS and US GAAP requirements on derivative netting contribute to the largest quantitative balance sheet difference between IFRS and US GAAP reporting financial institutions. We fully support the boards' efforts to eliminate these current differences. We believe that it is vital that the bases upon which investors evaluate relative leverage, exposures, returns on investment and financial position converge be based on consistent and robust principles. The IIF has for a long time supported convergence. It remains fundamental in the view of the Institute that a single set of high-quality international accounting standards is critical in today's global financial markets. In our view, convergence on sound offsetting requirements that reflects the true exposure of an entity arising from financial instruments including derivatives and repurchase agreements (repos) will be an improvement to financial reporting for both users and preparers of financial statements.

*Overall views*

Despite the boards' efforts to develop a converged approach to offsetting, we are unable to support the boards' proposals as drafted. We note that the proposal as drafted would render it difficult, if not impossible, for financial institutions to achieve any balance sheet offsetting, even in instances where the functional equivalent of net settlement is achieved. We

acknowledge and agree with the boards' objectives for providing information that is useful for assessing prospective net cash flows, the nature and amounts of the entity's economic resources and claims against the entity; and the entity's liquidity and solvency. We do not believe that gross presentation in all circumstances on the balance sheet necessarily achieves the boards' objectives. In particular, we do not agree that gross presentation provides a more informative view of financial institutions' financial positions in the context of exchange-traded and cleared derivatives, bilateral derivatives that are cash-margined, and centrally cleared securities financing contracts. An informative reflection of financial position must take into account common mechanisms adopted by exchanges and clearinghouses, which in combination with associated netting arrangements, provide robust credit and risk mitigants that mitigate/eliminate credit and liquidity risks by transforming the cash flow attributes of underlying contracts into the economic equivalent of net settlement. Gross presentation also fails to capture the true economics of similar bilateral transactions carried out under well-understood ISDA documentation. (In addition, it should be kept in mind that such transactions are subject to robust internal risk management (the requirements as to which have of course been tightened up under Basel III and related regulatory developments) including margin maintenance.) We believe reflection of such mechanisms and their corresponding economic effects is necessary to represent an entity's true financial condition to users of financial statements. We further note that net presentation is consistent with the boards' broad goal better to align risk management and processes with financial reporting as set forth in the boards' proposals on impairment and the IASB's proposals on hedge accounting and requirements for classification and measurement.

Gross presentation would actually misinform users of financial statements with respect to transactions managed as described above. We note that the boards believe existing and potential investors, lenders and other creditors need information:

- a) to help them assess the prospects for future net cash flows;
- b) about the nature and amounts of a reporting entity's economic resources and about claims against the entity, to identify its financial strengths, weaknesses, liquidity and solvency and needs for additional financing; and
- c) about priorities and payment requirements of existing claims to predict how future cash flows will be distributed among those with a claim against the reporting entity.<sup>1</sup>

In our view, gross presentation misinforms users with respect to:

- i. the entity's expected cash flows, as daily mark-to-market and cash collateralization processes already incorporate expected future contractual cash flows;
- ii. the entity's liquidity profile, given the fact that the funding requirements for derivatives transactions are driven by collateral requirements of such contracts, which are calculated on a net basis by counterparty;
- iii. the solvency risk of the entity, which is driven by open market risk exposure, not the gross receivable and payable balances;
- iv. the entity's leverage and solvency, as gross liabilities will be settled against gross assets;
- v. the credit risk exposure of the reporting entity given the existence of a robust, legally enforceable netting framework; and

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<sup>1</sup> ED paragraph BC13

- vi. the resources available to creditors, as gross assets are subject to prior claims by derivative counterparties.

In addition, we are concerned that the grossing-up of balance sheets, both compared to the current position under US GAAP and, to a lesser but not insignificant extent, under IFRSs, will distort and obscure the real economic risks of financial institutions. Under gross presentation, riskier financial assets may appear insignificant when balance sheets increase significantly in size as a result of grossing up of derivatives and repurchase agreements, which are often fully collateralized. Gross presentation reflects neither the underlying economics of transactions from the point of view of a firm's stakeholders nor the way assets and liabilities are actually managed nor management's view of its exposures.

We generally support the boards' convergence towards a principles-based approach in line with the principles set out in BC 9, viz. to offset only when (i) an entity only has in effect a right or an obligation for only the net amount and (ii) the amount resulting reflects an entity's expected future cash flows from settling two or more separate financial instruments. We believe these principles achieve the boards' objectives for providing information that is useful for assessing prospective net cash flows, the nature and amounts of the entity's economic resources and claims against the entity; and the entity's liquidity and solvency. IFRS reporting Members believe that they are generally consistent with industry interpretations of the current IAS 32.

However, one of our greatest concerns is that the detailed guidance is rules-based and does not allow entities to meet the overarching principles in situations in which an entity has the right and the intent to settle its financial assets and financial liabilities in a manner that is, *in effect*, the economic equivalent of net settlement; for example, where credit and liquidity risks associated with the settlement have been substantially eliminated. We are also concerned that the proposals do not recognize the unique nature of derivative contracts i.e., that derivatives typically require two-way cash flows throughout the life of the contracts.

In our view, accounting should be based on the economic substance of transactions. We note that applying the proposals as drafted would render it difficult, if not impossible, for financial institutions to achieve any balance sheet offsetting. Noting fundamental issues relating to gross presentation above, we do not believe it was the boards' intention to largely prohibit balance sheet netting when the principles outlined in the ED have been met in substance. If it is indeed the objective of the boards to eliminate balance sheet netting, we would strongly urge the boards to revisit this decision.

While the purpose of accounting standards is different from prudential regulation, Members are concerned that, in addition to reducing the utility of financial statements to users, as noted above, the proposed "gross" standard may influence the regulatory treatments under various regulatory jurisdictions. We acknowledge that regulatory treatments are a matter for the regulators to determine, subject to appropriate consultation; however, we question whether both accounting and prudential goals would be better met by a "net" approach, along the lines of current US GAAP.

Our responses to the questions set out in the ED further detail specific concerns (Appendix A). The areas of the guidance that are most at odds with the boards' overarching principles

are those relating to (i) the fact that the ED does not recognize the unique nature of derivatives (ii) simultaneous settlement and (ii) collateral obtained or pledged.<sup>2</sup> In addition, we raise concerns regarding proposed disclosures and transition requirements among others.<sup>3</sup>

We urge the boards to reconsider the proposal and develop a robust converged offsetting framework based on sound principles and guidance that adequately supplements those principles. In our view, the current US GAAP requirements under FIN 39 and FIN 41 provide a good starting point for the boards' analysis. Although we understand that US GAAP requirements rely on an exception to the principle for derivatives and collateral, we believe that the US GAAP approach has merit as it provides a practical approach to presenting certain financial assets and financial liabilities for which credit risk has been substantially eliminated. We believe that the information presented in that approach is more representative of the solvency, liquidity and credit risk resulting from derivative and repo transactions and hence more useful to users of financial statements. Nonetheless, we strongly encourage the boards to explore more principles-based approaches which are both practical and reflect economic risk exposures. Should you have any questions about this letter or the views expressed, please contact the undersigned ([dschraa@iif.com](mailto:dschraa@iif.com)) +1 202 857 3312) or Carol Wong ([cwong@iif.com](mailto:cwong@iif.com) +1 202 857 3633).

Very truly yours,



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<sup>2</sup> We understand that ISDA has provided extensive discussion of the technical specifics of the markets most affected by the proposals. We do not purport to duplicate that discussion here; however should the boards have any questions about the market or netting practice, we would be happy to discuss such issues further.

<sup>3</sup> Some Members raised concerns on the interaction between IAS 32 and IAS 39 noting that netting is relevant to calculating credit valuation adjustments for purposes of fair value measurement. The requirement to present on a gross basis would result in a dual requirement for preparers.

## Appendix A

### **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?*

We are broadly supportive of the criteria if they in fact result in offsetting where the expected cash flows and the exposures are in effect net. We are concerned that some of the guidance set out in relation to the application of these criteria is unnecessarily prescriptive and arbitrary, and would in effect largely prohibit balance sheet netting, which appears at odds with the boards' overarching principles. See our general comment letter to which this is attached.

The most notable constraints relate to (i) the fact that the ED does not recognize the unique nature of derivatives (ii) simultaneous settlement, and (iii) collateral obtained or pledged.

#### *Nature of derivatives*

We are very concerned that the ED does not recognize the fact that derivatives typically require two-way cash flows throughout the life of the contracts. Requiring gross presentation of such contracts implies that derivative assets only consist of cash inflows and derivative liabilities only consist of cash outflows, which is not the case. Some Members believe that reporting derivatives at the net present value of all cash flows that are subject to an enforceable master netting agreement better represents the fact that two-way cash flows are common place.

#### *Simultaneous settlement (paragraphs C11-C12)*

The constraints around the concept of simultaneous settlement are mechanical and rules-based to the extent that the substance of the boards' basis for conclusions is obscured in reference to an attempt at precision in time in calculating the "same moment". We note that many repo and reverse repo and securities lending /borrowing arrangements are settled based on a batch process. It is not generally possible for systems fully to settle at the same time across different markets and geographical areas owing to the volume of transactions in systems. We are concerned that it would be extremely difficult, if not impossible to meet the simultaneous settlement requirement under a strict reading of at the "same moment". However, batch-settlement processes are intended generally to achieve the same effect. It is counterintuitive to require gross presentation simply because settlement systems result in transactions' being several minutes off, particularly when the use of these settlement systems, and generally their rules with respect to finality of settlements as well, mitigate credit and liquidity risk.

We encourage the boards to develop a less rules-based approach around this concept based on credit and liquidity parameters, akin to the guidance of IAS 32.48 and FIN 41 which generally permit offsetting in the context of clearing and settlement arrangements that result in an economic outcome which is “in effect equivalent to a single net amount” based on the fact that settlement mechanisms result in “no exposure to credit or liquidity risk”.

*Collateral obtained or pledged (paragraph C14)*

The analysis of collateral obtained or pledged in respect of financial assets and financial liabilities in paragraph C14 does not reflect an understanding of the daily variation margin and similar mechanisms that have been adopted by clearing houses and exchanges to eliminate credit and liquidity risks associated with the settlement of derivative contracts. Daily variation margin and similar mechanisms in many cases constitute the effective economic equivalent of settlement.

Given how derivatives transacted through a clearing house are settled, variation margin (in the form of cash) is, in effect, an advance payment for settlement of cash arising from derivatives and thus is in substance a form of settlement of a net derivative position. We believe the accounting for such arrangements should be based on economic substance rather than legal form. We would also add that variation margin transferred on certain exchanges constitutes a legal form of settlement. Hence, there is no reason that margin accounts should be presented separately on a gross basis.

We note that under current IFRS practice, margin arrangements that are in substance settlements of the current value of outstanding contracts are accounted for as such. Again, we would encourage the boards to reconsider the appropriateness of the proposed rule on margin accounts.

We further note that paragraphs C11-12 and C14 would not only be a significant change for U.S. GAAP reporting financial institutions but also a significant departure in concept and approach for IFRS reporting financial institutions. We do not believe that this was the boards’ intention.

Further, some Members note that as it relates to bilateral OTC derivatives under a master netting agreement, in many cases, these instruments are also fully cash collateralized whereby collateral is called or posted based on the net exposure on a daily basis. As such, there is no credit or liquidity risk. This cash collateral mechanism for OTC derivatives is similar to derivatives transactions that are settled through a clearing house. If there are timing differences between market value changes and the movement of cash collateral, the uncollateralized balance would be recognized on the balance sheet. Members believe that net presentation for cash collateralized derivatives also meet the boards’ principles.

More broadly, it is important for the boards to focus on market and regulatory developments, especially the prevalence of fully collateralized derivatives today and the current regulatory push for more central counterparties and centralized clearing. These features aim to reduce credit and liquidity risk on transactions and within the system. To

ignore such risk mitigants for financial reporting provides a counterintuitive and misleading view of an entity's financial position for users of financial statements.

We encourage the boards to continue discussions with exchanges and clearing houses to gain a better understanding of settlement mechanisms applied in practice.

In a time of substantial change in the derivatives markets, largely driven by new regulatory and macroprudential requirements, we stress that a robust principles-based approach to offsetting would more adequately reflect the economic substance of transactions as markets, market infrastructure and practice with respect to bilateral transactions continue to develop.

### **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 (i.e. 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?*

We generally do not agree 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 as defined in the question. Moreover, we are concerned that a narrow description of unconditional may be difficult to operationalize and lead to presentation of less relevant information.

We further note that the conditionality to offset is linked to the ISDA framework which addresses conditional offsetting rights which are legally enforceable, we would encourage the boards to consider the ISDA's response on this issue.

### **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, in principle, offsetting criteria should be applied to both bilateral and multilateral set-off arrangements.

IIF Members are individually better placed to provide details of situations in practice in which a multilateral right of set-off may be present.

### **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?*

We strongly believe that the objective of greater transparency in derivatives and other instruments covered by similarly sophisticated settlement arrangements can only be achieved through a robust combination of quantitative and qualitative information. We note that IFRS 7 already provides a sound basis for meaningful disclosure of credit, liquidity and market risks. We agree that if it is concluded to be useful to some users of financial statements, gross information could be presented in notes to the financial statements. However, we are concerned that the disclosures prescribed in the ED appear to be somewhat arbitrary and unduly legalistic, placing an inordinate amount of emphasis on particular legal attributes of netting arrangements (conditional vs. unconditional) and potentially scoping in incidental contracts such as loans and deposits, brokerage contracts which have always been presented gross on balance sheets and for which credit risk is better conveyed through generally accepted credit metrics.

Moreover, we are concerned with the large volume of disclosures required under the proposed presentation requirement. Disclosures should supplement and provide further details to assist understanding items on the balance sheet. Disclosures are not for the purpose of re-presenting balance-sheet items or replacing balance-sheet items that have not been presented in a sufficiently informative manner.

The expansive disclosure requirements would be operationally burdensome and costly to implement without significant incremental benefits to users of financial statements. Furthermore, some proposed disclosures appear to be similar to disclosures that are already required and hence duplicative. These include disclosures relating to credit quality and fair-value measurements. We encourage the boards to consider whether existing disclosures already adequately address users' information needs before requiring additional disclosures.

#### **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?*

We are concerned with the requirement to apply the proposals retrospectively and provide comparatives. Members note that such requirements would pose significant operational challenges as many agreements would need to be analyzed from scratch. The proposals do not simply result in grossing up all financial assets and financial liabilities that are presented net today. Rather, financial institutions would be required to reassess contracts and in some cases even redo agreements. In addition, there are particular issues with unsettled regular way trades as the task of identifying the counterparty is often cumbersome before settlement.

The proposed retrospective application would also be onerous both to preparers and users given the volumes of disclosures required, without much substantive benefit. Consequently, Members would prefer prospective application of proposals.

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

Should the boards decide to issue a final standard based on the ED as drafted, a substantial effort will be required to develop and implement systems to capture the incremental contract-level data required. We suggest the boards consider an effective date no earlier than 2014. We generally encourage the boards to align the effective date of netting requirements with other financial instrument related standards and more broadly with the overall convergence timeline.