

Sir David Tweedie Chairman International Accounting Standards Board 30 Cannon Street London EC4MXH United Kingdom UBS AG 2011-100 Comment Letter No. 145

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Corporate Center Group Accounting Policy

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ED/2011/01, Offsetting Financial Assets and Financial Liabilities

Dear Sir David:

UBS AG appreciates the opportunity to comment on ED/2011/01, *Offsetting Financial Assets and Financial Liabilities*. UBS is a global financial institution that prepares its consolidated group financial statements in accordance with International Financial Reporting Standards (IFRS). UBS also has several subsidiaries that report standalone US GAAP financials. We believe the convergence of IFRS and US GAAP is vital to well-functioning global capital markets. Therefore, UBS is supportive of the efforts of the IASB and FASB in this area.

We fully support the boards' efforts to reconcile the current differences between IAS 32, *Financial Instruments: Presentation,* and the offsetting rules under Topic 210 of the FASB Accounting Standards Codification (formerly FIN 39 and FIN 41) that have resulted in significant disparities between the balance sheets of banks reporting under US GAAP and IFRS. We believe that it is vital that the bases upon which investors evaluate relative leverage, returns on assets and overall financial condition converge around a single robust principle. In this respect, convergence must be the boards' primary concern, especially given the global economy's sensitivity to the stability and financial strength of banking institutions.

Based on our observation of the board's deliberations and its public statements upon issuance of the joint proposal, we are surprised to find that the ED establishes an even more restrictive standard than current IAS 32. We acknowledge the boards' objectives for providing greater transparency into the credit, liquidity, and market risks to which an entity is subject. However, we disagree with the boards' assertion in BC 21 of the ED's basis for conclusions that "gross amounts of derivative assets and liabilities are more relevant to users of financial statements than net amounts for assessing the liquidity or solvency of an entity". In particular, we believe that net presentation provides a more informative view of a bank's financial position in the context of exchange-traded derivatives, cleared derivatives and securities financing arrangements, or cash-margined derivatives subject to legally enforceable master netting agreements. The standard market mechanisms accompanying these arrangements provide unique and robust credit and liquidity risk mitigants that transform the cash flow attributes of the underlying contracts into the effective economic equivalent of net settlement. Contrary to the boards' premise, we assert that, in such cases, presenting the gross carrying amounts of the underlying instruments on the balance sheet *misinforms* users with respect to:



- 1. the resources available to creditors, as the gross assets are subject to a priority claim by the counterparty and are not available to general creditors to the extent of liabilities within the same netting agreement;
- 2. the entity's leverage, as the gross liabilities will be settled against the gross assets; and
- 3. the entity's expected cash flows, as daily mark to market and cash collateralization processes (which are computed on a net basis) already incorporate expected future contractual cash flows.

We nonetheless support the boards' development of a converged principles-based model in line with the concepts set forth in paragraph BC 9; i.e., appropriate representation of "the rights and obligations associated with the financial asset and financial liability", to the extent that they create, "in effect, a right to or an obligation for only the net amount," such that "the amount resulting from offsetting the asset and liability reflects an entity's expected future cash flows from settling two or more separate financial instruments." We believe these concepts are stable points of reference and are generally consistent with the current industry interpretations of IAS 32.

It was our hope that the boards would take this opportunity to improve on the IAS 32 model by further attenuating its principles to advances in the global financial marketplace since the time of its drafting. However, the construction of the proposed detailed guidance in the ED sacrifices substance in favor of overly prescriptive and mechanical rules, some of which are fundamentally at odds with established practice under existing IFRS. The following are of primary concern:

- The constraints around the concept of "simultaneous settlement" in paragraphs C11 C12 are mechanical and rules-based to such an extent that the substance of the boards' basis for conclusions is obscured in favor of precision measurements of time. We encourage the boards to develop a less rules-oriented approach, using credit and liquidity parameters as primary determinants of whether contracts are *in effect* net settled, akin to the guidance of IAS 32.48 in its present format.
- The ED's assessment of collateral obtained or pledged in respect of financial assets and financial liabilities in paragraph C14 does not reflect the essence of the daily variation margin and similar mechanisms that have been adopted by clearinghouses and exchanges to eliminate credit and liquidity risks associated with the settlements of derivative contracts. The accounting for such arrangements should be based on substance rather than legal form. Under current IFRS practice, for instance, margin arrangements that are, in-substance, settlements of the current value of outstanding contracts are accounted for as such. The language in the ED represents a significant departure from IAS 32 in both concept and approach. Based on our understanding of the boards' deliberations, we do not believe this was an intended result.

We would further encourage the boards to consider the functioning of cash collateral payments under certain bilateral (i.e., non-cleared) arrangements. Like the settlement processes utilized by exchanges and clearinghouses, the substance of these arrangements results, for all intents and purposes, in the functional equivalent of net settlement. Here again, we believe that the principles would support net presentation where such arrangements are, in effect, the functional equivalent of net settlement, i.e., the collateral amount satisfies present obligations (based on a fair valuation) and credit and liquidity risk is mitigated.

We also note that many of our peers are supportive of an approach aligned with FIN 39 under present US GAAP. Although we agree that FIN 39 (netting solely on the basis of a master netting arrangement) provides a meaningful representation of credit exposure, we note the unit-of-account inconsistencies that arise in comparison with other recognition and measurement guidance (in which the unit of account is the individual transaction or confirmation). We further note that a netting agreement in and of itself does not necessarily demonstrate an entity's intent to net settle; rather it is the supplementary processes of daily mark to markets





and cash collateralization (e.g., variation margin) that accomplish this. A meaningful alternative to such an approach could be a linked-presentation model, under which an entity would identify groups of financial instruments that are in offsetting cash flow positions and where there is a conditional or unconditional legally enforceable right to offset by counterparty. Those financial instruments would be presented in the statement of financial position based on the net carrying value of the instruments (either within assets or liabilities) with display of both 1) the gross amount of assets and liabilities, and 2) the net amount. The net amount would be aggregated based on other relevant accounting guidance for the transactions. The netting of all other financial instruments would be subject to the principles in current IFRS. We believe that the linked presentation model would serve as a compromise to both boards' existing financial instruments netting standards and would meet all financial statement users' needs. We are supportive of further analysis of such an approach by the boards.

We strongly believe that the objective of greater transparency into derivatives, and other instruments covered by similarly sophisticated settlement arrangements, can only be achieved through a robust combination of quantitative and qualitative information. This cannot be accomplished on the face of the balance sheet. We note that IFRS 7 already provides a sound basis for meaningful disclosure of credit, liquidity and market risk. Although we agree that gross information should be presented in the footnotes, the disclosures prescribed in the ED appear to be somewhat arbitrary, placing an inordinate amount of emphasis on particular legal attributes of netting arrangements (conditional v. unconditional) and potentially scoping in scores of incidental contracts (loans and deposits, brokerage contracts, etc.) that have always been presented gross on balance sheets and for which credit risk is better demonstrated through generally accepted credit metrics. As proposed, compliance with the disclosure requirements of the ED will be extremely burdensome operationally, without providing significant incremental benefit to users.

Finally, if the boards choose to issue a final standard based on the ED, as is, we note that a substantial effort will be required to develop and implement systems to capture the incremental contract-level data. We therefore request that the effective date for implementation is no earlier than 2014.

Please see our detailed comments and responses to the questions for respondents in the attached appendix. If you would like to discuss any comments that we have made, please do not hesitate to contact John Gallagher at +1 203 719 4212 or Doug Pittera at +1 203 719 4616.

Regards,

UBS AG

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Appendix I

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 agree that the foundational principles for offsetting as set forth in para. BC 9 are appropriate in the context of the Conceptual Framework for Financial Reporting. However, we are worried that critical portions of the guidance in the ED have eroded the principles in favor of prescriptive rules. The two most problematic instances are summarized in the following sections:

Derivatives Variation Margin: Collateral v. Settlement

We are concerned with the discussion in para. C14 of the ED, in which the board has concluded that derivative variation margin payments, common to various clearinghouses and exchanges, are "collateral". We encourage the boards to consider the economic substance of the underlying operational settlement practices which have been designed to ensure that all credit and liquidity risk is closed out between counterparties and that profit and loss is realized on a daily basis. In some instances, these mechanisms constitute an economic and functional equivalent to settlement; i.e., the entities have, in effect, a single net financial asset or liability.

In particular, futures contracts and certain other exchange traded derivatives are designed such that an exchange or clearinghouse (hereafter, the "central counterparty" or "CCP") is a counterparty to all contracts. Each contract that trades across the central counterparty is assignable at any time to other clearinghouse members, exchange members, etc. (hereafter referred to as "trading partners"). The central counterparty periodically (at least once per day) marks each contract to market and computes a single net amount due from or payable to each of its trading partners based on their aggregated and netted marked positions. This payment amount is typically referred to as variation margin ("VM") and is generally payable in cash. The VM may be paid/received instantaneously through the use of Protected Payment System ("PPS") accounts, or on a T+1 basis via wire.

The VM permits the counterparties to fully realize any daily mark to market profit or loss on their open risk positions. Upon payment of the VM, the trading partner is generally deemed to be long or short its

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¹ The central counterparty may, in addition, require its trading partners to post Initial Margin ("IM"), which is a returnable deposit ensuring that sufficient funds are available on behalf of each trading partner to offset any losses incurred between the last payment of margin and the close out of clearing member's positions should the clearing member default. Despite its name, the IM is re-computed and re-balanced daily based on each trading partners' net portfolio position. IM is usually calculated by taking the worst probable loss that the position could sustain over a fixed amount of time, and can be paid in either cash or non-cash collateral. Generally, the IM and VM are separate and distinct concepts, computed and paid independently, and segregated (i.e., not commingled).



various contracts at the settlement price (fair value mark) at the close of the trading day². In other words, the effect of the VM is to effectively settle all contractual amounts due or receivable at their current market value, and re-establish any open position of the trading partner as if such position were acquired at the opening of the following day's trading. Logically, for exchange traded derivatives, this practice facilitates the ability of the trading parties to close out (i.e., sell) derivatives at any time prior to their expiration date without the need for subsequent settlement payments (other than the difference in the trading price from the time the prior VM was calculated).

Under IAS 32, current industry practice recognizes the above payments to be tantamount to settlement; not "collateral". "Collateral" is a term that may have a numerous technical meanings under the laws or regulations of various jurisdictions. However, it is generally considered to be property pledged by a borrower to protect the interests of a lender³. The conveyance of un-restricted cash is, however, not a "pledge". Inherently, it is either a settlement or a loan. Under rules common to many derivatives clearinghouses / exchanges, neither party has a right or obligation to refund amounts paid as VM unless a contingent future event occurs; i.e., fluctuation in the market price of the derivative. Intuitively, therefore, the VM payment cannot be considered a "loan".

We note that, in their outreach discussions, the IASB Staff have indicated that they do not wish to create an implied in-substance-defeasance model within the offsetting guidance. Historically, the insubstance-defeasance accounting concept generally contemplated property placed in an escrow fund; i.e., the creditor has a security interest in the property, but is not in control of liquid currency. Where the settlement mechanism is constructed such that the counterparty has received un-restricted cash in the full amount of any obligation outstanding with no present obligation to refund such amount, we believe that the creditor's claim has been de facto settled. We do not believe that such an arrangement should be analogized to in-substance-defeasance.

We are concerned that, in drafting the language in para. C14, the boards may not have anticipated the complexities and nuances of the settlement processes established by derivatives clearinghouses and exchanges (note: certain clearinghouses and exchanges also follow procedures similar to exchange-traded derivatives for exchange-cleared derivatives) and the consequential effects thereof. We therefore advise the Boards to strike this language from the standard.

Overall, we believe that, where the facts and circumstances described above exist, the presentation of gross derivatives assets and liabilities would not provide a relevant indicator as to an entity's resources or obligations. We also believe that such a determination should be based on the substance of the arrangement and not a strict legal definition. While we acknowledge the importance of the legal enforceability of the right of set-off, we believe the objective articulated in para. BC9, that "the entity has, in effect, a right to or an obligation for only the net amount," is correctly focused on principle rather than rule.

We would also suggest that the boards consider the operation of margining arrangements in eliminating a derivative counterparty's exposure to credit risk and liquidity risk through the daily calculation of profit and loss and posting of cash collateral. When the economic objective of such arrangements is to effectively net settle all present and expected future cash flows (as incorporated in the fair value of the instruments) on a daily basis, regardless of whether or not executed through a

² Certain central counterparties require intra-day margin or operate on a 24 hour basis. However, VM arrangements function in much the same way as described above.

³ Merriam-Webster Dictionary



clearinghouse or exchange, we believe that the substance of these procedures, when integrated with a MNA, would be best reflected by a net presentation on the balance sheet.

Simultaneous Settlement of Securities Financing Arrangements

We are troubled to see that the notion of "simultaneous settlement", as currently documented in IAS 32 and ASC 210-20-45-11 (formerly FIN 41), has been transformed from a "principle", based on credit and liquidity risk, into a mechanical measurement of time in the ED.

Large volumes of repurchase and reverse repurchase agreements and other securities financing arrangements are cleared daily across multiple global exchanges and clearinghouses (e.g., The London Clearinghouse, the Fixed Income Clearing Corp., etc.). For purposes of enhancing liquidity, minimizing credit exposure and creating overall market efficiency, the CCP's have created robust systems and processes over the movement of securities and cash. Those processes operate in a fashion consistent with the description provided in FIN 41 under US GAAP.

As an overview, CCP's are typically government regulated entities, which are required to maintain sound financial safeguards and risk-management controls. The CCP must generally maintain a strong (i.e., AAA) credit rating. This is generally achieved through the funding of equity and additional collateral ("clearing funds") by the CCP's members (i.e., banks and securities dealers). To date, no CCP has ever experienced a member default in which it had to draw on the clearing fund (Lehman's default was the most significant test of the clearing mechanism and no losses were incurred). All securities financing contracts among clearing members are novated to the CCP; i.e., the CCP steps in between counterparties in a principal capacity, in effect, reducing multiple bilateral exposures to a single net amount. In addition, the CCP's maintain rigid clearing practices to ensure the accuracy and legitimacy of all trades as well as the conformity of daily margin requirements and payments with the CCP's rules. In this manner, the credit risk exposure of the CCP members is nominal.

The rules of the CCP provide for (generally) unconditional net settlements. As financing arrangements mature, the CCP determines the most efficient means of transferring securities, typically compressing by CUSIP/ISIN into discrete batches; where logistically possible, if a given clearing member has both an obligation to deliver and a right to receive a specific bond (CUSIP) on the same date, the CCP will offset those amounts in a single batch. It is nonetheless possible that the clearing member's right and obligation may be settled in separate batches at different times during the settlement day. The gross movements of securities and cash occur on a DVP/RVP (i.e., "receive v. payment" / "deliver v. payment") basis, through the clearing member's designated settlement accounts. However, CCP rules generally require that member's designate settlement agents. The settlement agents perform all settlement functions for the clearing member, including the provision of intra-day credit facilities. As such, although batches of settlement account is in a debit position) or receive (if the settlement account is in a net credit position) a single net cash amount at the end of each day. The functioning of the intra-day credit facilities reduces clearing members' liquidity exposures to the net cash delivery amount due for each discrete settlement day.

Under IAS 32, it has been common industry practice to offset repurchase and reverse repurchase contracts where, similar to the description above, market mechanisms effectively eliminate all credit and liquidity exposure. Those who hold such a view generally reference the language in IAS 32.48 which permits 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." The ED, however, trades this approach for an instantaneous measurement concept which is not practical in even the most sophisticated clearing systems.

We do not believe it was the boards' intention to change the principle or the practice in such situations. As such, we recommend simply that the language of IAS 32.48 is re-instated.

Overall, we believe that IAS 32, as written, should be used as the foundation for the boards' joint project. Alterations and improvements thereon should not be made without a clear and comprehensive understanding of the affected markets and common arrangements therein, and should be focused toward enhancement of the principles; not the development of mechanical rules.

FIN 39 and Linked Presentation Alternatives

As stated in our cover letter, we firmly believe that gross balance sheet presentation does not, in itself, provide incrementally relevant or predictive information about derivatives contracts in respect of an entity's credit, liquidity and market risks. Such information can only be accomplished through a combination of qualitative and quantitative disclosure.

Although we find the exception-based approach of present US GAAP⁴ to be overly simplistic and rules-based, we agree with the conclusion in FIN 39 that "given a master netting arrangement ("MNA"), 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". Nonetheless, we recognize the unit-of-account inconsistencies that arise in comparison with other recognition and measurement guidance (in which the unit of account is the individual transaction or trade confirmation). We further note that a netting agreement in and of itself does not assure that the affected contracts are effectively net settled; rather it is the supplementary processes of daily mark to markets and cash collateralization that accomplish this. Therefore, we do not believe that the exception is fully faithful to the principle of FIN 39 5(c).

A meaningful alternative to the FIN 39 approach could be a linked-presentation model, under which an entity would identify groups of financial instruments that are in offsetting cash flow positions and where there is a conditional or unconditional legally enforceable right to offset by counterparty. Those financial instruments would be presented in the statement of financial position based on the net carrying value of the instruments (either within assets or liabilities) with display of both 1) the gross amount of assets and liabilities and 2) the net amount. The net amount would be aggregated based on other relevant accounting guidance for the transactions. The netting of all other financial instruments would be subject to the principles in current IFRS. We believe that the linked presentation model would serve as a compromise to both boards' existing financial instruments netting standards and would meet all financial statement users' needs. We are supportive of further analysis of such a view by the boards.

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

⁴ Notably, the exception to para. 5(c) of FIN 39 (ASC Topic 210), which provides for offsetting of derivative financial instruments under a master netting arrangement.



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 are concerned that, in its current drafting regarding the enforceability of set off rights, the ED may have some unanticipated consequences. Requiring rights of set off to be enforceable in <u>all</u> circumstances is a much higher hurdle than "currently enforceable" or "enforceable in bankruptcy/insolvency of one of the parties". Similarly, prohibiting a right of set off that may be removed by a future event (even if the probability of that event is remote) from meeting the unconditional right of set off criterion may have the same unintended consequence. For example, legal agreements typically seek to provide for equitable treatment of the parties in the event of a force majeure, and in the case of clearing houses, also seek to ensure the smooth and continuing functioning of the derivatives and securities markets. Therefore, clearing houses, for instance, may include provisions regarding force majeure events that require clearing members to obey the directions of the clearing house upon the notification of a force majeure event. While the agreements do not specify that clearing houses may require gross settlement in that event, it may be theoretically possible. We believe that the criteria should be drafted to be based on current enforceability of the provision at issue, not enforceability in the event of extremely remote contingencies or catastrophic market safe-quards.

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 guidance is applicable to both bilateral and multilateral set-off arrangements. However, in our experience, multilateral rights of set-off are rare.

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 do not believe that the proposed disclosure requirements will create any meaningful decision-utility in the financial statements. Like some of the guidance in the ED, they appear to be driven by contractual mechanics and legal form. Moreover, we do not understand how the quantitative disclosures proposed in the ED related to types of set-off rights (i.e., conditional v. unconditional, etc.) will have any substantive value to users.

Rather, we believe that the data used by management to identify and control risk should be the starting point for disclosure. IFRS 7, Financial Instruments: Disclosures (IFRS 7), already requires a number of robust and principles-derived disclosures for liquidity, credit and market risk and is the most appropriate starting place for improving information relating to financial instruments. The qualitative disclosures required by IFRS 7.33 address the types of risks generated by financial instruments and how those risks are measured and managed. To the





extent that quantitative information on conditional or unconditional set-off rights is important to management's assessment of risk, that information will be captured therein.

We note that it would benefit users to identify the circumstances in which netting is permitted with regard to a preparer's financial assets and financial liabilities so that users may understand the general population to which netting applies and the basis for this treatment. Additionally, the disclosures should be presented in such a manner that they reconcile the net amounts on the face of the financial statement to the gross amounts disclosed in the footnotes.

We are further concerned with the broad scope of the proposal and the nature of the disclosures. The incremental disclosure requirements are likely to be of little additive value for various types of financial assets and financial liabilities that may be subject to the disclosure provisions, e.g. loans, deposit accounts, trade accounts payable and receivable, mortgages partially financed with securities, etc. Additionally, as legal requirements may affect the accessibility of the accounts mentioned, it may not be possible to accurately determine the amounts in each account subject to offset, e.g. certain Social Security, disability and other government benefits are not available to offset other liabilities of the account owner, despite contractual offsetting provisions. The multitude of financial assets and financial liabilities subject to offsetting and the myriad forms of collateral and legal limitations to offset in some cases would make the exercise prohibitively expensive, time-consuming, and may not yield incrementally beneficial information for users. To this end, we support a scope reduction, either for the entire ED or for the disclosures, to financial instruments whose offsetting rights provide meaningful information to users.

Finally, we believe that users interested in credit risk as it relates to the legal right of offset would be better served by limiting the disclosure to areas where the offsetting detail may be meaningful in terms of the nature of the instruments and associated collateral. For instance, it is clear that for derivatives and securities financings that collateral maintenance and legal rights of offset are primary means of managing credit risk with respect to counterparties. It is not clear that offsetting disclosures by themselves, when those offsetting rights are not a significant management consideration with regard to credit risk, provide meaningful information for users. We support refining the proposed disclosures to those that are pertinent to users. Additionally, as far as the breakdown of the disclosure schedule by nature of the right of offset, making a distinction of whether a right of offset is conditional or unconditional for disclosure purposes abdicates the determination of what is meaningful in favor of a legal distinction that is independent of the economics of netting arrangements.

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.

In our view, if the final standard substantially reflects the proposals included in the Exposure Draft, we would need at least two to three years from the end of the calendar year in which the final standard is issued (i.e., no earlier than January 1, 2014) to evaluate the impact of the ED on processes, systems and the financial statements, and prepare for and implement the necessary changes needed to comply with the new guidance. Additionally, we would not support retroactive application as it is our view that there is limited usefulness in providing comparative information for standards that only impact an entity's statement of financial position; such is the case with offsetting. As such, we would recommend that transition only be applied prospectively in the initial period of adoption.