
**Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of the Comptroller of the Currency
Office of Thrift Supervision**

May 6, 2011

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
Post Office Box 5116
Norwalk, Connecticut 06856-5116

RE: File Reference No. 2011-100 – Balance Sheet (Topic 210) – *Offsetting*

Dear Ms. Cosper:

The staffs of the five federal financial institution regulatory agencies (the Agencies) appreciate the opportunity to comment on the Exposure Draft, *Balance Sheet: Offsetting*, issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (together, the Boards). Our views are based on consultation with internal financial statement users, including internal experts on derivatives, market risk, and regulatory capital; other users of financial statements; external audit firms; and representatives from several financial institutions.

This proposal is of importance to the Agencies because it has the potential to change total assets significantly for several of the largest U.S. financial institutions. Accounting information prepared in accordance with U.S. generally accepted accounting principles (GAAP) serves as the starting point for the Agencies' evaluation of the condition, performance, and risk profile of the financial institutions we supervise. In addition, a number of key ratios and regulatory limitations are based on assets and average total assets, including the denominator of the banking agencies' Tier 1 leverage ratio calculation. The total assets currently used in this ratio calculation have very few adjustments from total assets as determined in accordance with U.S. GAAP. This is due to the critical role of leverage in the financial services industry. Similarly, credit unions use unadjusted reported total assets in their regulatory net worth ratio denominator.

The Agencies support the development of a high-quality, converged standard on offsetting for financial statement presentation that requires offsetting when specific criteria are met. We believe the offsetting criteria should be based on legal enforceability and the economic substance of an entity's exposures to and from its counterparties. We have significant concerns with the proposal and its definitions surrounding unconditional legal enforceability, and the intention either to settle on a net basis or to realize eligible assets and settle eligible liabilities simultaneously. We believe the application of these proposed criteria would reflect

the form rather than the economic substance of derivative and repurchase agreement transactions subject to master netting agreements and therefore, would impair rather than improve financial reporting by providing less relevant information to financial statement users. Our comments, which are focused on derivatives, repurchase agreements, and associated collateral, are summarized below and described in more detail in the appendix.

Legal Enforceability

The Agencies disagree with a criterion based on an unconditional and legally enforceable right of setoff; instead, the Agencies believe the conditional right of setoff in existing master netting agreements that provide for net settlement upon a counterparty's default (e.g., bankruptcy, insolvency, or other defined credit event) should be sufficient. Considerable effort has been undertaken to ensure enforceability of these contracts under the laws of the United States and many other jurisdictions. We are unaware of instances in which legally enforceable netting agreements have not held up in the United States.¹ Contracts having conditional net settlement performed as expected even during the recent financial crisis. Furthermore, we have not seen market participants revising such contracts to incorporate unconditional settlement provisions. This absence of activity suggests to us the marketplace sees no practical benefit to unconditional netting provisions over conditional provisions.

Moreover, for accounting purposes we believe legal enforceability has no practical meaning or application other than in the event of a counterparty's default. If an appropriate legal framework exists, there is no substantive economic difference between an agreement that provides for net settlement under conditional events and an agreement for which net settlement is unconditional. Hence, legal enforceability on the default of a counterparty should be sufficient to satisfy this requirement without requiring that master netting agreements be unconditionally legally enforceable, that is, in the normal course of business. Regarding legal enforceability, we concur with the alternative view presented by Ms. Seidman and Mr. Golden.

Intent

The Agencies believe the accounting for derivatives and repurchase agreements should reflect the economic substance of an entity's exposures to and from its counterparties. Presenting the effects of an entity's risk mitigation activities resulting from the use of master netting agreements would seem a more appropriate objective for offsetting than a transaction-based

¹ From the Federal Deposit Insurance Corporation's (FDIC) perspective as a receiver or conservator, a master netting agreement consolidates all transactions within the scope of the agreement into a single contract. When acting in this capacity, the FDIC is required by statute to (a) transfer, (b) repudiate (subject to damages for the cost of cover), or (c) not disturb all of an institution's transactions with a counterparty and its affiliates as opposed to making selective decisions about individual "qualified financial contracts" (QFCs), which include derivatives and repurchase agreements. In the event an institution fails, the FDIC has one business day to determine its course of action regarding the disposition of QFCs under a master netting agreement prior to the counterparty being permitted to exercise any right of termination it may have as a result of the appointment of the receiver or conservator. The effect of the applicable laws is that a master netting agreement is treated as a single contract for all QFCs under the agreement.

concept (that looks to the individual subcomponents of the master netting agreement). An offsetting standard that considers the role of master netting agreements within the context of an entity's business strategy for managing its derivatives and repurchase agreement exposures would be consistent with the approach the Boards have taken in other recent proposals (e.g., impairment, classification and measurement, and – for the IASB – hedge accounting). Considering an entity's use of master netting agreements when assessing intent also is consistent with how counterparty exposures arising from derivatives and repurchase agreements are controlled. In addition, we encourage the Boards to consider the nature of collateral and margin amounts as used in the payment and settlement systems for derivative and repurchase agreement transactions, which are an important aspect of how counterparty relationships are managed. We do not agree with the conclusion in paragraph BC62 that such amounts are irrelevant in the context of these transactions, and we believe that margin practices allow a form of near continuous net settlement. In fact, these collateral and margin amounts are determined on the net amount owed between the counterparties.

The Boards should also reconsider the terminology and the notion of simultaneous settlement. Requiring that settlements take place “at the same moment” creates an unrealistic hurdle. In our estimation, entities with access to central bank clearing systems providing real-time gross settlement, and banking association systems that provide net funds settlement for participant banks may not meet this criterion as it has been proposed. The safeguards in such systems (in terms of liquidity and credit risks) make the advantage of settlement “at the same moment” insignificant. Furthermore, even using well-managed clearing houses for settlements may not enable reporting entities to satisfy the proposed criterion without having the clearing houses incur significant cost. We are concerned the Boards are setting a criterion that offers no practical commercial benefit in terms of assurance and safety of payments.

Real-time gross settlement systems that include daylight overdraft and intraday credit facilities have functioned effectively for repurchase agreements, for example, for years. Therefore, for repurchase agreements we believe that settlement occurring within the same business day is sufficient to satisfy the intention criterion. Derivative payment and settlement systems that operate under a similar principle, but one that reflects the higher volatility inherent in many derivatives, may be effective for addressing settlement for these instruments. We strongly encourage the Boards to reconsider this criterion and evaluate what characteristics of gross settlement and net settlement processing systems commonly used in the financial sector, such as central bank clearing systems, provide assurance of payment comparable to simultaneous settlement between or among counterparties.

Conclusion

Lastly, we note the common practice in the marketplace among institutions preparing financial statements using International Financial Reporting Standards is to provide supplemental information on offsetting consistent with current U.S. GAAP. This supplemental disclosure can be taken as an indication that the balance sheet presentation for derivatives and repurchase agreements under current U.S. practice is relevant and decision-useful to investors. Therefore, we believe that revisions to the Boards' proposed offsetting criteria that reflect the concerns noted herein, along with the proposal's increased disclosure

requirements are necessary to best meet the needs of financial statement users and would be more reflective of the economic substance of entities' exposures to and from their counterparties under master netting agreements. In addition, our recommended revisions to the Boards' proposed offsetting criteria would lead to a significantly different outcome than what we expect would result from the application of this Exposure Draft as written, which is almost no netting.

The Agencies appreciate your consideration of our comments. We would be pleased to discuss our views with you further. We have provided responses to certain questions in the Exposure Draft in the appendix to this letter.

Sincerely,

Steven P. Merriett
Assistant Director & Chief Accountant -
Supervision
Board of Governors of the Federal Reserve
System

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Melinda Love
Director, Office of Examination and
Insurance
National Credit Union Administration

Kathy K. Murphy
Chief Accountant
Office of the Comptroller of the Currency

Jeffrey J. Geer
Chief Accountant
Office of Thrift Supervision

cc: Sir David Tweedie, International Accounting Standards Board

APPENDIX – Questions for Respondents

Offsetting Criteria – Unconditional Right and Intention to Settle Net or Simultaneously

Question 1: *The proposals would require an entity to offset a recognized eligible asset and a recognized eligible liability when the entity has an unconditional and legally enforceable right to setoff the eligible asset and eligible liability and intends either:*

- 1. To settle the eligible asset and eligible liability on a net basis*
- 2. To realize the eligible asset and settle the eligible liability simultaneously.*

Do you agree with this proposed requirement? If not, why? What criteria would you propose instead and why?

We agree in general that the presentation of financial instruments should reflect both the entity's legal rights under the instrument and management intent. We disagree, however, with the manner in which these legal-rights and intent criteria have been defined and described in the Exposure Draft. We believe an outcome based on the criteria as proposed would not improve financial reporting nor provide more relevant information to financial statement users. Although the Agencies agree that neither gross nor net presentation addresses all major risks of derivative and repurchase agreement activities, we are convinced that net presentation is more meaningful than gross presentation in the critical areas of interest to investors and other financial statement users: credit and liquidity risks. For the other risks (market, legal, operational, and reputation) arising from these activities, neither presentation is superior. We also are concerned that the proposal's gross presentation would significantly overstate the reported assets and liabilities of financial institutions.

Specific to the legal enforceability criterion, we believe a right of setoff that is conditional upon a counterparty's default and is legally enforceable is sufficient. The legal setoff rights criterion is discussed in more detail in our response to Question 2.

The intention criterion for offsetting should focus on presenting the economic substance of an entity's exposures to and from its derivatives and repurchase agreement counterparties under master netting agreements, not on how certain payments are transmitted between counterparties. Reflecting the effects of an entity's risk mitigation activities resulting from the use of master netting agreements would seem a more appropriate objective for offsetting than a transaction-based concept (that looks to the individual subcomponents of the master netting agreement). An offsetting standard that considers the role of master netting agreements within the context of an entity's business strategy for managing its derivatives and repurchase agreement exposures would be consistent with the approach the Boards have taken in other recent proposals (e.g., impairment, classification and measurement, and – for the IASB – hedge accounting). The intention criterion also should consider the role and economic impact of collateral and margining amounts in the settlement process.

Moreover, simultaneous settlement, as currently defined, may not be operational because counterparties would find it overly burdensome to coordinate their activities so precisely. Furthermore, institutions generally should have the ability to treat settlements completed

within the same day as being simultaneous when their counterparty is a well-managed clearing house with adequate risk management safeguards, provided that the function of the clearing house is to ensure that the parties to a transaction are not exposed to each other's credit and liquidity risk. This notion would be congruent with the Group of Twenty commitment to having standardized over-the-counter derivative contracts traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by year-end-2012 at the latest.² Any guidance that is developed should not preclude the clearing houses from performing their settlement in batches while taking into account their technical constraints.

We agree with the FASB's reasoning underlying Accounting Standards Codification Section 210-20-45, Balance Sheet – Offsetting – Other Presentation Matters (formerly FASB Interpretation No. 41, “Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements” (FIN 41)), that under certain conditions “gross settlement may be considered for accounting purposes as the functional equivalent of net settlement.”³ For example, we see no practical difference between a simultaneous, real-time exchange of cash between two counterparties and an arrangement where each counterparty transfers cash to a custodian who maintains collateral and remits net amounts to the counterparty with the net receivable. Such an arrangement may simplify administration but has no practical difference from a simultaneous exchange.

Unconditional Right of Offset Must Be Enforceable in All Circumstances

Question 2: *Under the proposals, eligible assets and eligible liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of setoff. The proposals specify that an unconditional and legally enforceable right of setoff is enforceable in all circumstances (that is, 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 agree that the legal environment in which an institution is operating must accommodate an institution's legal rights under master netting agreements and protect an institution in the event of its counterparty's default. However, as noted in the cover letter, we do not agree that netting must be legally enforceable in the normal course of business because such enforceability has no practical meaning or application, other than in the event of default. We believe a right of setoff that is conditional upon a counterparty's default and is legally enforceable is sufficient. We believe comparability is enhanced when transactions that have the same legal rights, obligations, and cash flows have the same presentation on the balance sheet. In this regard, we agree with the example provided in the alternative view by Ms. Seidman and Mr. Golden (paragraph BC83) where the proposal would require different presentation for (a) a single derivative and (b) multiple derivatives with the same counterparty that are subject to a legally enforceable conditional master netting agreement that have similar cash flows. In this example, we concur with Ms. Seidman and Mr. Golden, who believe net

² [Leaders' Statement: The Pittsburgh Summit, September 24-25, 2009.](#)

³ FIN 41, paragraph 9.

presentation in these circumstances appropriately reflects the amount of credit risk exposure under that arrangement.

Disclosures

Question 4: *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?*

Financial statement users are interested in the nature and extent of risks arising from financial instruments to which an entity is exposed; thus, some form of net presentation in the statement of financial position reflects the matching of risk exposure and effective risk mitigation efforts through the use of master netting agreements. The Agencies broadly agree with the proposed tabular disclosure of gross, accounting net, and total net amounts. However, we do not agree with what would be presented in the balance sheet and would emphasize that neither gross nor net amounts alone are sufficient for understanding derivatives and repurchase agreements in many circumstances and that increased transparency through appropriate qualitative disclosure is needed. Therefore, we believe improved disclosure, as proposed, combined with revisions to the Boards' proposed criteria for offsetting that reflect the concerns noted in this letter would be of the greatest use and interest to financial institutions, their supervisors, their counterparties, their investors, and other financial statement users. We would encourage the Boards to refine the disclosure provisions of their proposal through further dialogue and outreach with key stakeholders.

One additional disclosure the Boards may wish to consider would be whether an institution should disclose its derivative activities related to its top ten exposures to counterparties.

We also are concerned about the practical challenges that financial institutions will face in searching for all rights of offset (e.g., loans/deposits) and the additional reporting burden of quantifying such amounts. Consideration should be given to keeping such kinds of netting disclosures to a reasonable level.

Effective Date and Transition

Question 5: *Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements and why? Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.*

The Agencies note that no effective date is specified in this proposal. As the Boards further deliberate the proposal, we suggest they consider the need to thoroughly field test the proposed requirements at entities of various sizes and levels of sophistication that engage in the types of transactions that will be affected by the proposal to ensure it is operational for the full range of such entities and to minimize any unintended consequences. This field testing also could help determine the necessary transition time.

Although we generally favor prospective application, we would not object to retrospective application in this circumstance as long as sufficient time is provided for implementation.

As noted in our letter to the FASB regarding its Discussion Paper, *Effective Dates and Transition Methods*,⁴ when determining the effective date of a final standard on offsetting, we encouraged the FASB to consider the resources the financial institutions most affected by the final standard will need and the costs they will incur as they implement the comprehensive set of supervisory reform measures known as Basel III. These measures, which will be phased in between 2013 and 2018, were developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision, and risk management of the banking sector⁵ and will require a significant implementation effort by the financial institutions subject to these measures.

⁴ [February 9, 2011, letter from the Agencies to the FASB, re File Reference 1890-100.](#)

⁵ Additional information about the Basel III implementation timeline is included in Annex 4 of *Basel III: A global regulatory framework for more resilient banks and banking systems*, which is available at <http://www.bis.org/publ/bcbs189.pdf>