Morgan Stanley

April 20, 2011

Susan M. Cosper
Technical Director
File Reference No. 2011-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Joint FASB and IASB Exposure Draft – Balance Sheet Offsetting

Dear Ms. Cosper:

Morgan Stanley appreciates the opportunity to comment on the FASB’s Exposure Draft, Balance Sheet Offsetting and the IASB’s Exposure Draft, Offsetting Financial Assets and Financial Liabilities (the “ED”). As requested by the FASB and IASB, we have prepared one comment letter on the proposals, which reflects our views as a global financial institution from both a U.S. GAAP and IFRS perspective. We have also contributed to the letters submitted by the International Swaps and Derivatives Association (“ISDA”) to the FASB and IASB and by the Securities Industry and Financial Markets Association (“SIFMA”) to the FASB, and are generally supportive of the views expressed therein.

We are supportive of the efforts of the FASB and IASB (collectively, “the Boards”) to pursue a common approach to offsetting of financial assets and financial liabilities, particularly as this represents the most significant difference in amounts presented in the balance sheet between financial statements prepared in accordance with IFRS and those prepared in accordance with U.S. GAAP. However, we do not believe the proposed principles in the ED represent an improvement to U.S. GAAP, nor IFRS, and are thus not supportive of convergence that would be based on the model proposed in the ED. Notwithstanding the fact that currently IFRS requires gross presentation of many contracts, including derivatives, we believe the principles underpinning the current offsetting guidance under U.S. GAAP provide the most useful and representationally faithful presentation of an entity’s assets and liabilities in the balance sheet, particularly as it relates to derivatives and repurchase agreements. Therefore, we strongly recommend that the Boards reconsider their proposal and develop a converged principle for an
offsetting model that results in the presentation of financial assets and financial liabilities on a net basis where credit risk has been substantially mitigated.

Usefulness and Relevance

As noted in the basis for conclusions (the “BC”) of the ED and discussed extensively during public deliberations, there appears to be no consensus amongst users of financial statements as to the usefulness of gross versus net presentation in the balance sheet. Therefore, we believe there is a high hurdle that must be overcome to demonstrate that the converged proposals, and the shift in offsetting principles towards those of IFRS, represent an improvement in global financial reporting and that the benefits outweigh the costs. We maintain that the proposals in the ED fail to satisfy these requirements.

The suggestion in the BC that gross presentation provides users with better information regarding expected future cash flows and the liquidity and solvency of an entity is counterintuitive as it relates to financial instruments carried at fair value. This is particularly true for derivative instruments under a master netting arrangement (MNA), which legally creates a single contract with the counterparty. The right or obligation of this single contract is the net receivable or payable of all the individual transactions governed by the MNA. New transactions undertaken under a MNA are priced by reference to other trades within the portfolio, taking into account the effect of netting. While we acknowledge that the unit of account for recognition purposes is the individual transaction, we also point out that the credit risk of the contract is represented at the MNA contract level. In the event of default, only a single amount, calculated based on the net exposure for all transactions with that counterparty, will be due.

In addition, in a majority of cases, transactions under a master netting arrangement are collateralized with cash whereby collateral is called or posted based on the net exposure between the two counterparties on a daily basis. For example, assume a scenario whereby Entity A has an MNA with Entity B and two underlying derivative transactions, one of which matures in five years and the other which matures in ten years. For the first five years, the cash collateral that is calculated under the MNA on a daily basis is the net daily exposure of the two transactions. It is possible that collateral may be adjusted daily by one net payment or by two gross payments (e.g., Entity A posts or returns collateral under the five-year transaction based on market movement in Entity B’s favor and separately receives collateral under the ten-year transaction based on market movement in its favor, or vice versa). Upon maturity of the five-year transaction, it is possible that either a separate cash payment will be made to settle the particular transaction or that cash collateral that was already posted will be used to settle the transaction. To the extent that settlement of the five-year transaction results in a change in net exposure under the MNA related to the remaining ten-year transaction, collateral will be posted. The settlement payment for the five-year transaction and collateral posting for the ten-year transaction may be made in separate payments or may be net settled, depending on the systems and operational processes employed by the counterparties. However, the result is such that the credit exposure under the MNA at any point in time is the net of the two derivative exposures and the collateral posted. There will be no net movement of cash upon
maturity of the five-year transaction. Thus, we believe the net exposure is the most meaningful representation for users to understand the rights and obligations under a MNA.

Grossing up the balance sheet for derivative contracts that are collateralized distorts and obscures the resources and obligations of an entity, as well as detracts from the ability of users both to understand the transactions, other events, and conditions that have occurred and to assess the entity’s future cash flows. The proposed rules will result in increasing asset and liability balances by trillions of dollars for financial institutions that report under U.S. GAAP, and will continue the required gross presentation under IFRS. In our view, the gross assets do not represent true resources and the gross liabilities certainly do not represent increased obligations of the entity as the obligation has been satisfied through the daily posting of cash collateral, which is based on the entity’s net exposure. As a result, the net balance resulting from offsetting derivative assets and liabilities reflects the entity’s true expected future cash flows from settling two or more separate instruments under a single MNA. Sophisticated users, including certain regulatory bodies, make their own netting adjustments where not provided for on the balance sheet. In our opinion, net presentation on the balance sheet provides a clearer picture of an entity’s economic resources and obligations.

We also question the Boards’ effective dismissal of credit risk as a relevant user consideration in assessing the financial strength or weakness of an entity. This seems entirely inconsistent with key principles in other recent related accounting proposals, such as the business strategy criterion for classification and measurement of the Boards’ financial instruments proposals and the linkage to risk management strategy in the IASB’s currently exposed hedge accounting model. An institution may use master netting agreements and credit enhancements such as collateral to reduce its counterparty credit risk. In such cases, an institution manages its credit exposures by incorporating these risk-reducing features to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. Therefore, we are unclear as to why an entity’s risk management strategy, whereby it manages its derivative portfolio with a concern for credit risk exposure and asset/liability management, is not deemed relevant for presentation of financial assets and liabilities.

**Simultaneous Settlement Criterion**

The proposed simultaneous settlement criterion, based on the moment in time at which an asset and liability are settled gross, is narrow and rules-based, as well as likely to result in the unintended consequence of a change in current practice under both U.S GAAP and IFRS, specifically for repurchase agreements and potentially for centrally cleared derivatives, based solely on the specific operational processes of various clearinghouses. We recommend that an offsetting model instead be based on a principle whereby offsetting is required in cases where credit and liquidity risk are substantially eliminated. Such is the case for centrally cleared instruments where credit and liquidity risk is effectively eliminated through excess collateralization and mechanisms such as overdraft facilities and intra-day credit lines.
Most clearinghouses process settlements periodically throughout the day as it is not operationally feasible, given the volume of transactions processed on a daily basis, to settle all transactions for each of its customers at "the same moment." A reporting entity is unable to track transactions cleared in each batch of cleared trades. Thus, it may not be possible to identify transactions in the same batch and therefore settled simultaneously. However, this does not necessarily subject those customers to significant credit or liquidity risk as the possibility of default on the part of the clearinghouse is remote, all transactions are typically fully or excessively collateralized at all points in time throughout the life of the instrument, and, where required, customers are provided with intra-day credit lines or overdraft facilities. Therefore, we suggest a principle-based model whereby such transactions could be presented net regardless of the operational settlement procedures, as long as credit and liquidity risk are substantially eliminated. The principles in current U.S. GAAP for offsetting of derivatives and repurchase agreements appropriately acknowledge this principle. Furthermore, it is our understanding that IFRS preparers have interpreted IAS 32 based on the provisions in FIN 41, believing that those provisions appropriately satisfy the principle of simultaneous settlement. Therefore, we propose that the principle be upheld in a future offsetting model.

While we understand that the Boards’ primary objective is financial accounting, a principle based on risk would also be more consistent with the regulator’s objective of reducing risk in the financial system by requiring a significantly greater number of contracts to be centrally cleared. It is counterintuitive that as regulators draft rules requiring central clearing with the mind to meet the objective of reducing risk, at the same time, the proposal in the ED puts forth a model which ignores the substantial elimination of risk.

**Collateral**

We are concerned by the characterization of all margin accounts as a form of collateral for exchange-traded or centrally-cleared derivatives. The proposal states that margin accounts are assets or liabilities that must be accounted for separately, similar to when an entity sells collateral that has been pledged to it and must recognize a separate liability representing the obligation to return the collateral sold. In addition to the operational nuances between clearing houses not being meaningful in terms of the principles underlying a quality accounting model, we also note that the legal form of collateralization of contracts cleared through clearing houses varies, although the economic substance of margining practices is the same between the various models.

In drafting the language contained in paragraph C14 of the proposal, the Boards may not have anticipated the complexities and nuances of the settlement processes established by various clearing houses. In certain cases, such as exchange-traded futures, variation margin is used to settle the fair value changes of each contract on a daily basis. In contrast, the current OTC derivative clearing models also call for the collection of variation margin based on daily market movements, but do not use the margin to legally
settle the contracts on a daily basis. However, at the end of the contract term, cash margin will be used to settle the fair value of the contract.

In substance, whether collateral is legally settlement of the contract or sequestered collateral, the underlying risk exposure in the contracts is the same. In all cases, the central clearing party measures the fair value of all open contracts and computes a net amount due from or payable to an entity based on its net exposure. This payment, referred to as the variation margin\(^1\), is typically settled in cash on a daily basis. Neither the clearing house nor the entity have a right or an obligation to refund amounts paid or received as variation margin unless there is a future change in the fair value of the net exposure. Therefore, the economic effect of the variation margin is to settle all open positions on a daily basis.

In our opinion, this mechanism constitutes the substantive equivalent of settlement and the net balance resulting from offsetting the variation margin and derivative asset or liability reflects an entity’s true expected future cash flows. Further, if OTC clearing models were to evolve to use daily margin amounts to legally settle the contract, we do not believe the balance sheet presentation should change as a result. Therefore, we do not believe it is appropriate that the legal form of margin as either settlement or collateral should be the basis for balance sheet presentation, but rather that economic substance should be the guiding principle. The offset of the collateral against the derivative balance provides users with the most accurate risk and liquidity profile of an entity and would be consistent with the presentation for futures contracts.

As it relates to bilateral OTC derivatives, in many cases these instruments are also fully cash collateralized, such that there is no net credit or liquidity risk. Between the times the market value changes and cash collateral is transferred, the risk of this uncollateralized amount is recognized on the balance sheet. Therefore, the net presentation of collateral for OTC derivatives also meets the principle described above.

Overall, we recommend the Boards develop a principle related to the presentation of cash collateral that focuses on substantial elimination of liquidity and credit risk, rather than on the legal form or operational processes, such that the true economics of transactions are reflected on the balance sheet.

*Pending Trade Receivables and Payables*

From a U.S. GAAP perspective, we do not understand or support the retraction of the guidance in ASC Subtopic 940-320-45-3 that permits the presentation of receivables and payables arising from unsettled regular-way securities trades on a net basis. The risk of nonperformance of regular-way trades is minimal given that the time between trade-date and settlement-date is short and because they are affirmed and settled through clearing

\(^1\) In addition to variation margin, central clearing houses require clearing entities to post initial margin, which is effectively an overcollateralization mechanism and is calculated based on expected future market movements such that the credit risk inherent in the one-day lag in collection of variation margin is mitigated.
organizations. The vast majority of trades are successfully settled on the intended settlement date through one net payment between the entity and the clearing organization. Therefore, it is not necessary to track trades operationally at a counterparty level between trade-date and settlement date. Trades which fail to settle on the intended settlement date are recognized on the balance sheet as receivables and payables on a gross basis, at which time the specific counterparty is identified and tracked in the system. Therefore, the reflection of the net amount of pending trades appropriately represents the expected cash flows to be settled within a short or "regular" period of time, unless settlement fails, at which time gross presentation is warranted.

Due to the insignificance of the number of trades which fail to settle within the regular time period as compared to the total daily trading volume, it has generally not been deemed necessary nor cost effective for entities which file under U.S. GAAP to track pending trade receivables and payables at a counterparty-level. Given that most trades will successfully settle at the settlement date, resources are best spent tracking only failed trades at an individual trade level in order to resolve the settlement failure. Therefore, and because of the guidance in ASC Subtopic 940-320-45-3 which has existed for a significant period of time, systems and processes to track individual unsettled regular-way securities trades are not in place. The system enhancements and human resources which would be required to reflect unsettled regular-way trades on a gross basis would be extremely costly and onerous to implement. We are not aware of issues with the current accounting for these amounts and the benefit of gross presentation to users is unclear. Further, we note that the FASB did not support the elimination of the current ASC language in the BC, nor was the issue discussed during public deliberations.

We strongly recommend that the guidance in ASC Subtopic 940-320-45-3 be retained in a converged offsetting model because we do not believe that the benefit of gross presentation of pending trade receivables and payables outweighs the cost that would be incurred in order for U.S. GAAP preparers to comply with the modified accounting standard. Further, because these trades settle in a short time period and due to the insignificance of trades which fail to settle compared to overall trading volume, we believe net presentation during the "regular" settlement period is reasonable.

Payment Netting

It is our understanding, based on public deliberations, that payment netting for financial instruments would not be permitted. However, we find the language in the ED regarding payment netting to be unclear as to whether or not, and in what circumstances, payment netting is required or even permitted. We are unclear whether offsetting is allowable only to the extent that all payments dates and the maturity dates of two or more instruments match, or whether individual payments throughout the life of the instrument which occur at the same time can meet the offsetting criteria. If the former is the case, we believe this will result in only coincidental offsetting for derivatives and in turn, would not accurately reflect expected cash flows as is purported to be an underlying principle of the proposed model. Instead, balance sheets would be grossed up for other-than-coincidental offsetting and we question the usefulness of the resulting information which would be presented.
However, if the latter is the case, and netting of interim payments is required, we believe
the systems currently in use would not be useful in their current state to identify the
amounts which would need to be offset. Significant costly changes to systems and data
capture processes will be required to analyze future cash payments between an entity and
its counterparties.

We do not believe either of these methods to be consistent with the unit of account
concept for financial instruments or with fair value measurement principles. If only
certain cash flows within an instrument were offset, the remaining amount on the balance
sheet would not be meaningful. A principles-based standard for offsetting, based on
credit and liquidity risk, would present far more meaningful information. However, if the
proposed model is to remain, we recommend that the Boards clarify their intention for
payment netting.

Unconditional Right to Set Off

We are also concerned over the use of the notion of an unconditional right to set off.
Although, it would appear that the Boards had specific conditional arrangements in mind
when choosing this language, in reality it is likely that very few, if any, set off
arrangements are truly unconditional. For example, an arrangement might be conditional
if there were a change in applicable law or an act of fraud. Therefore, we suggest that the
Boards consider modifying this principle to permit contingencies that are considered
highly remote.

Disclosures

In addition to our lack of support for the proposed offsetting model, we find the
disclosure requirements to be onerous as well as duplicative with otherwise required
disclosures in U.S. GAAP and IFRS. For example, current U.S. GAAP requires
disclosure of offsetting related to derivative contracts but the ED does not remove that
separate requirement. In addition, under IFRS, the IASB has recently introduced new
quantitative credit risk disclosures into IFRS 7, Financial Instruments Disclosure, as part
of the 2010 Annual Improvements, including the requirement to quantify the effect of
collateral and other credit mitigants. The proposals in the ED would also require the
disclosure of CVA/DVA by class of financial instrument. However, we are unclear why
disclosures related to offsetting should also encompass information regarding fair value
measurements. We recommend that the Boards identify and evaluate duplicative
disclosures and revise either the existing requirements or the proposed requirements
accordingly.

We also question the requirement to disclose certain information, such as scenarios where
an entity has an unconditional right of offset but does not intend to set off. As noted
above, we believe conditional but legally enforceable rights of offset are meaningful to
users and should be reflected in the presentation of assets and liabilities in the balance
sheet, complemented by disclosure of the amounts which have been offset. Finally, the
inclusion of all financial assets and liabilities in the disclosure, to the extent that the legal
ability to net these instruments is remote or the likelihood of the instruments actually being settled net is remote (e.g., loans), would not provide meaningful information to users. Therefore, the cost and operational burden of disclosing these items cannot be rationalized.

Regulatory Compliance Impact

Regulatory rules are also currently undergoing a period of significant change and it is therefore difficult to conclude at this point how the changes to offsetting rules will impact regulatory capital and leverage calculations. Although financial reporting and regulatory reporting do not necessarily have the same objective, it is preferable that they have a common starting point. Where there are differences, there is a need to be able to reconcile the accounting and regulatory requirements. Accordingly, we would expect that, where the proposals in the ED will have a significant impact on regulatory ratios, those regulatory rules may need to be revised.

While certain global regulatory requirements do not rely on offsetting under accounting guidance, we note that current regulatory requirements under Basel I, both in respect of leverage ratios and capital requirements, are accounting balance sheet-focused measures and thus sensitive to any changes in gross assets and liabilities. We therefore expect that U.S. regulators will need to modify the financial metrics currently derived from U.S. GAAP financial reports, particularly with respect to derivative contracts. As a result, new systems will need to be developed to calculate regulatory asset and liability balances distinct from U.S. GAAP balances. In addition, processes will need to be implemented to systematically identify and reconcile GAAP versus regulatory differences. These changes will not be without cost and would require a substantial implementation period.

Transition Method and Effective Date

As noted above, there are aspects of the proposed model, specifically the removal of the industry guidance for pending trades and the concept of payment netting, both of which would be operationally intensive to implement. We have also noted that we do not support either of these provisions. However, if the Boards’ reject our suggestions as it relates to these issues, we request that sufficient time is allowed between issuance of the final standard and the effective date so that systems and processes to facilitate compliance with these provisions can be developed. Also noted above, the potential impact on regulatory calculations will necessitate time for regulators to evaluate their requirements as well as for preparers to implement potentially significant system changes as accounting and regulatory rules diverge.

Consistent with our response to each of the Boards on the FASB Discussion Paper and the IASB Request for Views on effective dates and transition methods for certain projects currently underway, we prefer the single date approach to adoption, as this minimizes cost and disruption to entities and reduces the confusion of users, particularly as many of the standards are interlinked. As explained in that response, we recommend an effective date no earlier than January 1, 2016 if retrospective adoption is required, in order to allow
for a full two year implementation period before the first year of comparative information that must be presented under the new standards, which is three years for U.S. GAAP filers. If the Boards do not accept the single date approach and propose an earlier effective date for new offsetting rules, it may not be feasible for U.S. GAAP filers to determine the prior-period impact based on the systems currently in place, and we would therefore recommend prospective adoption in that case.

Again, we thank you for the opportunity to provide comments. Please contact me at 212-276-3019 or Mona Nag at 212-276-5129 if you have any questions.

Sincerely,

Peggy Capomaggi
Managing Director
Global Accounting Standards and Control