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Dear Sir David and Ms Seidman


We welcome the opportunity to respond to the Exposure Draft on ‘Offsetting Financial Assets and Financial Liabilities’ (the ‘Exposure Draft’) and thank the Boards for enabling us to participate in this debate.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US$2,455 billion at 31 December 2010. Headquartered in London, HSBC serves customers worldwide from more than 7,500 offices in 87 countries and territories in six geographical regions. HSBC’s businesses encompass a very broad range of financial services and products, including personal financial services, commercial banking, global banking and markets, private banking, asset management and insurance.

HSBC supports the efforts of the IASB and the FASB to produce a converged standard on offsetting. We believe that global consistency in the presentation of financial assets and financial liabilities in the statement of financial position is fundamentally important because it addresses a key concern of users by eliminating one of the largest quantitative differences between IFRSs and US GAAP. Accordingly, we believe that it is essential that the new proposals on offsetting provide an appropriate basis for convergence, as well as being of high quality.

We believe a converged proposal must provide a relevant and faithful representation in the statement of financial position of the types of transactions in which financial institutions engage, particularly regarding arrangements which in effect constitute net settlement. We believe that the proposals in the Exposure Draft do not achieve this, most significantly, we
believe offsetting should be required for derivative assets and derivative liabilities where a legally enforceable master netting agreement is in place and where credit and liquidity risks have been minimised so that the right or obligation which exists is in effect for only the net amount. Even though addressing this issue would create an exception to the principles set out in the Exposure Draft, we believe that this would be justified by providing more relevant information in the statement of financial position, thereby improving its usefulness for decision making. Alternatively, we would encourage the Boards to revisit the principles on which the Exposure Draft is based and explore other models which could lead to a comprehensive solution which both addresses the presentation of risk exposures in the statement of financial position and is securely grounded on principles.

If it is decided to achieve convergence on the basis of the proposals set out in the Exposure Draft, we strongly recommend that the Boards reconsider certain guidance, for example on cash collateral as it relates to cash variation margin, and the use of certain terms including 'unconditional' and 'simultaneous'. We believe that as drafted, these areas are likely to be interpreted very narrowly, inadvertently resulting in a significant restriction of offsetting compared to that commonly adopted under IAS 32 'Financial Instruments: Presentation', and reducing the decision-usefulness of information to users. Furthermore, we believe that the disclosure requirements are unduly onerous, and likely to involve disproportionate costs to implement and maintain compared to the benefits which users are likely to obtain.

Our detailed responses to the questions set out in the Exposure Draft are attached as an appendix to this letter. As always, we are available to discuss our comments with you in further detail if this would be helpful.

Yours sincerely

[Signature]
APPENDIX

Q1 Offset 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?

HSBC believes that exchange traded, cleared or cash margin derivatives subject to a master netting agreement in effect constitute net settlement and should be presented net. We believe that both gross presentation and net presentation approaches have their respective merits and drawbacks, and, as noted in the Exposure Draft, users may require both sets of information, but there is no consensus as to where this information should be presented. Because of the unique characteristics of derivative financial instruments and the way in which they are measured and settled, we believe that principles which reflect these aspects and reflect the risk management mechanisms in place at exchanges and clearing houses to reduce credit and liquidity risk would provide a more faithful representation of the economics of transactions and thus achieve a more relevant presentation of the economic risk exposures of financial instruments in the statement of financial position.

The exposure to credit risk and liquidity risk on a typical derivative contract under a master netting agreement are managed on a net basis. The exposure to liquidity risk is based on the net position with a counterparty and collateral would be exchanged on a daily basis based on the net fair value of all the open positions with that counterparty. In the circumstance of a default event, the liquidity risk and the credit risk would be based on the same position because any cash settlement would be calculated on the net position. Therefore, for derivatives transacted under a master netting agreement, we do not agree that a gross presentation achieves a more relevant presentation of the economic risk exposures of the derivative financial instruments. Furthermore, we do not believe that a gross presentation of derivative financial instruments subject to a master netting agreement provide users with more meaningful information on future cash flows. The derivative asset or derivative
liability represents a current fair value as at the date of the statement of financial position. This fair value would only represent an ability to generate future cash flows if the entity had intent to sell the derivative financial instrument at that date.

Therefore, for derivative assets and derivative liabilities, we believe offsetting should be required where a legally enforceable master netting agreement is in place and where credit and liquidity risks have been minimised so that the right or obligation which exists is in effect only for the net amount. We further believe that a statement of financial position based solely on a gross presentation could obscure true economic risks by making them appear insignificant as compared to grossed up balances for derivatives and repo agreements which are fully collateralised.

Even though addressing the concerns of financial institutions regarding arrangements which in effect represent net settlement would create an exception to the principles in the Exposure Draft, we believe it would be justified by providing more relevant information in the statement of financial position. While we acknowledge that the current US GAAP model lacks a basis in principles, we believe it has merit because it provides a practical solution for the presentation of financial assets and financial liabilities which are in effect settled on a net basis. We recognise that there could be other solutions which are similarly practical, but more securely grounded on principles and we would encourage the Boards to explore such options.

If it is decided to continue to pursue convergence on the basis of the proposals set out in the Exposure Draft, we would like to see the Boards reconsider the guidance on cash collateral. The application guidance contained in paragraph C14 states that ‘margin accounts are assets or liabilities that are accounted for separately’. It is unclear if this guidance is meant to include cash variation margin (i.e. the cash paid to a central clearing house based on the net fair value of the portfolio) or if it solely refers to collateral that is pledged as a security or guarantee (which would generally be conditional on default and therefore would not qualify for offsetting). In practice, cash variation margin transferred through a central clearing house in respect of derivative contracts is considered a form of settlement; it therefore seems inconsistent that variation margin would be excluded from offset. We believe instead that paragraph C14 should convey principles of accounting for collateral which would be based on the substance of the arrangements and not on their legal form.

Similarly, we would like to see more clarification around the intended meaning of ‘simultaneous settlement’. The language in paragraph C11 seems to imply that simultaneous settlement is intended to mean ‘at the same moment’ which we do not believe is a realistic reflection of how central clearing houses currently operate. We believe it would be operationally costly, if not impossible, to prove that two transactions were cleared at the same moment since electronic transactions are usually processed in batches. It seems that paragraph C11 would prevent the offsetting of contracts, most notably repo contracts, executed with a central clearing house and denominated in the same currency and maturing on the same day, unless
they are processed in the same batch and at the same moment. In circumstances where an entity has both the right and the intent to settle net, we do not believe that the detailed operational processes of a central clearing house should dictate the accounting presentation when the most relevant consideration is the way in which the settlement process affects exposures to risk.

Q2  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?

Except as set out in our response to Question 1 regarding derivative financial instruments, we generally agree with the principle that the right to settle net must be enforceable under all circumstances including bankruptcy, but we are concerned that the use of the word ‘unconditional’ in the Exposure Draft could be interpreted in such a narrow way as to reduce the number of financial assets and financial liabilities which currently meet the offsetting criteria under IAS 32 while significantly increasing operational complexity and cost. We would prefer to see wording such as ‘has a current and legally enforceable right that does not disappear in bankruptcy’, which we believe would more clearly convey the intended criterion.

Q3  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 multilateral set-off arrangements should not be excluded if they otherwise meet the criteria for offsetting.
Q4 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 agree that enhanced disclosure requirements on gross and net positions would provide useful information, but we believe that the proposed disclosure requirements require a level of detail which is not consistent with the rest of IFRS 7 ‘Financial Instruments: Disclosures’ and should be simplified. The disclosure of all financial assets and all financial liabilities by class of financial instrument may result in an excessive level of detail, obscuring important information for users, therefore we would prefer to see a more summarised level of disclosure, for example by balance sheet category.

We would question whether the benefit to users from the proposed disclosures would justify what we believe could be very significant costs in producing the information. For example it would be costly to acquire the data for retail banking relationships to meet the requirements in paragraphs 12 (scope), 12(c) and 12(d). A typical customer relationship in a retail bank would involve multiple balances for financial assets and financial liabilities such as current accounts, savings accounts, deposits, investment accounts, credit cards, short term loans and mortgages. Some of these balances may have an unconditional and legally enforceable right to offset (without intent to offset) and some may have a conditional right to offset under default or bankruptcy. We question whether this level of detailed disclosure would be of benefit to users.

Q5 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 general, HSBC believes that full retrospective application is the appropriate transition method for new standards. However, consistent with our response to the IASB on the ‘Request for Views on Effective Dates and Transition Methods’ (‘Request for Views’), we are concerned about the cumulative impact of adopting proposals for Financial instruments (IFRS 9 – Classification and measurement, Impairment and Hedging), Revenue from contracts with customers, Insurance contracts and Leases, which we believe represent a change in the same order of magnitude to that of the first time adoption of IFRSs. Consequently, we continue to encourage the Boards to consider our suggestions for practical expedients, as expressed in our response to the Request for Views, to facilitate retrospective transition.
As currently written, we believe the Exposure Draft would require significant changes from current practice under IAS 32, specifically relating to the use of the terms ‘unconditional’ and ‘simultaneous’, the treatment of variation margin and the onerous disclosure requirements. For many of these changes the underlying data needed to produce comparative data may not exist in the necessary form and may need to be generated from other sources, including extraction from the original source documents, which may not be readily available. Collecting and analysing historical data from alternative sources will significantly increase the expected time and cost to adopt the proposals.

We believe that an effective date and transition method on a final standard for offsetting should be aligned with the effective date and transition method set for IFRS 9 ‘Financial Instruments’.