

April 28, 2011

Financial Accounting Standards Board Technical Director – File Reference No. 2011-100 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

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

Re: FASB Exposure Draft, Offsetting

IASB Exposure Draft, Offsetting Financial Assets and Financial Liabilities

The Group of North American Insurance Enterprises (GNAIE)<sup>1</sup> is pleased to provide comments to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on the exposure draft of proposed Accounting Standards Update, of Topic 210, Balance Sheet, *Offsetting* (the ED).

We appreciate the Boards' efforts to address differences in the offsetting requirements in U.S. generally accepted accounting principles (U.S. GAAP) and International Financial Reporting Standards (IFRS) which have represented a significant quantitative difference in the amounts presented in statements of financial position prepared under U.S. GAAP and IFRS. We are pleased that the Boards developed the proposal jointly.

However, we are concerned with the offsetting criteria in the ED, specifically as they relate to derivative instruments. We believe that presentation consistent with the way entities manage credit risk for derivative instruments can provide more relevant information to users of financial statements. For other eligible assets and liabilities, we believe presentation gross or net based on the nature and function of the instruments (the business model) would achieve a principles-based approach consistent with other converging guidance. Regardless of the final offsetting criteria selected by the Boards, we believe that

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GNAIE is a trade organization comprised of leading insurance companies including life insurers, property and casualty insurers, and reinsurers in Bermuda, Canada and the United States. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations, and all are major participants in the US and emerging markets.



further enhancement of disclosure requirements as opposed to mandatory offsetting of eligible assets and eligible liabilities could achieve the comparability objectives of the FASB and IASB.

The comments below do not take into consideration the potential impact from the developments in the insurance contracts accounting project. The final conclusions in that project could impact the classification and/or presentation of certain contracts currently permitted to be presented on a net basis (i.e., the reinsurance receivable and the related deposit or funds withheld on a modified co-insurance contract). This may need some consideration in the development of the final offsetting guidance. To the extent that the scope of these two projects overlap, we recommend that the effective date for any changes to the offsetting guidance as it pertains to insurance contracts be aligned with the effective date of the proposed insurance contracts standard.

Below we have included our responses to the questions in the ED. If the Board desires a further discussion of our views, please contact Doug Barnert at (212) 480-0808.

Sincerely,

Kevin A. Spataro

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Chair, GNAIE Accounting Convergence Committee

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## **Questions from the ED:**

- 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 offset 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?

## Mandatory versus Optional Offsetting

We agree with converging the offsetting requirements in U.S. GAAP and IFRS, and agree that enhancing comparability of financial statements within and across industries is important; however, we believe further enhancing disclosures as opposed to mandatory offsetting eligible assets and eligible liabilities would accomplish the same objective. As a result, we continue to support an option to offset eligible assets and liabilities. We are concerned that mandatory offsetting may not fairly present how the entity is managing its resources.

We do not believe that users of financial statements would be harmed if the optionality that exists under U.S. GAAP (FIN 39) was retained. As discussed in the summary of the ED, the Boards found no consensus among users in outreach activities on the usefulness of presenting gross or net information in the statement of financial position. Consensus among users was that both gross amounts and net amounts resulting from offsetting are useful. We agree, and support disclosure requirements if optional offsetting was retained. These disclosures should clearly reconcile gross exposures to net credit exposures, which will enable users of financial statements to properly assess an entity's future cash flows, liquidity and credit risk.

The financial statement framework currently being developed by the Boards emphasizes that the objective of general purpose financial reporting is to provide relevant financial information about an enterprise that is useful to current and potential equity investors, lenders, and other creditors. As those users evaluate and invest in an enterprise based on management's business strategy, it is obvious that the same should be considered in the accounting principles on recognition and measurement. As expressed in other comment letters received on the Financial Instruments and Insurance Contracts projects, the business strategy for utilizing financial assets and liabilities should be the primary driver for the accounting treatment on the statement of financial position. Following this principle, if the business purpose of entering into a master netting arrangement is to consolidate multiple derivatives contracts with the same counterparty into one contract such that the net credit exposure is mitigated, then presentation of that relationship as one contract would reflect how the business is managing it. Enhanced disclosures similar to those proposed in the ED would explain this relationship and provide additional decision-useful information for users of financial statements, thus achieving comparability between financial statements.



The core principles of the current project on financial statement presentation state that an entity shall present information in its financial statements in a manner that (i) disaggregates information to explain the components of its financial position and financial performance, and (ii) portrays a cohesive financial picture of the entity's activities. The disaggregation and cohesiveness principles in the proposal work together to enhance the understandability of an entity's financial statement information. To that end, the disaggregation principle stresses that an entity present information in its financial statements so that the activities the entity engages in and related cash flows are clear. The function and nature of the item is critical in considering how to appropriately disaggregate. The cohesiveness principle stresses that an entity present information in its financial statements so that the relationship among items across the financial statements is clear.

In support of this conclusion, we note that the FASB staff outreach to analysts indicated a majority support for net presentation on the face of the statement of financial position based upon a conditional right of offset.<sup>3</sup>

We do not believe that simply presenting assets and liabilities gross on the statement of financial position without taking into consideration the nature and function of those eligible assets and liabilities is consistent with the principles set out in the Staff Draft. Accordingly, we agree with the views of some of the FASB staff that presenting information on a gross basis may not provide any more information about the timing or direction of cash flows than does presenting information on a net basis.

In summary, consistent with the principles in such emerging guidance as the Financial Instruments, Insurance Contracts, and the Financial Statement Presentation projects, we believe that our proposed model to allow an entity to present eligible assets and liabilities gross or net based on the nature and function of the instrument (the business model) along with enhanced disclosures that explain this relationship clearly achieves a principles-based approach that will enhance comparability between financial statements.

## Master Netting And Similar Arrangements

We do not agree with the Boards' proposed criteria for balance sheet offsetting, particularly that the right to offset an eligible asset and liability be unconditional, and do not believe the proposal will provide users of financial statements with more useful information to assess an entity's future cash flows or liquidity and credit risks. Consistent with the Alternative Views in the FASB ED, we would support offsetting when an entity has a conditional and legally enforceable right to set off assets and liabilities with the same counterparty.

We note the Boards' arguments in the ED's Basis for Conclusions that the statement of financial position is not intended to represent an aggregation of the credit risks of an entity. Specifically with respect to derivative instruments (paragraph BC21), the Boards stated their belief that gross presentation of derivative assets and liabilities would be more relevant to users of financial statements in assessing

<sup>&</sup>lt;sup>2</sup> Staff Draft of an Exposure Draft on Financial Statement Presentation, July 1, 2010

<sup>&</sup>lt;sup>3</sup> IASB/FASB Joint Board Meeting September 2010, Staff Paper 8A



the liquidity and solvency of an entity as such instruments can generally be settled or sold at any time for an amount equal to fair value.

We believe gross information with respect to derivative instruments can be relevant, but generally believe that net information in the statement of financial position would be most relevant for users of financial statements. As discussed in FIN 39, Offsetting of Amounts Related to Certain Contracts – an Interpretation of APB Opinion No. 10 and FASB Statement No. 105, the FASB concluded that "the amount of credit risk exposure – the amount of accounting loss the entity would incur if the counterparties to forward, interest rate swap, currency swap, option, or other conditional or exchange contracts failed to perform in accordance with the terms of those contracts – is one indicator of the uncertainty of future cash flows from those instruments" (par. 20) and that "given a master netting agreement, 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" (par. 21).

We do not believe that gross presentation would provide more useful information with respect to liquidity risk. The gross fair value assets and liabilities for a portfolio of derivative instruments incorporate expected payments for varying amounts (in different directions) in one or more future periods. In order to provide any relevant information about liquidity, both gross and net amounts would need to be considered in conjunction with existing footnote disclosures.

When a master netting agreement is in place, credit risk is clearly evaluated by entities on a net basis including for purposes of determining collateral posting requirements. In the event of default, credit risk effectively becomes a component of liquidity risk. During the recent financial crisis, a key derivatives counterparty triggered the "conditional" criteria, and a net asset or liability was the most representative presentation of an entity's exposure, ultimate settlement amount and thus liquidity. Therefore, we believe that net presentation for derivative instruments would provide a closer alignment between an entity's statement of financial position and how such instruments are managed. This would present information with respect to liquidity risk that would be no less relevant to users than as proposed in the ED, with the added benefit of providing net credit exposures on the statement of financial position.

With respect to the intent criteria in Paragraph 6(b) of the ED, we note that where an entity has a conditional legally enforceable right of offset, the intent of the entity upon the occurrence of the conditional event will clearly be to avail itself of that right to offset in its efforts to reduce exposure to loss. While the entity may not in the ordinary course of business net multiple derivatives settlements occurring on the same day with the same counterparty due to operational issues, that entity still has some level of intent to net settle. We urge the Boards to expand the intent criteria taking into consideration the ultimate intent of the entity or alternatively to remove the intent criteria in the case of a conditional right of offset. The fact that this legally enforceable right of offset functioned as intended during the recent financial crisis should be viewed as additional support for having a lower hurdle for satisfying the intent requirement.

If the Boards reconsider the offsetting criteria such that the assets and liabilities related to derivative instruments qualify for offsetting, we believe any receivables or payables related to the posting or receipt of cash collateral should be offset against such derivative assets and liabilities consistent with



current U.S. GAAP guidance, as such practice fairly portrays the overall net credit risk exposure under a master netting agreement.

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 offset. The proposals specify that an unconditional and legally enforceable right of offset 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?

Please refer to our response to Question 1.

3. The proposals would require offsetting for both bilateral and multilateral setoff arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral setoff arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of offset may be present?

Although multilateral setoff arrangements are not common within the insurance industry, we see no distinguishment between such agreements and bilateral agreements. Therefore, our comments herein apply to both types of agreements. We do think that the final ED should be applied to both types of agreements.

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?

If the proposed guidance is finalized without modification, we are concerned with the disclosure requirements in Paragraph 12(c) and 12(d), requiring quantitative disclosures of (1) amounts related to unconditional and legally enforceable rights to offset without an intent to settle net or simultaneously, and (2) amounts related to conditional rights of offset. We believe this level of information does not provide benefits to users that would outweigh the costs to preparers to assess and track such amounts. We believe that aggregating these amounts, combined with qualitative disclosures describing the reasons for a lack of intent or presence of conditional rights of offset, could convey similar information to the proposed disclosure requirements while reducing costs to preparers.

Additionally, we believe the portfolio-level fair value adjustments as discussed in Paragraph 12(b)(2) should not included in these disclosure requirements. We do not believe offsetting disclosure requirements should include specific disclosure of the impact of one valuation input on only certain financial instruments.



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.

We generally agree with the transition requirements. In order to implement the proposed changes, as written, various operational issues would need to be overcome such as updating, testing and integrating reporting systems. In addition, an effort would need to be made to inventory contracts that would fall under the scope of the proposed ED and evaluate and document those that are required to be netted and comply with the disclosure requirements, all within an adequate internal control framework. This evaluation will be somewhat complicated by the introduction of the use of clearinghouses in the U.S. due to the adoption of the Dodd-Frank Act. Additionally, comparative years would need to be recast.

We estimate that all of those efforts would require approximately one year to fully and adequately implement. As a result, an implementation timeline of at least one to two years (depending on other standards that are to be adopted at the same time) would be adequate. If the proposal is changed to take into consideration our points above, implementation efforts would be somewhat reduced.