

Staff Paper

Project **Offsetting of financial assets and liabilities**

Topic **Multilateral netting arrangements**

Background

1. At the September 2010 meeting, the boards discussed the appropriateness of offsetting of financial assets and liabilities. The Boards concluded that one of the issues to address in developing an offsetting model is:

whether offsetting should be on the basis of bilateral or multilateral netting arrangements

2. The staff provided an analysis of multilateral netting arrangements at the October 2010 meeting but the Boards did not make decisions, as the meeting was an education session.
3. At the November 2010 meeting, the Boards tentatively decided on offsetting criteria. However, the Boards did not discuss whether the offsetting criteria should apply to both bilateral and multilateral arrangements.

Purpose of this Paper

4. This paper asks for the Boards decision on whether offsetting should be required for both bilateral and multilateral netting arrangements that meet the offsetting criteria.

Analysis of the issue

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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5. The issue here is whether to limit offsetting only to the case where an entity has an asset and a liability with the same counterparty (bilateral) or to require offsetting for arrangements where more than two parties are involved (multilateral).
6. Traditionally, offset is allowed for arrangements between two parties. IAS 32 specifies that '**in unusual circumstances**, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off'.
7. An example of such a situation might be where a foreign branch of Country A bank makes a loan to a foreign subsidiary of a Country A parent. Country A parent is required to deposit an amount equal to its foreign subsidiary's loan with Country A bank for the same term. The bank has legal set off by the foreign subsidiary. Some will argue in this case netting should be required for the separate financial statements of the entities.
8. Another example is bank accounts that are maintained for a group of companies. In this case, each member of the group agrees that its credit balance may be the subject of set-off in respect of debit balances of other members of the group. Accordingly, some argue that netting should be required for the separate financial statements of the entities.
9. Instances of similar arrangements go beyond group scenarios:
 - The International Air Transportation Association (IATA) has set up a clearing house system by which sums due from member airlines to each other is netted out each month. Remittances are sent by IATA to airlines with a net credit balance and collected from airlines with a net debit balance. In some of these structures, IATA acts as a principal or an agent of the participants (in providing a clearing mechanism). If IATA acts a principal, then the contracts are bilateral in nature (ie between IATA and the individual members). On the other hand, if the scheme is drafted such that IATA acts as an agent, then it is a multi party agreement.

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Alternatives

10. Based on the above, the staff presents the following alternatives for the Boards to choose from:
- a. **Alternative 1:** An entity **should be required to offset** a recognised asset and liability if and only if the offsetting criteria is met and the right of offset arises from a bilateral agreement (ie between two parties)
 - b. **Alternative 2:** An entity **should be required to offset** a recognised asset and liability if the criteria for offset are met, whether the right of offset arises from a bilateral or multilateral arrangement (ie between two or more parties).

Alternative 1 – Only right of offset arising from a bilateral arrangement should qualify for offsetting

11. Some argue that it is difficult to satisfy all the other factors, including legally enforceable right to offset, under multilateral arrangements. They argue that, as stated in IAS32, there may be cases where multilateral agreement meets the intent and ability to offset criteria but those cases are ‘unusual circumstances.’
12. Hence they believe that requiring offsetting for multilateral arrangements would not be appropriate.

Alternative 2 – Rights of offset arising from both bilateral and multilateral arrangements should qualify for offsetting

13. Allowing offset for the situations outlined in paragraphs 7 -9 (and for such multilateral arrangements) will not be dissimilar to present US GAAP and IFRS guidance on offset of tax receivables and payables and deferred tax assets and liabilities, either between members of a tax group (in their respective financial statements) or in the consolidated financial statement of the group, if a legally enforceable right of offset exist, they relate to income taxes levied by the same taxation authority and the parties intend to settle net.
14. The Boards have tentatively agreed that offsetting should be required if agreed criteria are met. This option reflects the view that there is no strong reason to

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explicitly exclude multilateral netting arrangements from the scope of offsetting **if all the other criteria, including legal enforceability are met for the transaction.**

There is no conceptual basis for differentiating between bilateral and multilateral arrangements if the necessary criteria have been satisfied.

Question for the boards

Which of the alternatives in paragraph 10 do the Boards prefer?