IFRS
FASB

**IASB/FASB Joint Board Meeting
December 2010**

IASB Agenda reference	**4B**
FASB Agenda reference	**9B**

Staff Paper

Project	**Offsetting of financial assets and liabilities**
Topic	**Disclosure requirements**

Background

1. At the October 2010 joint board meeting, the staff provided the boards with a brief description of banks' accounting policies around offsetting (netting), and a summary of banks' note disclosures around offsetting (netting).
2. In reviewing the banks' disclosures, we found that disclosures vary, even within IFRS and US GAAP preparer groups. The banks we reviewed had disclosed their policies for netting and information on netting in various places. Some provided transparent disclosures of accounting policy and information in respect of netting. Others provided this information in less obvious places. Others disperse them throughout the notes to the financial statements.
3. The staff also conducted user outreach earlier in the project (see Agenda Paper 8C /Memo 5– September 2010) and user feedback indicated unanimous support for robust disclosures, regardless of the offsetting criteria.
4. At the November 2010 meeting, the Boards tentatively decided on offsetting criteria. However, the Boards did not discuss the disclosures that will accompany the offsetting criteria.

Purpose of this Paper

5. This paper presents the proposed disclosure requirements to be included in the exposure draft for offsetting of financial assets and liabilities.

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.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

6. In preparing the disclosure package, we reviewed the disclosure requirements under IFRS, US GAAP and Basel Framework as well as the financial statements and Basel II disclosures of major financial institutions. We have also taken into account the feedback received from users and market participants during staff outreach and what we perceive as gaps in current offsetting and credit risk disclosures.

7. Some of the proposed disclosure requirements are already required under US GAAP and IFRS (but in a different context or format).

8. The following paragraphs detail the disclosure requirements that we propose to include in the exposure draft for offsetting of financial assets and liabilities. The disclosures are broken down under the following headings:

   (a) Disclosure objectives

   (b) Specific disclosures for non derivative financial assets

   (c) Specific disclosures for derivative assets

   (d) Specific disclosures for derivative liabilities

   (e) Specific disclosures for credit derivatives and similar instruments

   (f) Disclosures regarding an entity's strategy for managing credit risks

9. After each of set of disclosures in paragraph 8(a) - (f), we note what we believe users will gain from the disclosures and also note whether similar information is already required by IFRS or US GAAP. Appendix A sets out an illustration of some possible ways to meet the proposed disclosure requirements.

10. The staff notes that it is desirable to have consistent wording for the above disclosures under both IFRS and US GAAP. The staff would evaluate how the proposed disclosures may be reflected in existing standards if the Boards agree with the proposed disclosures.

A. Disclosure objective

The need for disclosures relating to credit risk exposures and credit mitigating strategies

11. Both US GAAP and IFRS require disclosures about an entity's exposure to and management of risks arising from financial assets and liabilities. Following the recent financial crises, users of financial statements have requested more information about credit risks arising from derivatives and other financial instruments that an entity is a party to. The staff notes that for many financial institutions, credit risk represents over 50% of the risk-based economic capital of those institutions.
12. The staff also notes that an entity's net exposure to losses from credit risk may differ from the amount recognised on the face of the statement of financial position as a result of arrangements that modify the gross credit risks that the entity is exposed to. Hence additional disclosures are required for users to fully understand an entity' credit exposure and financial position.

The disclosure objective

To provide users of financial statements with information that enables them to evaluate the extent of credit risk associated with an entity's financial instruments, how the entity manages those risks and the specific strategies employed in managing those risks.

13. The general view of users is that the project should provide enhanced disclosures about the extent of credit risks associated with an entity's activities to help them better understand the effect of those risk exposures on an entity's financial position and future cash flows.
14. We understand that users of financial statements would also like information to understand the techniques used by an entity to identify, measure, monitor and control credit risks.

15. Entities manage credit risks differently and hence, management explanation of such processes for measuring and managing those exposures would help users to assess and compare financial position and performance and the associated risks for different entities.

16. The staff believes that information about the extent of credit risks associated with an entity's activities would provide users with useful information about the financial position of an entity and its liquidity and solvency position.

17. The staff also believes that disclosures describing management's objectives, policies, processes and strategies for managing credit risk would provide users with an overview of the credit risks created by financial instruments and how the entity manages those risks.

PROPOSED DISCLOSURE REQUIREMENTS

18. The following paragraphs detail the disclosure requirements that we propose to include in the offsetting exposure draft for the disclosure objective set out in paragraph 12.

B. Specific disclosures for non-derivative financial assets

19. We propose that an entity provide users with information about the extent of credit risks associated with an entity's non-derivative financial assets and how the entity's net credit exposure differs from the amount recognised on the face of the statement of financial position. That information should be presented in a single note and in a tabular format, unless another format is more appropriate, and should include:

    (a) For each type of credit exposure (eg repurchase agreements, security lending or loan receivables) an entity shall disclose:

        i. The maximum exposure to credit risk

ii. the gross carrying amounts, (ie before taking into account amounts offset in the statement of financial position and credit mitigating factors) if different from the maximum exposure,;

iii. amounts deducted as a result of the offset criteria in XX to derive the carrying amounts in the statement of financial position;

iv. the amount of cash collateral and fair value of non cash financial asset collateral (separately disclosed) obtained in respect of those assets;

v. The portion of those exposures that is covered by legally enforceable netting arrangements (other than those in (iii));

vi. The net credit exposure after taking into account the effect of the items in (i) – (v); and

vii. The portion of the net exposure in (vi) that is covered by guarantees, credit derivatives and other credit mitigating techniques.

[Except for the information on maximum exposure to credit risk, the proposed requirements are not presently required under IFRS or US GAAP).]

C. Specific disclosures for derivative assets

20. We propose that an entity provide users with information about the extent of credit risks associated with an entity's derivative assets and how the entity's net credit exposure differs from the amount recognised on the face of the statement of financial position. That information should be presented in a single note and in a tabular format, unless another format is more appropriate, and should include:

    (a) For each type of derivative contract (eg interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit

contracts, other contracts etc) that is in an asset position (net positive fair value) an entity shall disclose:

i. the gross notionals of those contracts;

ii. the gross fair values (ie before taking into account amounts offset in the statement of financial position and credit mitigating factors);

iii. amounts deducted as a result of the offset criteria in XX to derive the carrying amounts in the statement of financial position;

iv. the portion of the exposures that is covered by a legally enforceable netting agreement (other than in (iii));

v. amount of associated cash collateral and fair value of non cash financial asset collateral (separately disclosed) obtained in respect of those assets;

vi. the net credit exposure after taking into account the effect of the items in (ii) – (v); and

vii. the portion of the net credit exposure in (vi) that is covered by guarantees, credit derivatives and other credit mitigating techniques.

[Except for information about gross fair value and gross notional (which are required to be disclosed under US GAAP), all of the proposed disclosures are new.]

Basis for the proposed disclosures for derivative assets

Single note

21. As noted in paragraph 2, in reviewing the banks' disclosures, we found that disclosures vary, even within IFRS and US GAAP preparer groups. The banks we reviewed had disclosed their policies for netting and information on netting in various places. Some provided transparent disclosures of accounting policy in respect of netting. Others provided this information in less obvious places. Others disperse them throughout the notes to the financial statements.

22. Users have consistently criticised the presentation of disclosures about financial instruments (derivatives in particular) as difficult to understand and follow. The staff notes that the proposed disclosures would enhance the understandability of information about financial instruments, if included in a single location in the notes.

Tabular information

23. The staff notes that the proposed disclosures require the quantitative disclosure to be presented in a tabular format to best convey an overall understanding of an entity's credit exposure and the effect of any credit risk mitigating arrangements. The staff believes that using tables will improve the transparency of credit risk exposures as well as help users of financial statements understand their impact on an entity's financial position, financial performance, and cash flows.

Derivatives broken down by type of contract

24. Netting arrangements provide counterparties the ability to transfer and manage specific market risk exposures more efficiently, while minimising their exposures to counterparty credit risk.

25. Such mechanisms permit the management of existing market risk exposures by taking on offsetting contracts with the same counterparty. These arrangements eliminate the need to negotiate the termination value of existing contracts. With netting and the offsetting position being undertaken with the original counterparty, the no longer desired market risk is eliminated and no additional counterparty risk is assumed. Hence the staff believes that a breakdown of derivatives by type and the effect of netting arrangements on those exposures would be useful for analysing financial statements and the financial position of an entity.

26. Aggregating derivative assets and offsetting the aggregated amount on the basis of credit risk may provide a partial outlook of the risks faced by an entity. Aggregating the asset and liability positions of several instruments could further reduce users' ability to understand the risk exposures of an entity arising from such contracts. Investors can better assess these risks if they know the composition of

the entity's derivative portfolio and how netting agreements and other credit mitigating arrangements are used in managing those risks.

27. The volatility (the tendency to vary or fluctuate over time) of net credit exposure of a portfolio of derivative contracts depends partly on the volatility of each individual contract (derivative type and structure) and the extent to which the contracts move together in response to changing market conditions.

28. Portfolios that consist of more volatile contracts (eg foreign exchange contracts) are more likely to exhibit wide fluctuations in value, all else equal, than portfolios that consist of less volatile contracts.

29. The degree to which different contracts in the portfolio respond to changing conditions is probably the most important driver of volatility. The diversity of responses to changing market conditions dampens the tendency for the value of a portfolio as whole to fluctuate widely over time.

30. Evaluating the volatility and hence future credit exposure of a portfolio therefore requires some knowledge of diversity among the contracts in a portfolio. The staff believes a breakdown of an entity's portfolio into types of financial derivative (ie by primary risk) may assist in such an evaluation.

Netting arrangements

31. Netting arrangements can reduce the credit risk exposures of market participants, relative to what the exposures would be were the same parties liable for their gross exposures on the same set of underlying contracts.

32. An entity that can legally offset under a netting agreement is in a different financial position than one that cannot legally offset. Disclosing the effect of such agreements portrays this different financial position.

Collateral arrangements

33. In most cases collateral posted against derivatives positions is under the control of the counterparty and may be liquidated immediately upon a covered "event of

default". This arises both due to operation of laws governing financial transactions that recognise the right to liquidate collateral, and due to the nature of the collateral used—cash or securities delivered to the counterparty at the time the collateral is posted, and therefore under their immediate control.

34. As such, collateral posted in financial transactions serve a mitigating role in terms of counterparty risk management. Consequently, disclosing the amount and/fair value of collateral posted or obtained provides useful information in understanding the net credit exposure of an entity.

Volume of derivative activity

35. The proposed disclosures require an entity to disclose the gross notionals, broken down by primary risk, for all derivative contracts.
36. This disclosure provides an insight into the overall pervasiveness of the use of derivatives and the relative significance of an entity's overall exposure to derivative instruments.
37. The staff notes that reporting notional amounts, in and of themselves, is not an accurate indicator of the magnitude of risks being managed and may not capture the effect of some common strategies, such as synthetic terminations of derivatives (by entering into offsetting contracts) and the use of common instruments, such as four separate forward contracts instead of one swap contract with four coupon dates.
38. The gross notionals in many cases will significantly exceed the possible losses that could arise from such transactions. Moreover, for most derivative transactions, the notional amount does not change hands, it is used as a reference to calculate payments.
39. Gross notionals do provide some measure of the financial risks from derivatives. Gross notionals are correlated to the fair value of the derivative contracts: the larger the notional amount, the larger the gross market value from prices changes, all other things being equal. The staff also notes that users have requested this information to be able to identify the leverage associated with these instruments.

40. Thus the staff believes that, overall, information about an entity's volume of derivative activity may be useful.

D. Specific disclosures for derivative liabilities

41. We propose that an entity provide users with information about the amount and effect of an entity's derivative liabilities and how the entity's net exposure is managed. That information should be presented in a single note and in a tabular format, unless another format is more appropriate, and should include:

    (a) For each type of derivative contract (eg interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, other contracts etc) that is in a liability position (net negative fair value) an entity shall disclose:

    i. the gross notionals of those contracts

    ii. the gross fair values (ie before taking into account amounts offset in the statement of financial position and credit mitigating factors);

    iii. amounts deducted as a result of the offset criteria in XX to derive the carrying amounts in the statement of financial position;

    iv. the portion of the exposures that is covered by a legally enforceable netting agreement (other than in (iii));

    v. amount of cash collateral and fair value of non cash financial asset collateral (separately disclosed) posted by the entity in respect of those liabilities;

    vi. the net exposure after taking into account the effect of the items in (ii) – (v).

    (b) An entity shall disclose for derivative instruments that are in a net liability position:

    i. the existence and nature of credit-risk-related contingent features and the circumstances in which the features could be triggered;

ii. the aggregate fair value amounts of derivative instruments that contain credit-risk-related contingent features; and

iii. the aggregate fair value of assets that are already posted as collateral and (1) the aggregate fair value of additional assets that would be required to be posted as collateral and/or (2) the aggregate fair value of assets needed to settle the instrument immediately, if the credit-risk-related contingent features were triggered.

[Except for information about gross fair value, gross notional and contingent credit risk features (which are required to be disclosed under US GAAP), all of the proposed disclosures are new.]

Basis for specific disclosures for derivative liabilities

Disclosure of Existence and Nature of Contingent Features

42. The proposed disclosures require the following about contingent features: (a) the existence and nature of contingent features in liability derivative instruments, (b) the aggregate fair value amount of liability derivative instruments that contain those features, and (c) the aggregate fair value amount of assets that would be required to be posted as collateral or transferred under the provisions after the triggering of the contingent features.

43. The staff acknowledges that derivative instruments often contain contingent features (for example, material adverse change clauses or payment acceleration clauses) that could result in an immediate payment to a counterparty on an agreement that is in a liability position. A material adverse change clause could provide the counterparty with the right to terminate the derivative agreement before maturity if specific events occur, such as a downgrade of the entity's credit rating below investment grade. Contingent features within derivative instruments also may contain provisions that could result in a requirement to post additional collateral in instances in which the contingent feature is triggered.

44. The staff notes that the disclosure of the existence and nature of contingent features will provide important information about the timing or likelihood of those

contingencies being triggered, as well as the cash effect to the entity if the contingencies were triggered. Disclosing the aggregate fair value of derivative instruments with those features will also provide important information about the magnitude of those contingencies.

45. Moreover, disclosing the fair value amount of assets that would need to be posted as collateral or transferred in accordance with the settlement provisions about the triggering of the contingent features will provide a better understanding of the related effect of those features on an entity's financial position, financial performance, and cash flows, in particular the effect on a company's liquidity.

E. Specific disclosures for credit derivatives and similar instruments

46. We propose that an entity provide users with information about the nature and the extent of credit risks associated with an entity's credit derivative and similar contracts. That information should be presented in a single note and in a tabular format, unless another format is more appropriate, and should include:

    (a) quantitative information about the entity's use of credit derivatives and other instruments that reallocate credit risk. Such disclosures shall include, by type of instrument (eg total return swaps, credit default swaps, credit option, credit-linked notes etc) and segregated between use for the entity's own credit portfolio, as well as in its intermediation activities:

        i. the notional amounts, maximum amount of future payments and receipts and fair value of such instruments;

        ii. the amount of credit risk protection purchased and/or sold;

        iii. a breakdown by industry or counterparty type;

        iv. protection purchased and sold with identical underlyings;

        v. maturity profile of protection sold or purchased;

        vi. risk rating of the underlyings (ie breakdown by rating of the reference asset eg investment grade, non-investment grade, not rated)).

[None of the proposed disclosures for credit derivatives and similar instruments are currently required under US GAAP OR IFRS.]

Basis for specific disclosures for credit derivatives and similar instruments

47. The staff believes that there is a gap in currently disclosed information with respect to credit derivatives and credit linked instruments (such products include credit default swaps, total return swaps and credit options.). The staff believes, based on discussions with users, there is demand for accurate and clear information on such instruments and the credit risk created and mitigated by such instruments.

48. Credit derivatives are financial instruments whose value is derived from the credit risk associated with the debt of a third-party issuer (the reference entity) and which allow one party (the protection purchaser) to transfer that risk to another party (the protection seller).

49. Credit derivatives expose the protection purchaser to the credit quality of the protection seller, as the protection seller is required to make payments under the contract when the reference entity experiences a credit event, such as a bankruptcy, a failure to pay its obligation or a restructuring.

50. The seller of credit protection receives a premium for providing protection but has the risk that the underlying instrument referenced in the contract will be subject to a credit event. Thus the seller of credit protection is exposed to the credit of the issuer(s) of the underlying (reference entity).

51. A credit-linked note is a form of credit derivative structured as a debt security with an embedded credit default swap. The purchaser of the note writes credit protection to the issuer, and receives a return which will be negatively affected by credit events on the underlying reference credit. If the reference entity defaults, the purchaser of the credit-linked note may assume the long position in the debt security and any future cash flows from it, but will lose the amount paid to the issuer of the credit-linked note. Thus the maximum amount of the exposure is the carrying amount of the credit-linked note.

52. An entity may be both a purchaser and seller of protection in the credit derivatives market and may use these derivatives for different purposes. The entity may use such instruments in its capacity as a market-maker in the dealer/client business or to manage its portfolio of credit derivatives by purchasing and selling credit protection or to meet the needs of customers. As a seller of protection, the entity's exposure to a given reference entity may be offset partially, or entirely, with a contract to purchase protection from another counterparty on the same or similar reference entity.

F. Qualitative information about how an entity manages credit exposures and the strategies employed in managing those credit exposures

53. An entity shall disclose information about the techniques used by the entity to identify, measure, monitor and control credit risks. At the minimum, an entity shall provide:

(a) qualitative information about the nature of credit risk in its activities and describe how credit risk arises in those activities:

(b) qualitative information on its strategies, objectives, and practices in managing and controlling its credit risk exposures, including an explanation of the policies for obtaining collateral and establishing credit reserves and policies with respect to wrong-way risk exposures (ie where there is significant correlation between the underlying asset and the counterparty credit risk)

(c) the process and methods used to assess credit exposures on both an individual counterparty and portfolio basis,

(d) the mechanisms used to reduce and/or mitigate credit exposures, such as collateral, guarantees, covenants, bilateral and multilateral netting arrangements, and early termination agreements;

(e) qualitative information about the entity's use of credit derivatives and other instruments that reallocate credit risk. Such information shall include a discussion of how instruments are used, including strategy and objectives; and

(f) any additional information that it considers necessary to meet the disclosure objectives.

Questions for the Board – proposed disclosure requirements

1. Do you agree with disclosure objective set out in paragraph 12 and, if so, do you think that the proposed disclosure requirements in paragraphs 19 -53 meet the objective? What should be added or removed and why?

2. If you disagree with the disclosure objective, what should the disclosure objective be and what disclosure requirements would you propose? How do your disclosure objective(s) and requirements meet the needs of users of financial statements regarding an entity's credit exposure and management and control of those exposures?

Appendix A

The following examples illustrate some possible ways to meet the proposed disclosure requirements that will accompany the offsetting criteria.

Disclosures for non-derivative financial assets (paragraph 19)

					(iv) Collateral held				
CU million	**Maximum exposure to credit risk**	**(i) Gross carrying amounts**	**(ii) Amounts offset under XX**	**(iii) = (i) - (ii) Amounts reported on balance sheet**	Cash	Other non-cash financial instruments	**(v) Amounts covered by other netting arrangements**	**(vi) = (iii) - (iv) - (v) Net current credit exposure**	**Portion of net credit exposure covered by guarantees, credit derivatives and other**
Type of instrument									
Reverse repurchase agreements									
Securities lending									
Loan receivables									
Other									
Total by type of instrument	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**

Derivative assets (paragraph 20)

CU million						(v) Collateral held			
	Gross notional amounts	**(i)** **Gross fair values**	**(ii)** **Amounts offset under XX**	**(iii) = (i)-(ii)** **Amounts reported on balance sheet**	**(iv)** **Amounts covered by other netting arrangements**	Cash	Other non-cash financial instruments	**(vi) = ((iii) – (iv) – (v)** **Net credit exposure**	**Portion of net credit exposure covered by guarantees, credit derivatives and other**
Derivative assets									
Foreign exchange derivatives									
Currency swaps									
Exchange traded futures and options									
Total									
Interest rate derivatives									
Interest rate swaps									
Forward rate agreements									
Exchange traded futures and options									
Total									
Total derivative assets									

Derivative liabilities (paragraph 41a)

CU million						(v) Collateral posted		
		(i)	**(ii)**	**(iii) = (i) – (ii)**	**(iv)**	Cash	Other non-cash financial instruments	**(vi) = ((iii) – (iv) – (v)**
	Gross notional amounts	**Gross fair values**	**Amounts offset under XX**	**Amounts reported on balance sheet**	**Amounts covered by other netting arrangements**			**Net exposure**
Derivative liabilities								
Forward foreign exchange								
Currency swaps								
Exchange traded futures and options								
Total								
Interest rate derivatives								
Interest rate swaps								
Forward rate agreements								
Exchange traded futures and options								
Total								
Total derivative liabilities								

Credit-risk related contingent features in derivative liabilities: (paragraph 41b))

Some derivative instruments contain provisions that require the Company to either post additional collateral or immediately settle outstanding liability balances upon occurrence of a specified credit-risk-related event. These events, which are defined by the existing derivative contracts, are primarily downgrades in the credit ratings of the Company or its affiliates. The fair value of all derivative instruments with credit-risk related contingent features that are in a liability position as of xx December xxxx is CU xxxx. The Company has posted CU xx as collateral for this exposure in the normal course of business as of xx December xxxx. Each downgrade would trigger additional collateral requirements for the company and its affiliates. In the event that each legal entity was downgraded a single notch as of xx December xxxx, the Company would be required to post additional collateral of CU xxxx.

Credit derivatives and other credit linked instruments: (paragraph 46))

The following table summarises the Company's credit derivative portfolio by type of industry/counterparty and type of instrument as of XX December XXXX.

CU million	**Fair values**		**Notionals**	
	Protection purchased	Protection sold	Protection purchased	Protection sold
By instrument				
Credit default swaps				
Credit options				
Total return swaps				
Credit linked notes				
Total by instrument				
By industry/counterparty				
Bank				
Broker-dealer				
Monoline				
Non-financial				
Insurance and other financial institutions				
Total by industry/counterparty				

	Maximum payout/Notional amount			
CU million	**Protection sold**	**Protection purchased with identical underlyings**	**Net protection (sold)/purchased**	**Other protection purchased**
Credit derivatives				
Credit default swaps				
Total return swaps				
Credit options				
Other credit derivatives				
Total credit derivatives				
Credit-linked notes				
Total				

Protection sold – credit derivatives and credit linked notes ratings/maturity profile

CU million	**< 1 year**	**1-5 years**	**> 5 years**	**Total notional amount**	**Fair value**
Risk rating of reference entity					
Investment-grade (AAA/Aaa to BBB-/Baa3)					
Noninvestment-grade (BB+/Ba1 and below)					
Total	**(X)**	**(X)**	**(X)**	**(X)**	**(X)**

Risk rating by instrument

CU million	**Credit default swaps**	**Total return swaps**	**Credit options**	**Credit-linked notes**
Risk rating of reference entity				
Investment-grade (AAA/Aaa to BBB-/Baa3)				
Noninvestment-grade (BB+/Ba1 and below)				
Total	**(X)**	**(X)**	**(X)**	**(X)**