Offsetting of Derivatives under Master Netting Agreements

Citigroup, Deutsche Bank, Goldman Sachs,
JP Morgan & UBS.

February 16th 2010

Accounting Policy for Derivatives

IFRS

- Derivative assets and liabilities are presented gross unless IAS 32 rules are met
  - Currently legally enforceable right of set off exists; and
  - Intent to settle net or simultaneous settlement
- Offsetting is required (not optional) if rules above are met

US GAAP

- FIN 39 netting is theoretically optional but widely applied in practice
- Netting is applied when there is a Master Netting Agreement (MNA) that is “legally enforceable,” meaning that there is “reasonable assurance” that the right of setoff would be upheld in bankruptcy
- Amounts netted include:
  - Derivative payables and receivables
  - Associated cash collateral payables and receivables
- Contracts must be between the same two legal entities
- Applied across all products subject to the MNA

Practice of Settlements of Derivatives

Single Transaction

- Individual transactions under the MNA umbrella are considered separate financial instruments
- Practically the cash flows on a single transaction are settled net where they occur on the same day in the same currency
- Even where the cash flows occur in different currencies or different dates and settle gross, a single FV is presented on the balance sheet

Multiple Transactions

- May be settled net or gross depending upon operational infrastructure and agreements between the parties
- Main areas where IFRS offsetting is achieved is where clearing houses or exchanges facilitate net settlement and there is a legally enforceable right to settle net
- However the majority of OTC bilateral derivatives are presented gross under IFRS as they are not settled simultaneously and/or do not have a currently legally enforceable right of set off

Resulting in Largest US GAAP and IFRS difference

- Some IFRS and US GAAP banks have disclosed the impact of the policy difference to assist with concerns and questions raised by analysts
- Nonetheless, from a user perspective, the 1- 2 trillion differentials currently being reported between US GAAP and IFRS calls into **question the validity of the accounting rules**

@31.12.2008 in bn	DB (EUR)	JPM (USD)	UBS (CHF)	Citi (USD)	GS (USD)
IFRS Derivative Assets	1,224	2,742	854	1,172	982
Offsetting - derivative FVs	(977)	(2,476)	(652)	(993)	(767)
Offsetting - cash collateral	(120)	(103)	(41)	(64)	(126)
US GAAP Derivative Balance	127	163	161	115	89

Amounts reported on Balance Sheet

Arguments Supporting Net Presentation

- Net presentation allows users to better understand the credit risk of the portfolio:
  - All the individual derivatives are transacted and governed under one legal contract – ISDA MNA
  - Counterparty credit risk exists at the MNA level and is measured at the portfolio level for fair value measurement purposes
  - If a default should arise, only one claim will arise for the net exposure that exists for the portfolio of derivatives under the ISDA MNA, with one cash sum ultimately paid to settle the claim
  - Credit risk is therefore managed at the portfolio level, with entities only hedging the net credit risk exposure
  - Given their leveraged/conditional nature, the cash flows of derivatives can rapidly change from being assets or liabilities and therefore no useful information of future cash flows is lost with a net presentation
  - Net presentation is consistent with the way the instruments are managed by the entity and therefore provides the most relevant information to users
- Using an intent based measure which is dependent upon system capabilities and ad hoc agreements creates inconsistency and subjectivity
- The fact that derivatives may not in practice be settled net in the normal course of business should not be a driver for the accounting, as the underlying credit risk exposure is not changed