IASB / FASB Joint Meeting
– week commencing 14 June 2010

Staff Paper

IASB agenda reference	4 - Appendix A
FASB memo reference	

Project	**Balance Sheet - Offsetting**
Topic	**Right of offset**

Introduction to this session

1. This paper is a restatement of the analysis provided by the staff for the February 2010 education session on netting of financial assets and liabilities. Apart from the section titled 'Feedback from February Education Session' and the purpose session the contents are broadly the same. This paper serves as the Appendix to the June 2010 joint paper on offsetting (FASB memo reference 1/ IASB AP4).

This Paper

2. The paper provides -

   (a) a feedback from the Boards education session on offset of financial assets and liabilities in February 2010

   (b) an overview of the accounting, economic and legal implications of set off rights

   (c) a description of the ISDA Master Netting Framework and a summary of the key provisions of the Master Agreement as they pertain to offset of the rights and obligations of the parties to the agreement

   (d) an overview of other netting mechanisms

   (e) a summary of the major differences between US GAAP and IFRS guidance on offset of financial assets and liabilities

   (f) a summary of the accounting issues to be addressed as part of an offset project

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

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

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

Feedback from February Education Session

3. The Boards held an education session on netting in February 2010. The purpose of that session was for the Boards to increase their understanding of the role and workings of Master Agreements (of which the ISDA Master Agreement is the predominant form) from a panel of experts. In particular, the objective was that the Boards would increase their understanding of the legal meaning, basis and effect and also the commercial effect of the netting provisions in the ISDA Master Agreement.

4. The session did not discuss possible criteria (qualification) for offset of financial assets and liabilities for financial reporting purposes; or seek input as to what the right accounting for offset arrangements should be.

5. However, the information and understanding gained from this session should help the Boards in any future deliberations that address the accounting for right of offset.

6. Below is a summary outline of the session:

   (a) Representatives from the banking sector provided an overview of their organisation's netting policy and practice and also their understanding of industry practice with respect to netting under master netting agreements

   (b) Leading legal experts on financial law discussed (i) the legal meaning, basis and effect for the netting provisions in the ISDA Master Agreement (ie the single agreement provision, the payment netting provisions and the close netting provisions; (ii) whether the confirmations underlying one master agreement are separate agreements (individual contracts) under law; and (iii) whether the legal analysis and effect of contracts with or through central counterparties differ from the operation of the single agreement Provision under the ISDA Master Agreement

   (c) ISDA representatives provided a general overview of the Master Netting Agreement Framework, how the various elements (ie confirmations, schedules, the master agreement and the other documents) of the framework relate to each other and how the framework is intended to work

7. Although it was made very clear to the Boards of the differences in reported numbers under IFRS and US GAAP as a result of the difference in accounting guidance on offset, it did appear that legal position of the various netting mechanisms is not as clear cut as previously thought.

8. In conclusion the Boards proposed to invite the legal experts back for a more focused discussion in the future on those legal uncertainties should the Boards decide to revisit the accounting guidance for offset of financial assets and liabilities.

Overview of accounting, economic and legal implications of right of set off

Accounting

9. The guidance in both IFRS and US GAAP for offsetting (netting) of financial assets and financial liabilities are broadly similar (except for some derivative and repurchase agreements). Generally, under both IFRS and US GAAP, an entity can only net a recognised financial asset and financial liability if the entity have a legally enforceable (unconditional) right to set off and intends to set off those positions.

10. The view is that when an entity has the right to receive or pay a single net amount and intends to do so, it has in effect, only a single financial asset or liability (for accounting purposes).

Legal

11. The right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor.

12. Therefore to understand the economic implications of offsetting, it is necessary to understand the legal rules that provide and underpin those rights.

13. The right to set off is a legal right, and the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered (to ascertain whether the right of set-off is enforceable).

Economic

14. The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect an entity's exposure to credit and liquidity risk.

15. Netting arrangements 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.

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

17. 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.

18. 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.

19. For a regulated financial institution, position netting may also have regulatory capital implications.

Description of ISDA Master Agreement Framework

20. The contractual agreements documenting and governing derivative transactions have been standardised to a great extent by the financial industry and ISDA. The financial industry utilise in almost all cases, the terminology, definitions and forms of agreements developed by ISDA.

21. The ISDA master agreement involves a pre-printed master agreement (either local jurisdiction single currency or multicurrency-cross-border), a schedule, and a form of confirmation.

22. Generically, these documents are often referred to together as an ISDA master and these documents, together, form a single agreement between the parties.

Master agreement

23. The Master Agreement specifies the general terms of the agreement between counterparties with respect to general questions such as netting, collateral, definition of default and other termination events, calculation of damages (on default) and documentation. The master agreement contains the terms and conditions by which all (or as many as possible) relevant transactions between the parties are governed. Accordingly, one master agreement is entered into between a given market participant and each of its counterparties regardless of how many individual transactions are in place between it and each counterparty.

24. Multiple individual transactions are subsumed under this general Master Agreement forming a single legal contract of indefinite term under which the counterparties conduct their mutual business. Individual transactions are handled by confirmations that are incorporated by reference into the Master Agreement. Placing individual transactions under a single master agreement that provides for netting of covered transactions has the effect of avoiding any problems netting agreements may encounter under various bankruptcy regimes. Having only a single contract between each pair of counterparties to a Master Agreement also eliminates the problem of netting multiple contracts.

Confirmation

25. Confirmations provide the specifics of each trade between the two parties. The Confirmation also "confirms" the payment terms. It does not, however, contain the many important contractual terms and other elements found in a typical finance contract. Instead, these terms and provisions are documented in the Master Agreement. Each Confirmation is incorporated directly into the Master Agreement itself, as opposed to being treated as an individual and distinct contract. The confirmation supplements, forms part of, and is subject to, the ISDA Master Agreement.

Schedule

26. The schedule is used to make certain elections and any modifications (additions and deletions) to the standard terms in the pre-printed form (Master Agreement).

Other documents

27. If appropriate, credit support documents (guarantees and pledge agreements) are also annexed to the master agreement. There are also definitional booklets which are incorporated by reference into the other documents.

Master Netting Agreements – Netting provisions

28. The following offset provisions are available under the ISDA Master Agreement and similar agreements:

   (a) **Single agreement provision**: This is a contractual provision whereby the parties agree that all contracts between them shall be consolidated into a single contract as soon as each new contract is entered into. Section 1(c) of the ISDA Master Agreement, entitled Single Agreement, specifies that the master and all transactions under it form a single agreement. Under the ISDA Framework, multiple confirmations ('transactions') are subsumed under the Master Agreement forming a 'single' legal contract of indefinite term under which the counterparties conduct their mutual business. An advantage of the 'single' agreement provision could be that it reduces the counterparty's risks, and the existence of the net obligation represents an advantage also for the needs of capital adequacy reporting.

   (b) **Payment Netting:** Under payment netting provisions, both contracting parties undertake to accept the net performance of the other party. It may apply only to amounts or deliveries due on the same date and only if the payments are in the same currency or are the same asset. Section 2 of the ISDA Master Agreement, entitled "Obligations", addresses payment offset. This provision ensures UUU**automatic offset** of each party's obligation to make payments (automatic satisfaction and discharge) and replacement with an obligation to make payment or a right to receive payment of the net sum. This provision may be applied to cash flows resulting from multiple transactions where payments occur on the same date and in the same currency, if parties so elect in the schedule or in the confirmation. The advantages of this type of netting include a reduction in transaction costs connected with the payment of the offsetting claims, lowering of risk of insufficient liquidity and occurrence of errors.

   (c) **Close-out netting**: Close-out netting is a contractual mechanism, enabling unilateral termination of a financial contract (or financial contracts governed by a master agreement), in the case of a bankruptcy or other event stipulated in the agreement, and at the same time the

"netting" of their replacement values into a final balance, usually referred to as the "termination amount". The cost of the replacement of individual positions in such transactions by new ones is determined, taking account of market prices. The market price set in this manner is then converted into one currency and the net position established. A net payment is then made at this time. The party that is out-of the-money is obligated under the master agreement to pay the net amount to the in-the money party, regardless of who is the defaulting party. Sections 5, 6 and 9 of the ISDA Master Agreement set out a detailed mechanism for close-out netting under the ISDA Framework. This process is intended to reduce exposures on open contracts if one party should become insolvent or a like event occurs before the settlement date.

Other netting mechanisms

29. There are other contractual netting mechanisms that are used by market participants in managing credit and liquidity risks:

    (a) **Clearing through central counterparties (CCP)**: Another netting mechanism available to market participants is clearing through central counterparties. Clearing houses and exchanges provide a means of bringing together the claims of several entities, setting them off and determining their net value. Payment systems usually form a part of the clearing systems. Typically the clearing house is a party to the individual claims and obligations. The clearing house therefore stands between each buyer and seller, guaranteeing the performance of each contract. The clearing house or exchange collects margin from each member to guarantee all participants transactions. However, as the clearing house is the holder of individual claims and obligations, the insolvency risk of one of the participants would be indirectly borne by all the participants with long positions. Under this mechanism the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk (or at worst the risk of each individual transaction is mutualised across all clearing house or exchange participants).

    (b) **Netting by novation**: Some argue that the single agreement provision (explained above), is a form of netting by novation. Others are of the view that the two are distinct tools of offset. Netting by novation is a contractual provision whereby the parties agree that all contracts between them shall be consolidated into a single contract as soon as

each new contract is entered into. Netting by novation offers the opportunity of reducing credit risks by means of discharging mutual obligations and their replacement by a new net obligation. This operation may repeat also several times up until the final settlement date agreed in advance. An advantage of netting by novation is that it reduces the counterparty's risks, and the existence of the net obligation represents an advantage also for the needs of capital adequacy reporting. Although typical of bilateral agreements, netting by novation may also be used at a multilateral level through a clearing house.

(c) **Collateral arrangements**: 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. As such collateral posted in financial transactions serve a mitigating role in terms of counterparty risk management. Consequently, it sometimes argued that cash collaterals should be netted off against the fair value of derivative positions.

Differences between US GAAP and IFRS requirements

30. There are some key differences between the guidance under IFRS and US GAAP. Firstly, under IFRS where the offset criteria are met an entity is required to offset the financial asset and liability. US GAAP however permits offset in the specified conditions and thus treats offset as an accounting policy choice (if the offset criteria are met).

31. Secondly US GAAP allows for offset for some arrangements (under some specified conditions) where the ability to set off is conditional and there is lack of 'intent' to offset or such intent is conditional. US GAAP:

(a) allows for offsetting of the fair value recognised for forward, interest rate swap, currency swap, option, and other conditional or exchange contracts (and the related right to reclaim cash collateral or the

obligation to return cash collateral) if they are executed with the same counterparty under a master netting arrangement. (FIN 39)[1]

(b) allows for offsetting of amounts recognised as payables under repurchase agreements and amounts recognised as receivables under reverse repurchase agreements if specified conditions are met. The key conditions are the existence of a daylight overdraft or other intraday credit feature in banking arrangements associated with settlements and the transfer system; that the securities exist in "book entry form"; and the arrangement ought to be under a master netting agreement. (FIN 41)[2]

32. IAS 32 prohibits offset where the right of offset is conditional or enforceable only on the occurrence of some future event. However some of the requirements under paragraph 20(b) are similar to the requirement under IAS 32 that allows for offset when an entity intends to realise the asset and settle the liability simultaneously.

33. One conceptual difference between the IFRS guidance and US GAAP exceptions outlined above is that the expected outcome in the event of default or termination of the contract drives the US GAAP accounting (FIN 39 and 41 exceptions). IFRS, on the other hand, focuses on circumstances that are expected to arise both in the normal course of business and in default or termination.

Accounting Issues to be addressed

A. Right to set off

34. Offsetting has traditionally been required or permitted for financial assets and liabilities with another party. As explained earlier, both US GAAP and IFRS guidance on offsetting (netting) requires a right of setoff. Under IFRS, the right of set off must be unconditional whereas US GAAP makes exception for some conditional right of setoff.

[1] ASC 815-10-45-5
[2] ASC 210-20-45-11

35. The question here is whether the right of setoff can be conditional on a future event, for example, only in the default or insolvency of a counterparty to the contract. This has implication for collateral posted as part of financial transactions as the party that receives the collateral has stated right to liquidate the collateral on default.

36. The argument against offsetting a financial asset and a financial liability where there is a conditional right to offset is that, it runs against the 'basis' for offsetting. The basis for offsetting is that where there is both a right and intention to offset, doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. Doing so also reflects, in effect, that the entity only has a single financial asset or financial liability. Thus some argue that if that right is conditional on a future event, until such an event occurs, offset of the two positions would not be representationally faithful.

B. Single agreement provisions in Master Agreements

37. Others argue that, for contracts governed by a master agreement, conditional set off rights do not impair the representational faithfulness of the financial statement if such positions are netted.

38. The ISDA Master Agreement consolidates the master and all transactions under it into a single agreement. That is, multiple individual transactions are subsumed under the general Master Agreement forming a single legal contract. This provision (netting by novation) discharges mutual obligations and replaces them with a net obligation.

39. In effect, the parties only have a single financial asset or financial liability as the case may be. Thus some argue that even where the right of offset is conditional, a master agreement with netting by novation (a single contract provision), the financial asset and financial liability created should be offset and presented net.

40. It is debatable what the economic effect of such provisions is i.e. is it a derecognition/recognition issue, a netting issue or a question of measurement?

C. Intention to set off

41. The general principle under both US GAAP and IFRS is that offsetting a financial asset and a financial liability is permitted, if in addition to a right offset,

the entity intends to settle on a net basis. The argument is that in the absence of an intention to exercise the right to settle net, presentation of the asset and liability on a net basis would be inappropriate as the amount and timing of an entity's future cash flows are not affected.

42. Others argue that the right to set off is of itself a sufficient condition for presenting net a financial asset and a financial liability. They argue that if a right of setoff is enforceable, the financial asset and financial liability together form a single asset or liability regardless of how the parties intend to settle the two positions.

43. They also argue that intention to settle net is subjective and difficult to substantiate. It also begs the question why any party with a right of set off would prefer to make and receive gross amounts (if the amounts outstanding are in the same currency and fall due on the same date).

D. Automatic set off provisions in master agreements

44. The typical ISDA master agreement provides for **automatic offset** of payments in the same transaction due on the same day and in the same currency. As such an agreement requires automatic netting, it is doubtful if intention to net settle is necessary in such circumstances. Consequently some argue that for master agreements with such clauses, all positions in the same currency and with the same maturity dates should be offset.