Project **Balance Sheet - Offsetting**

Topic **Analysis of Offsetting Based On Different Types of Risks**

Introduction

1. At the June 2010 joint Board meeting, the boards asked the staff to perform further research on several issues, including the appropriateness and usefulness of offsetting in general and, in particular, the appropriateness and usefulness of offsetting based on different types of risks (see overview table below). Agenda paper 8A addresses the former, and this paper addresses the latter.

2. Generally, current guidance in US GAAP and IFRS permits or requires, respectively, offsetting based on whether (a) a legally enforceable right of set off exists, (b) the recognized asset and liability settle at the same time, and (c) there is an intent to offset. The current guidance is not based on whether two or more contracts have the same primary underlying risk. As a result, some argue that information about the different types of risks inherent in contracts is not transparent because contracts with differing primary underlying risks still are eligible for offsetting. Generally, US GAAP also allows offsetting for derivatives and repurchase agreements based upon credit risk.

3. The purpose of this paper is not to develop recommendations for the eligibility criteria for offsetting; rather it is to discuss different risk-based approaches to offsetting in order to obtain input from board members on how different types of risks should be incorporated into a proposed offsetting model, if at all.

Objectives of Financial Reporting

4. Paragraphs 20 - 53 of agenda paper 8A provide an overview of the current FASB and IASB frameworks, and the near final ballot draft of the joint conceptual framework. These frameworks guide the boards in developing sound accounting principles and provide the boards and their constituents with an understanding of the appropriate content and inherent limitations of financial reporting. It is vital to consider the conceptual frameworks when developing an approach to offsetting financial assets and financial liabilities.

Overview

5. The table below summarizes the different approaches and the risks on which those approaches are based.

	Criteria		
	Market Risk[1]	**Credit Risk [1]**	**Liquidity Risk [1]**
Approach			
Market and Liquidity Risk	✓		✓
Market, Credit, and Liquidity	✓	✓	✓
Credit Risk		✓	✓
Cash Flow		✓	✓

Market and Liquidity Risk

6. Under the Market and Liquidity Risk approach, financial assets and financial liabilities would be offset based on whether they have the same primary underlying

[1] **Market risk** is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (including currency risk, interest rate risk and other price risk). **Credit risk** is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. **Liquidity risk** is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. [IFRS 7, *Financial Instruments: Disclosures*, Appendix A.]

market risk (for example, interest rate risk, currency risk, commodity risk, equity risk, etc.) and whether they settle simultaneously or in a manner that is economically equivalent (for example, how repurchase agreements that mature on the same day are settled in the US). This approach would not require the financial assets and financial liabilities to have the same counterparty, the right of set off, legal enforceability, or intent.

7. For example, assume that an entity has two outstanding contracts: a forward to buy XYZ stock that is traded on a US exchange with the strike price denominated in US dollars and a forward to sell the same XYZ stock with a strike price denominated in Euros on the same date. These positions would be offset in the statement of financial position and be presented as a single financial asset or liability because the two contracts have the same primary underlying risk (i.e., XYZ stock price).

8. This approach is based on the notion that it is not appropriate to offset financial assets and financial liabilities with different types of primary underlying market risks (for example, offsetting an interest rate swap with a commodity contract) or to offset contracts that do not settle simultaneously or in a manner that is economically equivalent because doing so would not faithfully represent the types of risks an entity is exposed or the timing of the cash flows.

9. For example, assume an entity had an interest rate risk derivative with a $100 asset fair value and a foreign currency exchange risk derivative with a $60 liability fair value that settle simultaneously. If those financial instruments were reported as a net $40 interest rate risk asset on the balance sheet, there would be no visibility of the foreign currency risk that the entity is exposed to.

10. This approach would not reflect an entity's net credit risk exposure because financial assets and financial liabilities with different counterparties would be eligible for offsetting. Such an approach could produce misleading information because an entity's exposure to credit risk may be much larger than the net amount presented on the balance sheet.

11. To address those concerns information about underlying market risks could be presented in the footnotes to the financial statements rather than on the face of the

statement of financial position, similar to disclosures currently required by SEC Financial Reporting Release No. 48, *Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments* (FRR 48) and IFRS 7, *Financial Instruments: Disclosures* (IFRS 7) .

(i) FRR 48 requires disclosure of quantitative and qualitative information about market risk for derivatives and other financial instruments.

(ii) IFRS 7 requires disclosure of qualitative and quantitative information about financial instruments.

12. In addition, aside from the type of risk and liquidity risk, there are other characteristics of financial assets and liabilities that should be considered. For example, two interest rate swaps may not react the same way to changes in interest rates if the floating leg is based on different indices such as the London Interbank Offered Rate and the Euro Interbank Offered Rate. It is not clear how under this approach the net amount of these two interest rate swaps would provide useful information to investors. Therefore, this approach may not provide useful information unless the financial assets and liabilities being offset have identical critical terms (for example, maturity, floating rate index, counterparty, etc.)

13. Further, a single financial asset or financial liability has many risks and it may be difficult to identify one primary underlying risk. For example, a forward on equity securities has stock price and foreign currency exchange risk. This may cause operational difficulties for entities because they would have to determine the primary or predominant risk of every financial asset and financial liability to determine which items should be offset in the balance sheet. Furthermore, even if financial assets and financial liabilities are offset based on primary underlying risks, other risks present in the financial assets and financial liabilities could potentially be obscured. For instance, even though the contracts in the example in paragraph 9

are offset based upon their primary underlying risk (that is, XYZ stock price) this approach obscures the foreign currency risk present in the forward contracts.

Market, Credit, and Liquidity

14. The Market, Credit, and Liquidity approach is the same as the Market and Liquidity approach, except that the financial assets and financial liabilities would also be required to be with the same counterparty. Accordingly, the right of set off, legal enforceability, and intent to set off are required under this approach.

15. Many of the advantages and disadvantages of this Underlying Risk Approach B are the same as those identified above. Accordingly, the forwards on XZY stock described in paragraph 7 above would be offset and presented net on the balance sheet provided that they (a) settle net against each other, simultaneously, or in a manner economically equivalent to net, and (b) are executed with the same counterparty subject to a legally enforceable right to offset, and the reporting entity intends to enforce that right.

Credit Risk

16. Under a Credit Risk approach, the amounts of all financial assets and financial liabilities that are executed with the same counterparty that are subject to a legally enforceable master netting arrangement, or similar netting arrangement, would be offset, regardless of their other characteristics (for example, maturity, underlying type of primary risk, etc.).

17. This approach is based on the notion that offsetting based on the counterparty credit risk provides more useful information to users regarding future cash flows of the reporting entity because:

    (a) Presenting individual financial assets and liabilities without offsetting based upon this approach does not necessarily provide more useful information about the timing or direction of cash flows. For example,

presenting contracts on a gross basis does not provide information on the timing of the potential future cash flows for an entity that has a contract that has a $100 asset value with entity B, and a second contract that has a $40 liability value.

(b) An entity that can legally offset under a master netting agreement is in a significantly different financial position than one that cannot legally offset. Offsetting based upon credit risk portrays this different financial position by reporting the net credit risk position in the statement of financial position. This view is supported through the US and International regulators' focus on net credit risk in their analysis, as well as input from the majority of bank stock analysts that have commented on the project during outreach conducted by the FASB's investor liaison. However, there was no consensus on this issue among the users that responded to an international outreach conducted by the IASB as described in the User Outreach memo (IASB reference 8C and FASB reference 5).

(c) Counterparties typically post or receive cash collateral based upon their net position. For example, if entity A has a contract that has a $100 asset value with entity B, and entity B has a separate contract that has a $40 asset value with entity A, and both are subject to a master netting arrangement, then A typically receives cash collateral from entity B on the net $60 position with entity B. Assume the terms call for $45 cash collateral (the terms of cash collateral arrangements between entities will vary); the statement of position would reflect a net balance of $15. As entity A and B settle each contract, the amount of cash collateral posted changes as well. For example, if entity B were to pay entity A $60 so that the net position is $0, entity B will then receive back its cash collateral of $45, for a net cash flow of $15. Thus, it could be argued that this approach provides a more relevant portrayal of expected cash flows that is possible on the statement of financial position both at the date of the statement of financial position and in the event of default. Without offsetting in this manner, reporting entity A would present a $100 derivative asset, a $40

derivative liability, and a $45 collateral posting liability. This type of presentation could make it more difficult for users of the financial statement to predict the future net cash flow of $15 if in fact the netting were to actually occur.

18. While the objective of the guidance in proposed Accounting Standards Update: *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (Issued 06/29/10) is about measurement rather than presentation, the proposed Update includes guidance proposing that the effect of a net credit position be used as the basis for determining credit valuation adjustments. Specifically, paragraph 820-10-35-18I provides an exception to the fair value measurement model when an entity manages a group of financial assets and financial liabilities on the basis of its net exposure to market risk or credit risk. Further, paragraph 820-10-35-18L states that when an entity qualifies for such an exception, it shall include the effect of the reporting entity's net exposure to the credit risk of that counterparty in the fair value measurement when there is a legally enforceable right to set off one or more financial assets and financial liabilities with the counterparty in the event of default (for example, because the reporting entity has entered into a master netting agreement with that counterparty).

19. A disadvantage of this approach is that offsetting based on credit risk could misrepresent the amounts by which the instruments being offset under master netting arrangements are actually settled. It is not common, other than in default, that the instruments offset under master netting arrangements actually settle net.

Cash Flow

20. The Cash Flow approach would permit the offset of financial assets and financial liabilities when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. This will be the case when (a) the financial asset and financial liability are with the same counterparty, and mature at the same time, and (b) the reporting entity has the right to offset, the right is

legally enforceability, and it intends to do so either by net settlement or by realizing the asset and settling the liability simultaneously. This approach is provided on the basis that:

(a) an entity's capital providers are directly interested in the amount, timing, and uncertainty of cash flows from dividends, interest, and the sale, redemption, or maturity of securities or loans

(b) information about an entity's economic resources and the claims to them (its financial position), can provide a user of the entity's financial statements an insight into the amount, timing, and uncertainty of its future cash flows

(c) offsetting meets the objective of financial reporting if it reflects or provides information about an entity's expected future cash flows from settling two or more financial instruments simultaneously.

21. This approach is also based on the notion that, if parties to a financial asset and a financial liability can and will pay or receive a single net amount between them, the parties have in effect only a single financial asset or financial liability.

22. This approach will typically apply where determinable amounts are owed to and by the same counterparties. However, in some circumstances, two parties may agree to apply an amount due from a third party against the amount due to a creditor.

23. Although this approach may reflect the implication of the arrangement on the parties' exposure to credit and liquidity risk, those risks are not the drivers of this approach. For example, entities may agree to delay settlement of one contract in order to offset amounts outstanding by a contract that will settle at a later time. Such a scenario may involve instruments of different maturities and hence may give no indication of liquidity risk. Similarly, there would be situations where an entity's credit risk on a financial asset may have been mitigated by a financial liability position but the asset and liability would have to be presented separately in the financial statements. However, in many cases, this approach will reflect or show directly the liquidity and credit risks to which those cash flows are exposed.

24. Hence, under this approach, assets and liabilities resulting from the following arrangements will not be offset but will be presented gross in the financial statements:

(a) subject to other accounting guidance on whether simultaneous transactions represent one contract, several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument')

(b) financial assets and financial liabilities arising from financial instruments having the same primary risk exposure but involve different counterparties

(c) financial or other assets pledged as collateral for non-recourse financial liabilities

(d) financial assets set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation.

(e) An entity undertakes a number of financial instrument transactions with a single counterparty under a master netting agreement and the agreement provides the non-defaulting counterparty with the right to close out on a net basis all financial instruments covered by the agreement in the event of default by the other counterparty.

Question for the boards
Do the Boards want to incorporate risk in the offsetting model to be developed in future meetings? If so, which risks would you like to incorporate?