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Staff Paper

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Project **Offsetting of financial assets and liabilities**

Topic **User outreach**

Purpose

1. At the June 2010 meeting, the boards discussed offsetting and asked the staff to obtain user feedback on the usefulness of offsetting financial assets and liabilities.
2. This paper provides the boards with a summary of the feedback received.

Outreach performed

3. In July and August 2010 the IASB and the FASB staff met separately with analysts from asset management firms, investment banks and rating agencies to discuss their views on offsetting. The IASB staff also invited users to participate in an online survey on the issue. The FASB staff also met with members of the FASB's Investors Technical Advisory Committee and the IASB met with members of the Corporate Reporting Users' Forum on several occasions during the year.
4. There was no overall consensus regarding the appropriateness of providing gross versus net information. Feedback varied depending on geographic location of user and companies as well as the type of user (buy/sell and equity/credit). However, the majority of these users agreed that a high-quality, converged standard should be developed to allow for international comparability, especially among banks.

General feedback

Gross Presentation

5. Some users prefer gross presentation with no offsetting. These users stated that the gross amounts are used in their ratio analysis because they are more comparable. For example, for purposes of computing tangible common equity, analysts like to use regulatory-basis assets rather than U.S. GAAP assets because of the offsetting permitted under current U.S. GAAP.

6. A gross presentation is more appropriate even in cases of synthetic terminations of derivative instruments, for example, when an entity with an outstanding interest rate swap or a commodity futures contract enters into an offsetting contract with the same counterparty to 'lock-in' the gain or loss on the original contract. Some users believe that useful information is lost when offsetting is permitted in these situations where the original contract is not terminated or cancelled.

7. Some users are concerned that offsetting results in reduced leverage in the balance sheet, and therefore, could be misleading. They would prefer to have any mitigating information disclosed in the notes so that they can decide for themselves in which circumstances offsetting is appropriate, and if so, use offsetting as part of their analysis rather than the required or optional offsetting under current standards.

8. Some users were not persuaded by the argument that the risk of default for an exchange-cleared transaction is low because the exchange may not have adequate capital to avoid defaults during a major market meltdown.

9. Users were also not convinced that offsetting should be allowed just because the maturities of the asset and the liability are identical. They pointed out that even when the maturities of the asset and the liability are identical, the counterparty can refuse to give up the asset to the reporting entity yet demand that the reporting entity pay its liability. For example, this could happen when the counterparty is either in bankruptcy or near bankruptcy.

Net Presentation

10. Several users view asset and liability balances with the same counterparty as, first and foremost, a credit issue. They view it secondarily as a liquidity issue, and lastly as an instrument-specific risk and exposure issue. Because they view it primarily as a credit issue, they believe counterparty netting is appropriate in most circumstances. They believe disclosures about maturities and specific instrument risk can be provided to highlight any information that netting may be obfuscating.

11. Similarly, other users stated that net presentation accurately portrays the true credit risk in normal market conditions and should remain on the face of the balance sheet. Gross numbers are useful during extreme market conditions, and should be disclosed. Further, they believe that offsetting contracts, such as master netting arrangements, have been legally enforced in various countries. Correspondingly, these users do not believe that an entity must have the intent to set off, but must have the legal right to do so.

12. One user noted that a timely measure of the leverage ratio is very important and whichever presentation allows for this should be used. Similarly, some users stated that the application of netting guidance should drive consistency in the leverage ratios used by regulators. This would be a positive development and could be a better indication of banks' potential counterparty risk and economic leverage than gross presentation.

13. If the boards were to specify criteria for offsetting, most users would prefer that offsetting be required (rather than permitted) when those criteria are met. Permissive or optional accounting hinders comparability among companies in the same industry.

14. Some of these users believe that it is more important to ensure that the items to be offset have the same risks and characteristics than having the same maturities. For example, they would not offset an interest rate derivative asset with a commodity derivative liability even if their maturities were identical because the risks and characteristics of the two derivatives are different.

Additional feedback by type of analyst

Asset manager

15. Credit analysts would like to see both net and gross exposure. In addition, while they may accept presentation based on the right of set-off for derivatives they do not necessarily agree with the same application for loans and deposits. They have become more careful in their lending activities, as they now believe that a parent's credit guarantee may not have the same weight or provide the same protection as it may have in the past due to the problems they are seeing with transactions across different jurisdictions and with different legal entities.

16. Equity analysts would like to see gross information on the face of the balance sheet to understand a company's leverage. In addition, they are not comfortable with the idea of presenting net information across legal entities[1] or across jurisdictions as there have been many different interpretations of the rights when settling these transactions, and these factors add yet another layer of legalities and complexities when there is no intention to offset. These analysts would like additional disclosures explaining the economic justification for entering into derivatives. Ideally, they would like to see a table in the notes detailing: 1) the gross notional amounts of the instruments, 2) the fair value of the cash flows of the instruments, and 3) the gross positive replacement value of the instruments so they can have the ultimate loss information[2]. They would also like additional information on the actual counterparties that the financial institutions are facing.

Investment bank analysts

17. Users indicated that while the current approach under the FASB model was more intuitive, the IASB model was better in practice as businesses are built on intention and not on extreme situations. They are also concerned with the differences between financial and regulatory reporting and would like to see more disclosure around the level of complexity of the derivatives companies have entered into.

[1] Some staff note that preparers under US GAAP generally do not net derivatives across legal entities.
[2] Some staff note that the table described by this user is similar to that required in by US GAAP.

Rating agency

18. These analysts would like to have both information: net on the face of the balance sheet for the credit analysts and gross in the notes. They think that if net presentation based on risks is allowed it should only be based on counterparty risk. Although they do analyse liquidity, these users are looking primarily at mitigating credit risk and not at cash flows. They would like to see additional disclosures similar to the disclosure requirements in paragraphs 815-10-50-4A and 815-10-50-4B of the FASB Accounting Standards Codification™ (*Derivatives and Hedging*)[3], which includes the gross fair values of asset and liability derivatives and their location on the balance sheet. These users believe a master netting agreement is sufficient for allowing netting, and that net presentation does not have to be mandatory.

19. If the bank is using derivatives for many different purposes, these users prefer gross presentation. However, if banks are only using derivatives for trading, the users believe that net presentation is sufficient and they believe that netting different maturities doesn't matter as banks can sell-off their open positions (even if they are over-the-counter contracts).

20. Interestingly, the same rating agency users do not think that customer deposits and loans should be netted because settlement of these instruments is different than derivatives. Because derivatives can be net settled for a fraction of their nominal amount netting is reasonable. However, the gross amounts that are going to be paid under deposits and loans should be shown on the balance sheet.

21. Further, these users prefer gross presentation for corporates as it is easier to explain the entities' cash flows.

IASB user group members

22. As above, feedback varied based on the user's need of the financial information. The general feedback is that since the banks these users cover do not net (due to

[3] Originally issued in paragraph 44C(a) of FASB Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities,* an amendment of FASB Statement No. 133.

operational issues), they were more comfortable looking at gross amounts if the preparer had no intention to offset.

23. Some of these users did find netting to be more appropriate as they believe that the risk systems, especially in financial institutions, have greatly improved over the years and therefore the netting reflects the way the entity manages its risk. Others indicated that if risk management is the most important indicator of how an entity runs its business, then financial instruments should be shown gross in the notes and net on the balance sheet as this may show the true risk. However, even those that would like to see net on the balance sheet wanted to see the netting based on intention to net in the normal course of business.

24. Other users in the group were not comfortable with offsetting over-the-counter contracts if there was any residual risk between the two contracts. In addition, as banks have internal limits with single counterparties it is more important for users to understand the gross amounts the banks have with these counterparties.

25. Intraday credit limit is another important item when understanding an entity's ability to net and enter into transactions with the same counterparty. Master netting agreements are not sufficient for this, and these users are afraid that there are too many uncertainties with these netting agreements. These users did not want to see any netting on the balance sheet, or, if necessary, think that the netting requirements should be as narrow as possible. Preparers can use the notes to explain their exposure on a net basis.

Other

26. Some users and constituents argue that this project should align the accounting netting guidance with the Basel II requirements. As a result, the staff also reviewed the Basel guidance on netting for purposes of capital adequacy calculations (in the Basel II Accord). The staff notes that there are significant differences between the Basel II netting guidance and the accounting requirements on netting:

- Basel II allows offsetting of loans and deposits (if certain conditions are met) whereas both IFRS and US GAAP do not permit such treatment

- US GAAP allows for netting of derivatives and associated cash collateral whereas Basel II allows for netting of positions under financial contracts and both cash and physical collateral
- Basel II takes into account certain items (which may be considered an asset or a liability under Basel II calculations) in arriving at net balance for capital adequacy purposes, whilst these items are not recognised under either US GAAP or IFRS
- Basel II takes into account liquidity (timing of cash flows) by requiring maturity adjustments but this is not required under IFRS and US GAAP netting approaches
- Basel II allows for netting of all repo contracts whereas US GAAP allows only netting of some repos and reverse repos.
- Amounts taken into account by Basel II, as the value or deemed value of derivatives and guarantees, are significantly different from the fair value of those instruments as are recognised under IFRS and US GAAP.

27. The staff notes that aligning the accounting netting guidance with the Basel II requirements is difficult to achieve as the differences between accounting netting requirements and Basel II are significant. The staff believes that the objective of financial statements and hence the goal of the Boards may not necessarily be congruent with that of prudential regulation and hence the information requirements will inevitably be different.

Online survey

28. As mentioned in paragraph 3, the IASB staff invited users to participate in an online survey to regarding their analysis of balance sheets and the usefulness of having gross versus net information. The staff received completed responses from 21 analysts, including both buy-side and sell-side, and equity/credit analysts from the UK, Turkey, France, US, Portugal, Rwanda, Japan, Libya, Kuwait, China, Mexico, Canada, and Thailand. The questions asked and responses received are summarised below.

    a. **Question #1:**

Do you require both gross and net values of financial asset and liability positions, and in particular derivatives, when analysing financial statements?

Responses:

Out of 21 respondents, 76 percent indicated that they required both gross and net values of financial instruments. They cited the following reasons:

- *Analysis of counterparty risk [Sell side: equity].*
- *Netting assets and liabilities affects ratios that are important to understanding companies' performance and financial positions and so gross information is important as well as net. If there are factors that limit the ability of the preparer to net settle, gross information should be included. Further, gross information is more meaningful than net information when the contracts where netting is appropriate and the underlying inputs fall within different levels of the fair value hierarchy (e.g., if the receivable is in level 1, but the payable is level 3). Similarly, the gross information is meaningful when thinking about adjustments to the valuation arising from credit risk and whether that risk adjustment arises from the holder (own credit) or the counterparty. [Sell-side: equity/credit]*
- *Gross values are helpful in understanding the magnitude of operations while net values provide greater insight into default risk and risk management practices. [Credit]*
- *Gross liability positions tell me what the overall financial risk to the company is. What its required cash outflow is likely to be. Gross asset position tells me what potential liquid (or reasonably liquid) assets are available to meet the liability in the absence of operating cash flows. Net position links specific liabilities with assets that either contractually or by company strategy are linked. [Equity]*
- *We do not trust the "netting" agreements unless, strictly limited, existing IFRS style ones. [Buy-side: equity]*

- *Matching between both values gives readers more overseeing and highlighting differences and how much affects the positions. [Buy-side: credit]*
- *With that disclosure it is possible to give a better analysis [Buy-side: equity]*

The remaining 24 percent of the respondents do not require both information for the following reasons:

- *Netting would be a more appropriate presentation in the financial statements given the way financial institutions measure and manage their derivatives risk exposure; so long as there is no doubt about the legal right to set-off under all circumstances and there is little risk of disagreement concerning measurement of risk exposure for each of the individual contracts. The existence of a master contract which serves as an umbrella contract for the others would be important. [Buy-side: credit]*
- *I believe reporting net values make more senses for the users as it is easier to understand the net position of that particular firm. It also helps prevent Balance Sheet inflation (due to gross values reporting). In addition, most of the transactions done by any particular institutions will be under ISDA Master Agreement and having Credit Support Annex to mitigate credit risk, therefore, looking a gross value may not help the users gain much understanding in terms of counterparty credit risk. By the way, if possible, I wish there are some footnotes showing how much credit exposure under derivatives transactions done by any particular institution taken into account of ISDA Master Agreement and Credit Support Annex. [Sell-side: credit]*

b. Question # 2:

Assuming you need both gross and net information, which information would you prefer to see on the face of the balance sheet and which should be disclosed in the footnotes to the financial statements?

Responses:

Out of 21 respondents, 33 percent indicated that they preferred to see gross positions on the balance sheet for the following reasons:

- *Footnote disclosure would permit me to see if specific assets and liabilities are linked. A net position on the balance sheet is misleading in my view if all financial assets cannot or will not be used to settle the financial liabilities. [Equity]*
- *We want the face of the balance sheet to show the fullest possible amount for assets and liabilities. Notes or management info can show if there are effective risk mitigants. [Buy-side: equity]*

67 percent of the 21 respondents prefer net information on the balance sheet. They included the following comments:

- *In some cases, substance is better reflected on the balance sheet by netting (example where assets can only be used to settle liabilities). In this case, footnote disclosure is required for analysts and investors to have a better understanding of the nature of assets and liabilities of an entity. [Sell-side: equity]*
- *Actually I would prefer to see both on the face of the balance sheet. It's more useful. [Buy-side: equity]*
- *As mentioned, I don't think that inflated balance sheet makes any sense to me. [Sell-side: credit]*

c. Question #3:

If net information is presented either on the face of the balance sheet or in the footnotes, should netting be allowed based on an unconditional right to offset, or on a conditional right to offset (ie only in bankruptcy or default)?

Responses:

Out of 21 respondents, 57 percent think that netting should be unconditional (ie in the normal course of business) and stated the following:

- *It should be unconditional to avoid potential abuses because this gives entities a great deal of flexibility and room to manoeuvre. It can also lead to inconsistencies which will not help comparability. [Sell-side: equity]*
- *My preference is for unconditional. However, I would be fine with conditional if conditions were fully disclosed. [Equity]*

Ten percent think that netting should be conditional. One credit user indicated that *settlement netting is an operational, not an accounting, issue. If the bank can set-off in event of default that is the most salient fact.*

One third of the respondents had no preference and two expanded on their reasons below:

- *There is no such thing as an "unconditional right to offset", or even proven to be 100% effective in bankruptcy or default. [Buy-side: equity]*
- *No preference as both can somewhat help mitigate counterparty credit risk.[Sell-side: credit]*

d. Question # 4:

If netting is based on risk exposure, should it be allowed for different types of risks?

Responses:

Of the 21 respondents, 48 percent believe that netting should be allowed for different types of risks as follows:

- *Credit risk, Interest rate risk, Foreign Currency risk and Liquidity risk. [Sell-side: Equity/credit]*
- *With disclosure of type of risk. [Equity]*
- *Credit, Interest, Market [Buy-side: credit]*
- *Given the fact that they are all under ISDA Master Agreement and can be netting. [Sell-side: credit]*

- *We would only wish to see netting based on risk exposure for those positions with the same counterparty. We would not wish to have netting across counterparties. [Buy/sell-side: credit]*

Out of the 52 percent that do not think that netting should be based on risks, only one included further explanation:

- *"Risk exposure" is a highly subjective, internal management control, not one for the balance sheet. [Buy-side: equity]*

e. **The staff also received the following additional comments/explanations from the surveys based on the general concept of offsetting/netting:**

- *The netting disclosures should include robust discussion about why the disclosed netted amounts make sense, and there should be a fairly narrow/strict hurdle for what is permitted to be netted in the disclosures. Risks may be disguised if there is a broad view of what's allowed to be netted. [Buy-side: equity/credit]*
- *Previous financial reporting practices that showed minimal risk exposure due to the purchase of insurance from monoline insurance companies concealed a major problem that surfaced when these AAA insurance companies ran into financial difficulty. Any proposed rules should take this into account. [Buy-side: credit]*
- *We would like to have disclosures that would reconcile gross to net positions by product type that would include the impact of cash collateral offsets. OK with allowing netting to be optional, not mandatory. [Buy/sell-side: credit]*
- *The Lehmans bankruptcy has proven that netting is highly problematic, even when used in the current IFRS sense, let alone in the wooly "master netting agreement" sense of FASB. The riskiness of banks needs to be expressed on the balance sheet, and offset by management discussion or notes as to how this is mitigated. [Buy-side: equity]*