IASB/FASB Meeting
Week commencing 13 June, 2011

IASB Agenda reference	**5A Appendix A**
FASB Agenda reference	**15A Appendix A**

Staff Paper

Project	**Offsetting Financial Assets and Liabilities**
Topic	**Offsetting approaches – Unconditional rights of set-off (Alternative 1)**

Introduction/Purpose of the paper

1. This paper discusses the approach proposed in the ED taking into account the analysis and recommendations of the staff in Agenda Papers/Memos 5B/15B – 5D/15D (**Alternative 1**). Alternatives 2 and 3 are discussed in Agenda Paper/Memo 5A/15A Appendix B and C respectively. Some staff recommend the offsetting approach described in this paper (Alternative 1 – revised ED Approach), taking into account the staff recommendations in Agenda Paper 5B – 5D/Memos 15B – 15D over the approach described and discussed in Appendix C (Alternatives 3 and 3a). Other staff recommend the offsetting approach in Appendix C (**Alternative 3 or 3a – hereinafter referred to in this paper, together, as Alternative 3**) over the approach discussed in this paper.

Unconditional right of set-off and intention to offset (Alternative 1)

2. Under this approach, an entity would be required to offset a recognised financial asset and a recognised financial liability when the entity

   (a) has an unconditional and legally enforceable right to set off the financial asset and financial liability and

   (b) intends either:

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(i) to settle the financial asset and financial liability on a net basis or

(ii) to realise the financial asset and settle the financial liability simultaneously.

Basis for Alternative 1

1. Consistency with the objectives of financial reporting

3. In developing the approach in the ED (Alternative 1), the boards evaluated whether and when offsetting in the statement of financial position is appropriate or provides useful information.

4. In evaluating whether and when offsetting in the statement of financial position is appropriate, the boards considered whether offsetting is consistent with the objective of financial reporting information as described in the boards' *Conceptual Frameworks for Financial Reporting*.

5. The boards' *Conceptual Frameworks* specify that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. It explains that existing and potential investors, lenders and other creditors need information:

   (a) to help them assess the prospects for future net cash flows to an entity;

   (b) about the nature and amounts of a reporting entity's economic resources and claims against the entity to identify the reporting entity's financial strengths, weaknesses, liquidity and solvency and its needs for additional financing; and

   (c) about priorities and payment requirements of existing claims to predict how future cash flows will be distributed among those with a claim against the reporting entity.

6. Thus, the objective of financial reporting necessitates provision of information in the statement of financial position about the economic resources of the entity (its assets) and the claims on those resources (its liabilities and equity).

7. Offsetting obscures the existence of some assets and liabilities. Generally, presenting assets and liabilities net limits the ability of users of financial statements to assess the future economic benefits available to, and obligations of, the entity and hence their ability to assess the entity's financial strengths and weaknesses.

8. The boards therefore decided that offsetting financial assets and financial liabilities does not, generally, meet the objective of financial reporting, as set out in the *Conceptual Frameworks,* and that financial assets and financial liabilities should, generally, be presented gross in the statement of financial position.

9. The boards concluded that offsetting a financial asset and a financial liability in the statement of financial position is consistent with the objective of financial reporting only if, on the basis of the rights and obligations associated with a financial asset and a financial liability, the entity has, in effect, a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability) and the amount resulting from offsetting the asset and liability reflects an entity's expected future cash flows from settling two or more separate financial instruments.

10. The boards concluded this will be the case only if (a) the entity has the ability to insist on a net settlement or enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event), (b) that ability is assured, and (c) the entity intends to receive or pay a single net amount, or to settle the asset and liability simultaneously.

2. Consistency with the qualitative characteristics of information in financial reports

11. The boards also considered whether offsetting is consistent with the qualitative characteristics of information in financial reports as described in their *Conceptual Frameworks* in evaluating whether and when offsetting in the statement of financial position is appropriate.

12. The *Conceptual Frameworks* state that the qualitative characteristics of information in financial reports are the attributes that make information in financial statements useful to users of financial statements. They also state that, for financial information to be useful, it must be relevant and faithfully represent what it purports to represent.

13. The *Conceptual Frameworks* define relevant financial information as information that is capable of making a difference in the decisions made by users and further state that financial information has that capability if it has predictive value, confirmatory value or both.

14. The *Conceptual Frameworks* explain that for financial information to be useful, it must not only provide relevant information, it must also faithfully represent the phenomena that it purports to represent.

15. The boards concluded that, generally, presenting assets and liabilities net limits the ability of users of financial statements to assess the future economic benefits available to, and obligations of, the entity and hence their ability to assess the entity's financial strengths and weaknesses as offsetting obscures the existence of some assets and liabilities and reduces transparency of financial statements.

16. Presenting assets and liabilities net masks the scale and nature of an entity's business and reduces users' ability to identify the amount of assets and liabilities that generate the entity's revenues, gains and losses and thus makes it difficult to analyse the relationship between the carrying amount of financial instruments and the associated gains or losses reported in the statement of comprehensive income.

17. Offsetting is conceptually different from the derecognition of financial instruments. Although conceptually different, offset that results in a net amount of zero and derecognition resulting in no gain or loss are indistinguishable in their effect in the statement of financial position. Likewise, not recognising assets and liabilities of the same amount in financial statements achieves similar reported results. Hence the boards concluded that offsetting could provide misleading information about an entity's financial position.

18. The boards concluded that, generally, the presentation of gross amounts of assets and of liabilities provides more relevant information than a net presentation as net presentation of assets and liabilities in the statement of financial position generally does not provide a complete depiction of the assets and liabilities of an entity.

19. However, the boards concluded that when the proposed offset criteria are met, offsetting meets the relevance criteria as doing so reflects that the entity has, in effect, a right to or obligation for only the net amount (ie the entity has, in effect and in all circumstances, a single net financial asset or financial liability) and the amount resulting from offsetting the asset and liability reflects an entity's expected future cash flows from settling two or more separate financial instruments. Hence in these circumstances offsetting is relevant and it faithfully represents the economic resources of and claims against an entity and thus should be required.

20. The boards also concluded that this is the case if the entity has the ability to insist on a net settlement or enforce net settlement in all situations, including in the normal course of business (ie the exercise of that right is not contingent on a future event), the ability to insist on a net settlement is assured, and the entity intends to receive or pay a single net amount, or to settle simultaneously.

21. Thus, under Alternative 1, financial assets and financial liabilities would be presented in the financial statements in a manner that provides information that is useful for assessing:

    (a) the entity's ability to generate cash in the future (the prospects for future net cash flows);

    (b) the nature and amounts of the entity's economic resources and claims against the entity; and

    (c) the entity's liquidity and solvency.

3. Information content of gross amounts vs net information

22. The shared goal of the boards is to produce high quality financial reporting standards to assist in the efficient functioning of economies and the efficient allocation of resources in capital markets. Hence in evaluating whether and when offsetting (netting) on the face of the statement of financial position is appropriate, the boards should consider (in addition to the issues analysed above) whether netting provides better information than the gross amounts.

23. Prior to developing Alternative 1 (and subsequent to publication of the offsetting ED), the boards found no consensus among users on the usefulness of presenting gross information or net information about financial assets and financial liabilities in the statement of financial position.

24. There was, however, consensus among users that information about both the gross amounts of financial assets and financial liabilities and the net amount that results from offsetting is useful. This is also consistent with feedback from users on the proposals in the ED.

25. It is important to bear in mind, however, the general principle of financial reporting is that assets and liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity and not the other way round. Thus to choose a net number above gross presentation, the net ought to provide <u>better</u> information than gross information, in addition to meeting the other criteria discussed earlier in the paper.

26. It is also worth noting that there is little debate as to whether, when an entity has only a single derivative asset or liability, an entity should present that item at fair value on its balance sheet and whether that representation provides useful information. Likewise, if an entity has only derivative assets or derivative liabilities many agree that the fair value of those assets or liabilities should be presented on the balance sheet and will convey useful information.

27. Hence the argument against presenting the gross fair value of an entity's financial assets and liabilities on the balance sheet arises only when an entity

has both financial assets and financial liabilities (under a master netting agreement).

(a) Basis for presenting net or gross information in the financial statement

28. The proposed approach in the ED reflects a general principle of financial reporting, that is,

    (a) assets and liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity and

    (b) offsetting recognised assets and recognised liabilities detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows.

29. Under the proposed approach, offsetting is required if, and only if:

    (a) on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has, in effect, a right to or an obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability), and

    (b) the amount resulting from offsetting the asset and liability reflects an entity's expected future cash flows from settling two or more separate financial instruments.

30. The conditions described in paragraph 29 are met if:

    (a) the entity has the ability to insist on a net settlement or enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event),

    (b) that ability is assured, and

    (c) the entity intends to receive or pay a single net amount, or to settle simultaneously.

31. In all other circumstances (under the proposed approach), financial assets and financial liabilities would be presented separately from each other according to their nature as assets or liabilities.

32. On the other hand, net presentation of financial instruments (under a master netting agreement or similar arrangements) is on the basis that the net amount reflects the entity's exposure should either the entity or one or all of the counterparties default or goes (go) bankrupt.

33. This is, firstly, inconsistent with going concern based accounting.

34. Those who support gross presentation are not convinced that requiring offsetting on the basis of what might or might not happen in the future (ie an assumption that an entity or its counterparties will default or become bankrupt) would be appropriate.

35. They also argue that, the argument for net presentation is based on faulty logic. They note that the argument that presenting the net amount shows the extent of the entity's exposure in default of all counterparties would paint an incomplete picture, even if financial statements should be prepared on that basis.

36. They believe that presentation of net fair value of derivative positions alone without presenting all assets and liabilities on a similar basis does not take into account the probability that given that a particular counterparty or all counterparties fail to deliver, the entity or other institutions in the system would also fail to deliver (a major concern arising from the recent financial crises). This is based on the fact that financial institutions are usually linked, either directly, through the interbank deposit market and participations in syndicated loans, or indirectly, through lending to common sectors and proprietary trades.

37. Financial institution distress dependency tends to rise in times of distress since the fortunes of institutions decline concurrently through either contagion after idiosyncratic shocks or through negative systemic shocks.

38. Derivative markets are particularly vulnerable to systemic shocks. The value of derivative positions can change rapidly. Moreover derivative markets are

dominated by a few large firms. Thus the failure of one firm and the response of others can lead to endogenous adverse changes in asset values and to rapid changes in market liquidity and knock on effect on other players in the market.

39. Thus they argue that at least one of they key basis for presenting the net amount on the balance sheet is misleading and indefensible and paints an incomplete picture of an entity's exposure.

(b) Information on credit risk

40. Alternative 3 would allow netting when an entity has a conditional right of offset. Under that alternative, 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.) This approach is based on the notion that offsetting based on the counterparty credit risk provides more useful information to users.

41. Those who support gross presentation argue that offsetting based on a conditional right of set-off will result in financial statements that depict only the entity's exposure to credit risk. They argue that the statement of financial position does not represent an aggregation of the credit risk of an entity: it is not its purpose to set out the rights or the obligations of an entity if counterparties fail or become bankrupt. Thus they conclude that offsetting on the basis of a conditional right of set-off would not result in financial statements that are representationally faithful.

42. Supporters of gross presentation emphasise that conditional rights of set-off are present in many arrangements, for example, non-recourse debt arrangements and banker and customer relationships (which in many jurisdictions have a stronger legal basis for offset), and offset is not allowed for any of those arrangements. They believe there is no conceptual or practical reason for

singling out contracts governed by a master netting agreement (ie conditional right of offset) and cash collateral for offset in accounting.

43. The supporters of gross presentation believe that although offsetting on the basis of absence or mitigation of a particular risk may provide a partial outlook and it results in incomplete representation of the financial position of an entity. Netting on the basis of mitigation or elimination of credit risk will mask the presence of other risks and it reduces the representational faithfulness of the financial statements. They believe that aggregating the asset and liability positions of financial instruments could further reduce users' ability to understand the risk exposures of an entity arising from such contracts.

44. Those who are opposed to net presentation based on credit risk also reject the idea that the net amount (current exposure) represents the credit exposure of an entity.

45. They argue that the net amount, even if one accepts that it represents the entity credit exposure at the end of the reporting period, does not provide any relevant or useful information (as it is backward-looking information and provides no indication whatsoever on credit exposure going forward).

46. They argue that particular financial information is relevant and useful if that information is capable of making a difference in the decisions made by users. Financial information has that capability if it has predictive value, confirmatory value or both.

47. Although the net amount may provide a snapshot of credit exposure at a single point in time, there is a fundamental difference between derivatives and unconditional payables and receivables. The nature of derivative contracts is such that their market values can fluctuate substantially, even over a relatively short period of time. Because the credit exposure of derivatives can fluctuate dramatically, measuring exposure at a single point in time does not yield an accurate assessment of the credit exposure of a derivative portfolio going forward. Thus, they argue that net fair value of derivative positions does not

provide a reliable indication of an entity's credit exposure even a day after the end of the reporting period.

48. Moreover, even at the reporting date, the net amount is not a reliable measure of the credit risk of the entity. By netting financial assets and liabilities without regard for maturity or payment dates, no indication is given of credit risk. Also, the net amount does not take into account guarantees provided, other assets posted as collateral, any hedges (eg credit default swaps or options) entered into by the entity, wrong way risks embedded in the portfolio of financial assets and liabilities and potential future movements in the portfolio. Supporters of gross presentation believe that, in this respect, gross presentation is relatively better and does not result in the misleading picture that is provided under net presentation.

49. The net presentation approach is inconsistent with how both market participants and supervisors measure credit risk - total credit exposure is calculated as the sum of current and potential exposure whilst taking into account factors such as maturity differences, potential future exposure and wrong way risks.

50. Some argue that the gross amounts do not provide information about credit risk either. Even if that is the case, that argument however, turns the issue on its head. It is not that the gross should be proven to better than the net but vice versa. It is important to bear in mind, however, the general principle of financial reporting is that assets and liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity and not the other way round (and the issues highlighted in paragraphs 25-27). Thus to choose a net number above a gross presentation, the net ought to provide better information than the gross information.

51. The gross amount provides transparency around the financial position of the entity. It will alert a user to any counterparty exposure and direct the user to obtaining further information from the disclosures, other sources or directly from management. Hence those who support gross presentation argue it gives a better indication of the financial position of the entity and better information.

52. Under existing and proposed requirements, when an entity enters into a contract that hedges its exposure to a particular risk, it is not required or permitted to present the asset and the liability in that hedge relationship net in the statement of financial position (although the arrangement may even result in complete mitigation of the entity's exposure to a particular market risk). Supporters of gross presentation believe there is no reason why net presentation should be allowed or required solely because a master netting agreement reduces an entity's credit exposure (one type of risk) on financial contracts.

(c) Amounts, uncertainty and timing of future cash flows

53. In the boards' *Conceptual Frameworks*, the boards indicated that - "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers…."

54. The *Conceptual Frameworks* further explain that the decisions that capital providers make include whether and how to allocate their resources to a particular entity (that is, whether and how to provide capital) and whether and how to protect or enhance their investments. They also emphasise that when making those decisions, capital providers are interested in assessing the entity's ability to generate net cash inflows and management's ability to protect and enhance the capital providers' investments. The *Frameworks* further state that 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.

55. As set out in the boards' *Frameworks*, 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. That information also is expected to help capital providers to identify an entity's financial strengths and weaknesses and to assess its liquidity and solvency.

56. Both gross and net information may not provide all the information that a user needs to assess the amount, timing and uncertainty of future cash flows resulting from financial instruments. Whether an entity presents gross or net on the balance sheet, further explanation will be needed for a user to fully appreciate the uncertainty of future cash flows (eg description of the financial instruments, associated rights and obligations and the underlying factors that drive the value of the instruments). However a net exposure of zero (assuming for example that the entity has some financial assets and liabilities) will provide no information about uncertainty of future cash flows whereas the gross amount will provide some indication (in that case) or can lead a user to ask the right questions or to look for further information.

57. Even if both the gross and net information about financial instruments was provided, on the balance sheet, it may not give a complete picture of timing of cash flows. Similar to the uncertainty of future cash flow, additional analysis or information will be required to understand the timing of future cash flows. Thus both US GAAP and IFRS require disclosures on liquidity and timing of future cash flows of financial instruments.

58. Those who support gross presentation argue that the gross amount provides an indication of the present value of future cash in flows and outflows of an entity. They further argue that the net amount provides no indication of future cash flows except when the proposed offsetting criteria are met (taking into account the recommendations in Agenda Papers 5B-5D /Memos 15B-15D).

59. Hence, they believe that offset is appropriate and should be allowed or required when and only when those conditions are met.

60. A derivative can generally be settled or sold at any time for an amount equal to its fair value and as noted by some respondents, derivative instruments are commonly settled at fair value before expiry or maturity.

61. The supporters of gross presentation argue that one disadvantage of net presentation 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 an event of

default or bankruptcy, that the instruments offset under master netting arrangements actually settle net.

62. They also believe that, as noted by the staff in Agenda Paper 5/Memo 13A (discussed at the May 2011 meeting), net presentation of financial instruments where the offsetting criteria is not met entails significant liquidity risks and would be misleading.

63. Thus, on balance, they believe that the **gross amounts** provides more information about the timing, uncertainty and amount of future cash flows than the net amount.

(d) Information on market risk

64. Supporters of gross presentation believe that there is more to market risk than can ever be shown on a balance sheet. Hence presentation of either the net or gross amount on balance sheet would require additional disclosure to fully inform users of the risks that an entity is exposed to. As such both US GAAP and IFRS requires additional disclosures on market risks arising from an entity's financial instruments.

65. That said, they believe that gross amounts generally provide better information about the entity's derivative and non-derivative portfolios and its exposure to market risk.

66. Gross presentation of derivative assets and liabilities depicts a market assessment of the present value of the net future cash flows directly or indirectly embodied in those assets and liabilities, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur. Periodic information about the gross fair value of an entity's derivative portfolio (under current conditions and expectations), for example, should help users both in making their own predictions and in confirming or correcting their earlier expectations.

67. They believe that zero gross exposure is different from zero net exposure (if offset is on the basis of a conditional right of set-off), because the latter may

have significant counterparty, operational or other risks. For example, a bank that has a large amount of derivative contracts outstanding but without any significant net exposure could still make very large losses if prices change significantly or important counterparties fail and netting arrangements do not work.

68. They also argue that it is indefensible to conclude, for example, that the following entities are similar in their risk profile (assuming for simplicity that the assets and liabilities are based on similar underlying factors):

    (a) An entity with an interest rate swap portfolio comprising of an asset position of $200m and $100m liabilities and

    (b) An entity with an interest rate swap portfolio comprising of asset position of $1.1 billion and $1 billion liabilities

69. They argue that gross market values do provide some measure of the financial risks from derivatives. These are all open contracts that are either in current gain or loss position at current market prices and thus, if settled immediately, would represent claims (or liabilities) on counterparties or on the entity. Gross market values are correlated to the notional amounts of the derivative contracts: the larger the notional amount, the larger the gross market value from prices changes, all other things being equal.

70. Moreover, the gross amount represents the entity's best estimate of future cash flows taking into account possible future movements in all relevant factors. Hence they argue the gross fair value represents the value of the entities rights and obligations taking into account market risks or future movements in the underlying factors.

71. Thus they argue that the gross presentation of such assets and liabilities generally provides relevant information and is more useful to investors, creditors and other users of financial statements than a net presentation.

(e) Solvency and liquidity

72. Supporters of gross presentation believe that, generally, the presentation of gross amounts of derivative assets and liabilities is more relevant to users of financial statements than net amounts for assessing the liquidity or solvency of an entity, except when the principle in the ED is met.

73. They argue, as noted earlier, that a derivative can generally be settled or sold at any time for an amount equal to its fair value and as emphasised by some respondents, many derivative instruments are settled at fair value before expiry. Thus the gross amounts (except when the offsetting criteria are met) are more indicative of an entity's solvency and liquidity.

74. They also argue that a disadvantage of net presentation is that offsetting based on credit risk could misrepresent the amounts by which the instruments being offset under master netting arrangements are actually settled (ie liquidity and solvency). It is not common, other than in an event of default or bankruptcy, that the instruments offset under master netting arrangements actually settle net.

75. They believe that, as demonstrated at the May 2011 education session, this problem is not necessarily resolved by a cash variation margin mechanism and that net presentation of financial instruments where the offsetting criteria is not met entails significant liquidity and settlement risks and would be misleading.

76. The supporters of gross presentation believe that net presentation (of the gross amounts of the assets and the liabilities) in the statement of financial position, reduces users' ability to understand the implied economic leverage position of an entity. Leverage is of concern to users because of two effects: (a) it creates and increases the risk of default and (b) it increases the potential for rapid deleveraging.

77. They also argue that netting based on credit risk mitigation will have an impact on reported total assets and liabilities. These totals are used by some users in measuring or calculating leverage, solvency and other key indicators. To the extent that netting reduces users' ability to compute these metrics, one may

conclude that netting on the face of the balance sheet provides less relevant information to users.

78. Netting involves aggregating assets and liabilities. Financial assets and liabilities may be viewed differently by different users and hence users may take them into account differently in assessing the solvency and liquidity of an entity. Netting, thus, will reduce users ability to make such analysis.

(e) Other considerations – similarities between offsetting and treatment of swap agreements

79. In developing the ED, the boards evaluated the similarities in and differences between offsetting a financial asset and financial liability under this approach and netting of payments underlying a (single) swap agreement. The accounting treatment of a swap agreement is that of a single financial arrangement (ie a swap is a single financial instrument and it is accounted for as such).

80. There is some similarity between offsetting and some payment arrangements in a swap contract. Typically, the contractual payments underlying the swap contract are netted before payment is made (but this is not always the case). A swap contract that is structured so that the settlement dates for the pay leg and receive leg are the same and requires or provides that amounts payable and receivable must be settled net (ie the difference between the pay leg and the receive leg) would be consistent with the proposed offset criteria as the contract would typically provide an unconditional and legally enforceable right of set-off and the entity can demonstrate intention to settle net.

81. However, not all swap contracts are structured in the manner set out in paragraph 80. Irrespective of the settlement provisions, the accounting treatment of a swap agreement is that of a single financial arrangement (ie a swap is a single financial instrument and it is accounted for as such). That is, the swap agreement is the unit of account.

82. The offsetting criteria are not relevant when there is only a single financial instrument. Offsetting is applicable only when an entity has both a financial asset and a financial liability and the conditions for offsetting are met.

83. Thus the supporters of gross presentation believe that offsetting under Alternative 3 is different from net presentation of the different rights and obligations in a single derivative instrument (eg the payment obligations and right to receive cash under an interest rate swap agreement).

84. Moreover, the right of the parties to a swap agreement to pay a net amount on settlement is not a conditional right. Hence the right to pay a net amount in a swap agreement is different from conditional rights of set-off in master netting agreements (close-out netting), which are enforceable only on the occurrence of some future event, usually the default, insolvency or bankruptcy of the counterparty or other credit-related events.

85. Some argue that respondents' comments on this topic points to an issue of unit of account. Supporters of gross presentation note that the issue of unit of account and how a swap agreement ought to be accounted for is beyond the scope of this project. This project is about offsetting of items already recognised under applicable guidance on financial instruments. Thus if the boards believe there is a need to revisit the guidance on recognition of derivative instruments, it would be necessary to address the issue more broadly under the financial instruments project. They believe this project would not be the most appropriate vehicle to address such concerns.

86. Based on the analysis under this heading, the supporters of gross presentation do not believe there is a contradiction between the offsetting guidance and the treatment of swaps for accounting purposes and even if there was a contradiction, it would have to address in the appropriate project.

(f) Other considerations – single agreement provision in master netting agreements

87. In developing the proposed approach, the boards considered the argument that offsetting positions under contracts governed by a master netting agreement with conditional set-off rights do not impair the representational faithfulness of the financial statements because a master netting agreement consolidates the master agreement and all transactions covered by it into a single agreement.

88. One general issue relating to the master netting framework (irrespective of whether the right of set-off provided by the arrangement is conditional or unconditional) is whether the separate parts of the framework (ie the master netting agreement, schedule, confirmations and credit support annex) constitute a single contract or a number of separate contracts.

89. There is scope for different views on this issue, and it may be that the terms of the individual transaction, case law and the laws of a particular jurisdiction might favour one view over the other. Even in jurisdictions with more established commercial and financial law practice such as England there is varying interpretation[1]. The staff notes that most master agreements are executed with English or New York law as the governing law.

90. However, the main issue is the effect of such provisions: is it a derecognition/recognition issue, an offsetting issue or a question of measurement?

91. If the entire master netting agreement is to be treated as a single contract (and hence a single financial instrument for accounting purposes), it would raise issues of recognition and derecognition. The question would be when to recognise such an agreement as an asset or a liability and subsequently how to treat any new transaction (ie whether subsequent transactions are modifications of the contract or change the nature of the asset or liability previously recognised in such a way that the previously recognised asset or liability should be derecognised).

[1] *Judgment in Court of Appeal in Kleinwort Benson v. Birmingham C.C. [1996] 4 All E.R. 733*
Inland Revenue Commissioners v Scottish Provident Institution [2003] STC 1035

92. Moreover, the boards would have to revisit the hedge accounting guidance. If all derivative instruments are accounted for as a single financial instrument, the requirement to designate an entire derivative as a hedging instrument would need to be reviewed as hedge accounting would be unworkable. Also the derecognition (as a result of adding one more transaction to one big complex derivative) of the instrument (and thus a portion of that instrument that is designated as a hedging instrument) will necessitate going through a de-designation and re-designation process.

93. Under existing requirements, each of the transactions covered by a master netting agreement is recognised separately as an asset or a liability as the case may be. The supporters of gross presentation cannot see any conceptual reason for treating all transactions related to a master netting agreement as a single financial instrument, in particular as:
    (a) each trade or transaction is exposed to risks that may differ from the risks to which the other trades or transactions are exposed;
    (b) the pricing of the individual transactions is independent;
    (c) each transaction is typically negotiated as a separate trade with a different commercial objective;
    (d) each of the individual transactions represents a transaction with its own terms and conditions and is not meant to be performed concurrently or consecutively with other transactions; and
    (e) an entity has separate performance obligations and rights for each of such transactions and each may be transferred or settled separately.

94. Today separate transactions subject to a master netting agreement are treated as separate contracts and thus accounted for as separate financial instruments. Those who support gross presentation conclude that due to the considerations set out in paragraph 93, irrespective of whether all the transactions constitute a single contract at law, consistently with current requirements, each of those arrangements (transactions) should be recognised and presented separately as an asset or liability, as the case may be.

95. In developing the ED, the boards concluded that counterparty risk is a matter of measurement rather than presentation and thus mitigation of credit risk per se should not be the basis for offsetting. Hence, both IFRS and US GAAP fair value measurement guidance requires that the effect of master netting agreements on counterparty risk should be taken into account in measuring derivative portfolios under MNAs (ie the net amount is used as the basis for determining credit valuation adjustments 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).

96. They further argue that if the effects of the master netting agreement are already taken into account in measuring the value of the entity's portfolio of financial instruments, then it is not necessary to present the entity's portfolio of derivatives net as the credit mitigating effect of the master netting agreement is already recognised.

97. The supporters of gross presentation believe that for presentation purposes, net amounts are also important but should be disclosed in the notes.

98. They note that financial statements contain notes, schedules and other information that supplement the information in the primary financial statements. For example, they may contain additional information that is relevant to the needs of users about the items in the statement of financial position and the statement of comprehensive income, such as disclosures about the risks and uncertainties affecting the entity, information about geographical and industry segments and the effect on the entity of changing prices.

99. Similarly, they argue that information about the effect on credit risk of conditional set-off arrangements is best provided by the disclosure of the nature, effect and extent of such arrangements.

(f) Other considerations

100. Some respondents argued that presenting derivative assets and liabilities net on the basis of credit risk mitigation is more representative of how they do and manage their businesses. They believe that view to be inconsistent with prudent management of a business and requirements under the various prudential regulations. Supporters of gross presentation are not convinced by this argument. They argue that entities manage other risks (eg market and liquidity risks) in addition to credit risks and, in fact, credit risk is primarily driven by market risk and counterparty default probability.

101. Also, some respondents argued that net presentation gives a better indication of uncommitted resources available to an entity. The supporters of gross presentation disagree with that view. They argue that on settlement of instruments under an MNA, an entity is not obliged to give those amounts to the counterparty and they will be available for use by the entity for any purpose. The entity may be required to post collateral in the future but that does not prevent the entity's use of the cash for other purposes.

102. Some respondents highlighted possible regulatory impact of presenting derivatives that do not meet the proposed offsetting criteria, gross on balance sheet. Apart from prudential regulators from one jurisdiction, no regulator (including both prudential and securities regulators that met with the staff and those that commented on the proposals – including the Basel committee) raised any concerns in terms of impact on leverage ratios or capital adequacy of regulated entities.

103. Supporters of gross presentation believe that consideration of the economic effect of transactions is what should drive the analysis of the performance of entities. They argue that whether assets and liabilities are presented net or gross does not change the economic position of an entity and neither does net presentation mean the entity has not recognised those gross amounts, and therefore it should not impact performance analysis.

104. The staff notes that some of the regulators recommended that if the boards decide to finalise the approach in the ED, the boards should consider a later effective date to allow sufficient time for preparers and regulators to make any necessary changes to accommodate any new requirements.

Legal enforceability – conditional rights of set-off

105. After considerable research and outreach by the staff, the staff do not agree on the primary question of legal enforceability. Some staff believe that the enforceability of the ISDA master netting arrangements in bankruptcy is questionable and thus conditional rights of set-off in the master netting agreement should not be included in the criteria for offsetting, and others believe it is legally enforceable in all major capital markets.

106. At the February 2010 education session a group of leading experts in international financial law[2] raised certain concerns about the effectiveness of termination and close-out netting provisions in bilateral contracts, in particular the ISDA master agreement.

107. One of the points in their presentation was the importance of cross-border considerations because different countries have different legal environment and local laws in some countries may not recognize the typical English law or New York law. Some countries are known to be debtor-friendly while others are creditor-friendly with respect to permitting set-off on insolvency.

108. The group's presentation included world maps showing the type of legal environment in different countries as of 2007 when a legal firm had performed a survey on the netting issue.

109. They noted that the international position on set-off and close-out netting is extremely disharmonious. As a result some jurisdictions have developed protective statutes ('carve-outs') which allow for set-off and netting only in financial markets. The carve-outs, however, protect only certain types of

[2] This group of leading experts in international financial law consisted of lawyers invited by the staff and did not include any of the legal experts noted in the alternative views below. However, this group did include a lawyer from Allen & Overy, in which the lawyer participated in their personal capacity only. It should be noted that this lawyer spoke strongly in favor of the enforceability of close-out netting at the February 2010 education session.

financial contracts or only contracts between certain counterparties or only if the contract is a specified market contract.

110. The group also raised the following concerns about the master netting agreement:

(a) Generally speaking, close-out netting is available at the option of the non-defaulting party. That party may decide not to trigger the cancellation procedures if the outcome, in financial terms, would be detrimental to it.

(b) At the same time, however, the non-defaulting party may be entitled to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty.

(c) Typically, in the case of these trading contracts, other amounts may also be payable which are eligible for the overall set off eg margin deposits and unpaid amounts owing by one party in respect of deliveries which have already been made by the other party. The validity of collateral worldwide is complex. The position can be intriguing where a non-defaulting party is out of the money and so decides not to terminate on the insolvency of the other party. This is even more problematic as some of the collateral provisions in the agreement may be challenged at law in insolvency.

(d) Master Agreements are predicated primarily on concepts of New York Law and English Law, with the result that those common law systems are capable of generating some subtle but significant alterations in the understanding of those concepts over time through court judgments. Similarly, consensus market views of the law in particular contexts may not necessarily be sanctioned by courts in the long run.

111. Some staff believe, based on decided cases and binding precedents, that some provisions of or added to the ISDA Master Agreement may not be upheld in some jurisdictions and that courts in different jurisdictions may arrive at different conclusions in the same case or fact pattern.

112. They also believe that there is limited decided case law in any jurisdiction relating specifically to financial derivatives -thus making it difficult to project the outcome of some of these contracts or some of the provisions in such contracts in a bankruptcy scenario. They argue that many of the complexity of the underlying financial structures involving derivatives are yet to be analysed for the first time from a real world bankruptcy perspective.

113. This point was made clear by the Judge in Perpetual Trustee Co. Ltd (Lehman Bros Holdings Inc et al) v. BNY Corporate Trustee Services Ltd. The judge commented that – "*One of the distinguishing characteristics of the Lehman bankruptcy cases is the complexity of the underlying financial structures many of which are being analyzed for the first time from a real world bankruptcy perspective. It is expected, as a result, that the cases of LBHI and LBSF on occasion would break new ground as to unsettled subject matter. This is one such occasion*".

114. These staff believe that in some jurisdictions a non-defaulting party (in an ISDA Master Agreement) is entitled to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty as a result. Also, as close-out netting is available at the option of the non-defaulting party (by contract), in some jurisdictions, the non-defaulting party may decide not to trigger the cancellation procedures if the outcome, in financial terms, would be detrimental to it.

115. In many jurisdictions the provisions of the ISDA Master Agreement, as supplemented in the Schedule, are enforceable in accordance with their terms. Some of these jurisdictions uphold freedom of contract, a cardinal feature of the ISDA architecture, and hold the parties to their negotiated bargain.

116. As with any freely-negotiated contract, some of the provisions may have undesirable consequences. Although certain provisions have undesirable or unexpected consequences for one party that can be exploited by the other, this will not however persuade the courts or give the courts power, in some of those jurisdictions, to rewrite the contract.

117. As noted by the group of lawyers at the February 2010 education session, the non-defaulting party may be entitled to suspend the performance of its own

obligations whilst the relevant default event applies to the defaulting counterparty as a result.

118. The ISDA Master Agreement imposes a conditions precedent on the payment obligations of each of the parties, in particular, that no actual or potential event of default, has occurred and is continuing with respect to the other party, and that nothing has occurred which has led to action being taken to achieve an early termination of the outstanding transactions under the agreement.

119. In effect, the payment obligations of the non-defaulting party are suspended where the condition concerns an event of default relating to the other party and the payment obligations of both parties are suspended if the termination procedures have been commenced.

120. An example of the operation of such a provision can be seen in the Australian case of *Enron Australia Finance Pty Ltd v TXU Electricity Ltd*. In that case, an insolvency event of default had occurred with respect to Enron. In reliance upon the condition precedent in the Master Agreement that no default should have occurred relating to that party, TXU (the non-defaulting party) refused to make payments that would have otherwise fallen due to be made by it. The court held that the other party was entitled to rely on the provision, even though on a net basis it owed money to Enron (the insolvent party) and despite the fact that it had not exercised its rights to terminate the transaction following the occurrence of the insolvency of Enron.

121. A similar conclusion was reached by the court in England in the case of *Marine Trade S.A. -v- Pioneer Freight Futures Co Ltd and another [2009]*. That case provided an earlier English authority for the proposition that a party may rely on Section 2(a)(iii) of the ISDA Master Agreement to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty and provided some insight as to the conclusions that an English judge might reach if ISDA Master Agreements concerning Lehman Brothers entities were to be litigated in England. This is in contrast to the position in the US following recent litigation there (see appendix B - the *Metavante* decision).

122. Due to the problems these precedents pose, the Joint Administrators of Lehman Bros International Europe ('LBIE') made an application in May 2010 to the High Court for directions as to the meaning and effect of Section 2 (a) (iii) of the ISDA Master Agreement. The Joint Administrators were concerned that certain counterparties to derivatives transactions with LBIE may opt not to close out the transactions under their ISDA Master Agreement for a long period, or indefinitely, by relying on Section 2 (a) (iii), thereby avoiding making payments that would otherwise have been due to LBIE. The Application asks (amongst other things) whether reliance on Section 2 (a) (iii) to withhold payments to a party that is in administration is permitted as a matter of English Law[3].

123. In the case of Lehman Brothers International Europe (LBIE), five parties were relying on section 2(a)(iii) to avoid obligations that otherwise would have accrued and will otherwise accrue to LBIE's favour under their respective outstanding derivative transactions. This is now been contested in court by the Joint Lehman Administrators.

124. The English court, ruled in **December 2010** in the above Lehman case that paragraph 2(a)(iii) is suspensive in effect - permitting the non-defaulting party to withhold payments to LBIE and cannot be required to issue a notice of termination. The court, having considered the principles for identification of implied terms of contracts, decided that it was unable to imply that such suspension is for a reasonable time only. It noted that it would be wholly inconsistent with any reasonable understanding of the MNA that payment obligations arising under a transaction could give rise to indefinite contingent liabilities because of the possibility that an event of default may be cured long after the expiry of a transaction. It however noted that if the conditions of default were cured before the end of the contracts then the obligation of the parties to make on going payments will be restored (but in bankruptcy of a counterparty that situation is unlikely).

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[3] At least four counterparties are seeking to rely on this provision and not make further payments to LBIE.

125. In relation to the point as to whether a non-defaulting party was under an obligation not to act arbitrarily, capriciously or unreasonably when considering if it should elect for early termination, the court accepted that the exercise of a contractual discretion in circumstances that affect both parties may call for the application of honesty and good faith and that the discretion should be exercised for the purposes for which the discretion was conferred. He went on to say that it would, **"nonetheless be a very rare case in which the apparently regular exercise of a purely contractual discretion can be successfully challenged".**

126. The judge concluded that the discretion that was conferred upon a non-defaulting party by section 6(a) of the MNA, to decide whether all outstanding transactions between the parties should be terminated, was given by way of a contractual right and was plainly to be exercised by the non-defaulting party in a way that it considered would serve its own interests. On the facts of the case, the judge concluded that he could not understand how it might be alleged in the present case that the swap counterparties had acted dishonestly, in bad faith or otherwise than for a purpose for which the right was conferred upon them when they decided not to elect to terminate the swaps. They were justified in deciding not to terminate by taking into account the likely consequences to them if they had decided to terminate, including the cost of entering into replicated swaps and the unlikelihood of obtaining a payment on termination from LBIE. Their decision was also justified by the market conditions that had prevailed after the exercise of their election.

127. In HM Treasury's consultation document, "*Establishing Resolution Arrangements for Investment Banks*[4]", the UK government noted that – "the ISDA Master Agreement provides that the obligations of a party under each transaction under the Master Agreement are conditioned upon the other party not defaulting. This condition precedent is set out in section 2(a)(iii) of the Master Agreement. The Master Agreement allows the non-defaulting party to treat the insolvency event as an event of default and gives it the right, but not the obligation, to terminate all transactions under the agreement. Contractual

[4] See paragraph 7.7

sections such as section 2(a)(iii) are valid under UK law, if properly drafted so as not to offend the "anti-deprivation principle". Section 2(a)(iii) can be relied upon by the non-defaulting counterparty effectively to "suspend" payments to the defaulting counterparty. Although technically there is no suspension of payments due to section 2(a)(iii) the payment obligations do not arise because the condition precedent is not fulfilled."

128. In paragraph 7.8 of the HM Treasury's consultation document, "*establishing resolution arrangements for investment banks*", the UK government also noted that – 7.8 Section 2(a)(iii) does not specify a time period within which the non-defaulting counterparty needs to decide whether or not to terminate all transactions under the ISDA Master Agreement, in effect allowing the non-defaulting counterparty to *suspend its decision indefinitely and during that time not to make any ongoing payments to the failed investment firm.* This is most likely to arise in practice where, on a termination, a net close-out payment would be owed by the non-defaulting counterparty to the failed firm.

129. The HM Treasury in paragraphs 7.9 – 7.14 of its consultation paper identified the possibility of a counterparty taking such a position as an issue of concern that, if a market solution is not found, legislation is likely to be required to prevent such a position being taken by a non-defaulting party in future insolvencies.

130. The above demonstrate that the close out netting provision might not be triggered in some jurisdictions.

131. Some staff believe that these precedents cast doubt on the efficacy of the Master Netting Agreement and raises concerns about the potential for courts in different jurisdictions to arrive at opposite conclusions on similar fact patterns or in interpretation of the same paragraph in the Master Agreement. Once again this points to a limitation of the master netting agreement itself and hence its usefulness as a credit mitigation tool. The staff notes that this raises possible concerns about the workings of the close-out provision.

132. The staff who support this view notes that the above cases point, at the minimum, to a quasi-walkaway provision in the MNA for the non-defaulting party which may owe money to the in-the-money defaulting party. The

enforceability of close out netting provisions (ie the ability to value each terminated transaction, to net those amounts and to calculate a single amount which is then payable by one party to the other) is vital as it underpins some aspects of the international capital adequacy rules (Basel II and III). The Basel framework sets out various conditions that an entity must meet to treat a conditional right of set-off as credit risk reducing and provides that any agreement with such walkaway clauses in them do not qualify for netting (ie for determining credit risk).