IASB/FASB Meeting
Week commencing 13 June 2011

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

Staff Paper

Project	**Offsetting Financial Assets and Liabilities**
Topic	**Offsetting approaches – Conditional rights of set-off (Alternative 3)**

Introduction/Purpose of the paper

1. This paper discusses an approach based on the conditional right of setoff similar to US GAAP (**Alternative 3**). Additionally, this paper outlines a conditional right of set-off— collateralized derivatives approach (**Alternative 3a**) which would allow derivatives and the related variation margin to which the entity has a conditional right of offset to be offset, subject to certain criteria as outlined below. Alternatives 1 and 2 are discussed in Appendices A and B respectively.

2. Section 1 provides a summary analysis of Alternatives 3 and 3a. For the boards' ease in comparison of the documents, Section 2 of this paper retains the ordering of the Basis for Alternative 1 discussed in Appendix A.

Section 1

Conditional right of set-off (Alternative 3)

3. US GAAP currently has an exception to the right of set-off criteria whereby a reporting entity may offset fair value amounts recognized for derivative instruments and also fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instrument(s) recognized at fair value executed with the same counterparty under a master netting arrangement.[1] Alternative 3 is consistent with this current US GAAP approach.

[1] FASB Accounting Standards Codification ® 815-10-45-1.

4. In contrast to the approach in the ED (as modified based on staff recommendations provided in Agenda papers 5B-5D/Memo 15B-15D), Alternative 3 would also permit netting of bilateral OTC derivatives trades executed under master netting agreements. Based on outreach performed, many derivatives cleared through central clearing parties (CCPs) already satisfy the offsetting criteria under the conditional right of setoff approach (as modified).

Collateralized Derivative Approach (Alternative 3a)

5. Alternative 3a would limit offsetting under Alternative 3 to only collateralized derivatives that satisfy certain additional criteria as outlined below. The staff believe that Alternative 3a (the collateralised derivative approach) would lead to more offsetting than is allowed under Alternative 1 or Alternative 2 but less offsetting than is allowed under Alternative 3 or current US GAAP. The collateralized derivative approach is based on the premise that the posting of high credit quality and liquid collateral/ variation margin reduces the counterparty's exposure to credit and liquidity risk with the associated net derivative position. Under this approach, the substance of the collateral procedures would determine the presentation in the statement of financial position.

6. Some staff believe that offsetting a group of derivative financial instruments and related variation margin would be appropriate if:
   - (i) an entity has a conditional right of offset (eg close-out netting) under a master netting agreement;
   - (ii) the arrangement includes a variation margin mechanism;
   - (iii) variation margin is posted or called on a daily basis and
   - (iv) the right of the party in receipt of variation margin to offset the variation margin and the amounts due under the related financial instruments is legally enforceable in the event of an early termination event such as bankruptcy.

7. This approach is intended to recognize the variation margin mechanism as a credit and liquidity mitigant and the functional equivalent to net settlement in the event of default or bankruptcy.

8. This approach differs from the modified ED approach (as discussed in Alternative 1 and AP 5B-5D/Memos 15B-15D) in the following respects:

   (a) There is no requirement to have an unconditional right of offset (eg select payment netting) and hence payments on a specific date could be settled gross. [Although, under Alternative 3a, the variation margin process ensures that high credit quality and liquid collateral against the net open derivative position is obtained daily to minimize risk.]

   (b) Variation margin is not required to form part of the settlement process. Therefore, there is no specific requirement for the party in receipt of the variation margin to have **no** obligation to return the amount posted and the party posting the variation margin to have no right to insist on the return of the amount posted as variation margin (ie collateral posted is conditional). [Under Alternative 3a, the counterparty is entitled to keep the collateral only when an event of default or early termination occurs.]

   (c) Variation margin is not required to form part of the settlement process and there is no requirement for the settlement of the underlying contracts and variation margin to be combined in a single payment process (eg where settlement of interim and final amounts combined with variation margin flows and a net amount is paid or received). [Under Alternative 3a, collateral does not form part of the settlement process, except in close-out netting. Alternative 3a would require daily posting of variation margin.]

Basis for Alternatives

Overall

9. Those who support an offsetting approach based on conditional rights of set-off (Alternative 3 or Alternative 3a) note the following key points for the basis for their alternative:

    (a) Master Netting Agreement (paragraphs 51-56): In some jurisdictions, a legally enforceable master netting agreement is one contract. In those jurisdictions it also consolidates the underlying derivatives into a single unit of account in an event of default.

    (b) Information Content (paragraphs 21-56): The amount of credit risk exposure is one indicator of the uncertainty of future cash flows and in the view of some the most relevant given the analysis of market, liquidity (settlement) and credit risk.

    (c) Collateral (Alternative 3a, paragraphs 5-8): A daily cash variation margin mechanism provides credit and liquidity mitigants which are functionally equivalent to net settlement in the event of default or bankruptcy.

Section 2 (retains the sequencing used in Appendix A)

1. Consistency with the objectives of financial reporting

10. In making an assessment of which offsetting approach best meets the objectives of the conceptual framework, the boards should consider paragraph OB8 from the *Conceptual Framework for Financial Reporting* which states, "Individual primary users have different, and possibly conflicting information needs and desires. The Board, in developing financial reporting standards, will seek the information set that will meet the needs of the maximum number of primary users."

11. As noted in Appendix A, the objective of financial reporting as outlined in the boards' *Conceptual Framework for 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).

12. Some argue that 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. Some believe the presentation approaches proposed by Alternative 1 and Alternative 2 inherently assume that derivative receivables calculated on a trade-by-trade basis represent resources to creditors other than derivatives counterparties, and that derivative payables, calculated individually, represent claims that are identical in nature to other liabilities. However, derivative assets are subject to a priority claim by the counterparty and are not available to general creditors to the extent of liabilities within the same netting agreement in the event of default or bankruptcy. Similarly, derivative payables are not parri passu to those of other creditors in bankruptcy or default events.

13. Upon termination of a contract by the non-defaulting party, derivative assets (resources) are unavailable to satisfy other claims; further, the net termination amount (including collateral amounts) under the close-out netting provisions of a master netting agreement is not subject to stay under bankruptcy laws which govern the most significant capital markets, unlike other claims.

14. On a going concern basis, the presentation of derivative receivables and payables that are subject to a master netting arrangement on a gross basis is also an overstatement of the resources of an entity because of the nature of common collateral agreements and settlement processes that ensure that derivative cash settlements are returned the next day as collateral. If an entity receives cash to settle a derivative receivable that is currently eligible for netting against the related derivative payables and cash collateral amounts, that cash is not freely available to general creditors of an entity. The same amount of cash may be required to be returned to the counterparty within the next day under the terms of the variation margin mechanism to rebalance the credit exposure between the two counterparties that had changed as a result of the settlement of the derivative receivable.

15. Even for uncollateralized derivatives, derivative assets do not represent resources freely available to other creditors due to the restrictions upon transfers of the derivative assets to other parties without the consent of the original counterparty. While such consent cannot be unreasonably withheld, the unfavourable change in credit risk that would occur due to the counterparty's payable and receivable no longer receiving the benefit of close out netting upon an event of default would be sufficient cause to withhold consent.

2. Consistency with qualitative characteristics of information in financial reports

16. As noted in Appendix A, the *Conceptual Framework* states that for financial information to be useful, it must be relevant and faithfully represent what it purports to represent.
17. Throughout all outreach to date, financial statement users have consistently communicated that both gross information and net information are relevant pieces of financial information to users of financial statements.
18. Some argue that presenting assets and liabilities net generally 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 strengths and weaknesses. As noted in Appendix A, the ability to assess an entity's strengths and weaknesses is more complicated than the analysis of a single number on the statement of financial position.
19. Net presentation based on conditional rights faithfully represents what it purports to represent which is the credit risk of an entity allowing offset when a master netting arrangement exists because the net presentation discloses the amount of credit risk exposure under that arrangement. Those who support net presentation based on conditional rights argue that measuring credit exposure on a netted current exposure basis provides the most accurate and relevant point in time snapshot of credit exposure for a derivatives portfolio. It does not and is not intended to reflect the volatility of the exposure. Volatility and other characteristics about assets and liabilities needed to fully analyze the

derivatives portfolio cannot be fully understood from the face of the financial statements through either gross presentation or net presentation.

20. Appendix A notes that 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. An entity typically reports its derivatives gains and losses as a net amount in its income statement. This project permits the current netting of derivatives gains and losses to continue. Grossing up derivative amounts without grossing up the related gains and losses will not enable further analysis of the relationship between the income statement and statement of financial position. Rather, additional detail about derivatives gains and losses are provided in a company's disclosures, along with the gross fair value derivative amounts.

3. Information content of gross versus net information

21. As noted in Appendix A, 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 offsetting (netting) on the face of the statement of financial position is appropriate, the boards should consider whether gross provides better information than the net amounts.

22. Regardless of the method used for balance sheet offsetting, the most effective method for transparently portraying the underlying risks (including credit, liquidity and market risks) associated with derivative transactions is through a combination of qualitative and quantitative disclosures. Although investors were split on the most preferable method of presentation on balance sheet, they were nearly unanimous that both gross information and net information provide decision useful information.

23. As noted in Appendix A, it is a general principle of accounting that assets and liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity. For derivatives included in a master netting agreement (and Alternative 3a for collateralized derivatives), supporters of this approach describe below why net presentation provides better information than gross information.

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

24. The proposed presentation approaches in Alternative 1 and Alternative 2 may overstate the underlying risks as there is no correlation between unhedged underlying risk (open positions) and gross presentation

25. Some argue that uncertainty in the derivatives market can be exacerbated during periods of stress, and gross presentation is preferable as exposures will not be understated. However, supporters of Alternative 3 and Alternative 3a believe that gross amounts on the face of the statement of financial position is a detriment to financial statement users since larger gross amounts obscure the underlying net economic position. They also note that gross amounts have been misinterpreted, since larger gross amounts have been interpreted as reflecting greater underlying market risk when, in fact, it may actually be lower. Also, larger gross amounts have been interpreted as reflecting higher credit risk, yet the net amount is a more accurate presentation of credit risk.

26. Appendix A discusses settlement risk, specifically, that a distressed entity might default and there is potential contagion risk across financial institutions. However some believe that neither gross nor net presentation of current exposures on the balance sheet accurately captures settlement risk. Supporters of Alternative 3a believe that settlement risk is substantially the same between the modified ED approach and Alternative 3a. Supporters of Alternative 3 note that current offsetting criteria in the US worked well during the recent credit crisis.

(b) Information on credit risk

27. The amount of credit risk exposure, that is the loss that the entity might incur if the counterparties of their derivatives failed to perform, is one indicator of the uncertainty of future cash flows from those instruments. Net presentation based on credit reflects such risk for recognized assets and liabilities and is consistent with how entities actually manage credit risk. Entities determine credit risk considering netting arrangements and evaluate credit exposure and the need for collateral based on such net amounts. Conversely, gross presentation does not provide information about an entity's credit risk.

28. Those who support net presentation based on conditional rights agree that this alternative gives prominence to credit risk in the statement of financial position. As noted above, those who support this approach believe that measuring credit exposure on a netted current exposure basis provides the most accurate and relevant point in time snapshot of credit exposure for a derivatives portfolio. It doesn't and isn't intended to reflect all risks associated with the derivatives balances. However, it is representationally faithful to what it purports to present which is the associated credit risk.

29. Some argue that a conditional right of set-off is also present in many other arrangements, for example non-recourse debt, and offsetting is not permitted for those instruments. Those who support net presentation for derivatives subject to a legally enforceable master netting agreement believe that derivatives are different, evidenced by their treatment as a net single contract in bankruptcy. That is, as noted in paragraphs 12-14, the net termination amount (including collateral amounts) under the close-out netting provisions of a master netting agreement is not subject to stay under bankruptcy laws which govern the most significant capital markets, unlike other claims.

30. Some argue that gross amounts provide more transparency about the financial position of the entity. The sole evaluation of a gross balance on the statement of financial position does not provide an investor with transparency about how a company manages its derivatives portfolio. Transparency comes from evaluation of the complete information set, both gross balances and net

balances combined with the derivative disclosures and, if needed, further discussions with management.

31. As noted in paragraph 46 of Appendix A, some argue that a net amount provides no relevant or useful information as it is backward looking information and provides no indication whatsoever on credit exposure going forward. The net amount proposed by Alternative 3 is the net credit position at the end of the financial reporting period based on the fair value of the derivative and collateral positions. Both the net exposure and the gross exposure are subject to daily movements. If there are significant changes from either a fair value or a net credit position, then the entity would have to evaluate the individual events to determine the appropriate guidance related to subsequent events, that is, either recognition or disclosure.

32. Some users indicated a strong preference for either gross or net presentation to the point of not utilizing the other number at all for analysis; however, that does not invalidate the vast majority of users who stated that both gross information and net information is decision useful.

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

33. As noted in Appendix A, neither gross nor net provides 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, the user of the financial statements may need to review the disclosures to get a more complete picture of an entity's liquidity profile. Some argue that net exposure of zero will provide no information about the 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. Proponents of net presentation believe that in either case, the user must ask further questions and/or consult the relevant footnotes to obtain the desired level of information.

34. The basis for FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* states that "Given a master netting arrangement, presentation of the aggregate gross fair values of the individual contracts

would not provide more information about the uncertainty of future cash flows from those contracts than net amounts would." While the fair value amount is a representation of the current market assessment of future events that will have cash flow consequences, the conditional nature of the contracts means that the eventual cash flow consequences may differ from the amounts reported on balance sheet.

35. Supporters of Alternative 3 note that many respondents who commented on the Exposure Draft noted that their primary liquidity concerns were based on funding requirements, as many derivatives are subject to collateralization agreements, which are based on net fair values. Additionally, ratings contingent provisions with liquidity implications are predominantly based on net exposure.

(d) Information on market risk

36. Supporters of net presentation concur with supporters of gross presentation that market risk is more complex than a balance sheet could portray. Additionally, they concur that either presentation would require additional disclosures to provide users of financial statements with decision useful information about market risks. As such both US GAAP and IFRS require additional disclosures on market risks.

37. Market risk, by definition, is the sensitivity of potential future changes in the underlying which cannot be expressed as an amount on balance sheet (as that amount would have to be as of a point in time). A portfolio of derivatives may be virtually immune to market risks, yet have a large amount assets and liabilities on a gross basis; or a portfolio of derivatives may be significantly exposed to market risks, yet have virtually no current fair value on a gross or net basis.

38. Supporters of net presentation agree that zero net exposure is different than zero gross exposure. They disagree with the supporters of gross presentation who infer that only a zero net exposure can have significant counterparty, operational or other risks, for example a derivative with a fair value of zero still has associated risk.

39. The supporters of gross presentation argue that a bank that has a large amount of derivative contracts outstanding without any net exposure could still realize very large losses if prices change significantly or important counterparties fail and netting arrangements do not work. If prices change significantly from reporting period end, then neither the analysis of a gross balance nor the analysis of a net balance is going to provide an investor better information at reporting period end which is consistent with the notion that market risk is more complex than a balance sheet presentation could occur. Alternative 3 would only require offset if a legally enforceable master netting agreement exists, and therefore, if an entity believes than the master netting agreement would not be enforceable, then the positions would be required to be reported gross.

40. Supporters of gross presentation and supporters of net presentation would agree that the following entities have a different market 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.

    Supporters of net presentation note that the offsetting presentation of both portfolios would be consistent under Alternative 3, however, the market risk, in either scenario (that is through both gross and net presentation), would be evident in the derivatives disclosures.

(e) Solvency and liquidity

41. Neither gross presentation nor net presentation perfectly presents cash flow and liquidity risks. Disclosures are needed to provide such information comprehensively. Derivative balances represent the net present value of future cash flows for contracts and do not contain predictive value of cash movements Supporters of net presentation believe that net presentation based on conditional rights is more relevant for presentation in the financial statements because it

represents a better depiction of the economic resources of an entity and claims against those resources.

42. The offsetting approach in Alternative A is based on the elimination of most settlement (liquidity) risk (aside from daily fair value changes). The reality is that all overnight settlement risk, including fair value changes, will be settled and be non-existent by the time that the financial statements are issued. Any significant event from a liquidity and/or solvency perspective is required to be evaluated as a subsequent event and will be evaluated for either recognition in the financial statements or disclosure. Under both gross presentation and net presentation, the liquidity risk related to settlement likely will no longer exist at the date that the statement of financial position is issued.

43. Proponents of Alternative 1 believe that an unconditional approach for set-off better informs on liquidity risk than net presentation. At a fundamental level, the fair value of a single derivative contract does not provide relevant information about its liquidity profile because payments can occur at different amounts, times and in different directions, which are all then encapsulated into a single fair value measurement.

44. When a single derivative is combined with other contracts for presentation in accordance with both Alternative 1 and Alternative 2, then the issues inherent in an individual derivative as discussed in the previous paragraph are multiplied across the portfolio. Therefore, the reported amounts do not inform financial statement users about liquidity risk. Additionally, cash flows and fair values are often uncorrelated (that is, out-of-the-money sales positions still result in gross cash inflows (eg in the energy industry, given the prevalence of nonfinancial commodity derivative instruments).

45. Some argue that net credit presentation reduces users’ ability to understand the implied economic leverage position of an entity. As it relates to derivatives, two of the primary mitigants are the master netting arrangement and cash collateral margining provisions. When the two are present such as in Alternative 3a, net presentation provides an economic pictures of leverage

46. In regards to an entity’s solvency, volatility is driven by the risk in open market positions. For example, in a perfectly matched derivatives portfolio with no net open market risk, derivative receivables would grow equivalently

with derivative payables based on movements in the underlying market indices and therefore there is no effect on the solvency of the entity. Most major derivative dealers typically dynamically hedge market risk and manage it on a net basis to a relatively low open risk position. Therefore gross information is not a particularly useful indicator on how much derivative asset balances have to decline before a firm becomes insolvent.

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

47. The Alternative View in the FASB ED expresses a view that the proposal would require different presentation for (a) a single derivative and (b) multiple derivatives with the same counterparty that are subject to a legally enforceable conditional master netting agreement that have similar cash flows. For example, a swap with multiple gross cash flow streams is recognized and measured at fair value, which reflects the expected net cash inflows and outflows of the contract. Yet, two forward contracts with the same counterparty under a legally enforceable conditional master netting arrangement would be measured separately at fair value and presented gross in the statement of financial position as an asset and liability.

48. Supporters of this approach would argue that a legally enforceable master netting agreement effectively consolidates multiple derivative arrangements with the same counterparty into a single agreement.

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

49. In broad terms, a master netting agreement specifies the general terms of the agreement between counterparties with respect to general operational items, such as netting, collateral, definition of default and other termination events, calculation of damages (on default) and documentation. The master netting agreement contains the terms by which all relevant transactions between the parties are governed.

50. The objective of a master netting agreement is that multiple individual transactions are subsumed under the agreement forming a single legal contract of indefinite term under which the counterparties conduct their mutual

business. Individual transactions are handled by confirmations that are incorporated by reference into the master netting agreement. Placing individual transactions under a single master netting agreement that provides for netting of covered transactions is a legal construct to avoid any problems netting arrangements may encounter under various bankruptcy regimes. Having a single contract between each pair of counterparties to a master netting agreement mitigates the legal exposure surrounding netting multiple contracts.

51. It is worth clarifying that Alternative 3 does not suggest that all arrangements whereby a master netting agreement exists should be offset in the financial statements and presented net. A legally enforceable conditional right of offset is required in order to meet the criteria and qualify for the related net presentation.

52. Some argue that recent court cases call into question the validity of the concept of one contract and more specifically, close-out netting in some jurisdictions. Supporters of Alternative 3 note that recent court cases have been around specific provisions within the ISDA contacts and not the contracts themselves, or close-out netting. The recent cases have involved other specific provisions in the ISDA master netting agreements, such as:

    (a) The operation of the "Mutual Suspense" provision

    (b) Issues involving the "Setoff Provision" (which allow a non-defaulting party to setoff non-derivative obligations), more specifically related to affiliate setoff

    (c) The use of certain subordination mechanisms in structured finance transactions

    (d) The appropriateness of the calculation of individual transaction values.

53. Supporters of Alternative 3 are not aware of any specific recent litigation matters that may call into question the enforceability of the close-out netting provisions of the ISDA Master Netting Agreement or other similar netting agreements.

54. Additionally, supporters of this view note than an entity that can successfully legally offset, in an event of default or bankruptcy, under a master netting agreement, is in a significantly different financial position than one that cannot legally offset. Close-out netting refers to a process involving termination of obligations under a contract with a defaulting party and subsequent combining of assets and liabilities into a single net payable or receivable. The result of close-out netting is to reduce credit exposure from gross to net exposure. Offsetting based upon credit risk portrays this different financial position by reporting the net credit position.