IASB/FASB Meeting
Week commencing 13 June, 2011

IASB Agenda reference **5A**

FASB Agenda reference **15A**

Staff Paper

Project	**Offsetting Financial Assets and Liabilities**
Topic	**Offsetting approaches – Unconditional and conditional rights of set-off**

Introduction/Purpose of the paper

1. At the 17 May 2011 joint meeting, the boards discussed the feedback received on the proposals in the offsetting ED (Agenda Paper 5/Memo 13A – May 2011).

2. The staff notes that feedback received on the ED does not indicate a single preferred approach. Many respondents support the proposed offsetting approach in the ED as the basis for net presentation on the balance sheet. However, many others prefer offsetting based on the conditional right of offset in certain circumstances. And still others were indifferent as to the balance sheet presentation, as long as both gross and net information are available and the offsetting requirements in accordance with US generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs) preparers were converged. The staff stresses that one message that has been consistently received is that there should be a converged solution for offsetting financial assets and financial liabilities.

3. The purpose of this paper is to facilitate the boards' discussions on a way forward, in particular, whether the offsetting model should be based on an unconditional right of set-off or on conditional right of set-off (for some or all financial instruments). The analysis and alternatives presented in this paper (and the appendices) reflect comments received on the ED and feedback provided by the boards at the May 2011 joint meeting.

4. This paper asks for the boards' decision on whether -

   (a) they would like to pursue the approach proposed in the ED (ie a model based on unconditional right and intention to offset) taking into account the analysis and recommendations of the staff in Agenda Papers 5B-5D/Memos 15B-15D (**Alternative 1**) or

   (b) they would like to adopt the current IFRS requirement for offsetting, which requires offsetting if an entity *currently* has a legally enforceable right to set off the recognised amounts (and intends either to settle net or settle simultaneously) (**Alternative 2**) or

   (c) they would prefer to pursue an approach that is based on conditional rights of offset for certain derivative instruments (**Alternative 3**).

5. Appendices A – C to this paper set out the arguments for and against the above alternatives. Appendix A deals with Alternative 1 and Alternatives 2 and 3 are discussed in appendices B and C, respectively.

6. As noted in paragraph 2, one message that has been consistently received is that there should be a converged solution for offsetting financial assets and financial liabilities. As noted in the feedback analysis (Agenda Paper 5/Memo 13A – May 2011), many support the current IFRS approach and many also support the current US GAAP approach. Both camps argue that their preferred approach is better and has held up well in the recent financial crisis. The staff believes that the debate should not be about whether US GAAP approach is better than the IFRS approach or vice versa but rather about whether and when offsetting is appropriate and provides useful information.

A. Summary of alternative approaches

7. Alternatives 1 – 3 may be seen as different points in a spectrum –

   (a) Alternative 1 – this approach requires a right of set-off that is exercisable in both the normal course of business and in bankruptcy, insolvency or default.

   (b) Alternative 2 – this approach would require a right of set-off that is legally enforceable in the normal course of business.

(c) Alternative 3 – this approach looks to a right of set-off that is only enforceable in bankruptcy, insolvency or default of one of the counterparties to certain derivative transactions executed under a master netting agreement.

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

8. Alternative 1 would involve finalising the approach proposed in the ED. The approach proposed in the ED would require an entity 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:

      (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.

9. Agenda Papers 5B-5D/Memos 15B-15D discuss how the boards might address the concerns raised by respondents in respect of the proposed approach in the ED (ie unit of account, treatment of collateral and simultaneous settlement) –

   (a) **Agenda paper 5B/Memo 15B –** addresses the issue of unit of account and collateral, including a staff recommendation for addressing this issue in the context of the proposals in the ED.

   (b) **Agenda paper 5C/Memo 15C –** provides an analysis of the definition of simultaneous settlement and intent, including staff recommendations on how respondent comments may be addressed.

   (c) **Agenda paper 5D/Memo 15D –** addresses the question of degree of assurance required to conclude on legal enforceability and issues around unconditional right of set-off. This paper also includes staff recommendations for addressing respondents comments.

10. **The papers in paragraph 9 are only relevant if the boards decide to pursue the approach proposed in the ED. Hence should the boards decide not to pursue the approach in the ED, these papers would not be discussed.**

Currently enforceable right of set-off and intention to offset (Alternative 2)

11. IAS 32 *Financial Instruments, Presentation* requires that - "an entity **currently** has a legally enforceable right to set off" and an intention to settle net or simultaneously to achieve offset of a financial asset and a financial liability.

12. Hence, some argue that under IFRS the right of offset (unconditional right of offset) should be enforceable only in the normal course of business (given the reference to current enforceability).

13. Based on that interpretation, this approach looks to the right of set-off that is available to the parties in the normal course of business and not what the parties can do in bankruptcy of either party.

Conditional right of set-off for certain derivative instruments (Alternative 3)

14. Under this alternative, the boards would finalise the proposed approach in the ED, but provide an exception for derivatives similar to existing US GAAP. (US GAAP allows an entity to offset amounts recognised for derivative instruments (and related cash collateral) executed with the same counterparty under a master netting arrangement when the entity does not intend to settle net[1] or cannot settle net in the normal course of business.) Additionally, the boards could consider an alternative to this approach (Alternative 3a) which would allow the net presentation of all collateralised derivative positions and cash collateral when there is daily posting of cash collateral (variation margin) and a legally enforceable conditional right to offset. Some believe this approach would decrease the offsetting which is currently allowed under US GAAP to a smaller population of derivatives, namely those subject to daily posting of cash collateral which reduces the associated credit and liquidity risk.

[1] Accounting Standards Codification Topic 815-10-45-5

Some believe that under this approach, the substance of the collateral procedures would affect the presentation in the statement of financial position.

Question 1: Proposed approach
Which of the alternatives (Alternatives 1 – 3) set out in paragraph 7 do the boards want to pursue?