



Staff Paper

Project **Offsetting Financial Assets and Liabilities**

Topic **Simultaneous settlement and intent criteria**

Purpose of the paper

1. At the 17 May 2011 joint board meeting the staff discussed the feedback received on the proposals in the Exposure Draft (the ED) *Offsetting Financial Assets and Financial Liabilities* (Agenda Paper 5/13A). Based on the feedback received, the boards asked the staff to provide further analysis of the following issues :
 - (a) the definition of simultaneous settlement,
 - (b) treatment of collateral, and
 - (c) the unit of account to which the offsetting criteria can or should be applied.
2. Agenda Paper 5B/Memo 15B discusses the issues around collateral and unit of account. This paper discusses the issues around simultaneous settlement, including the operationality of the definition of simultaneous settlement and an overview of different settlement systems. This paper also discusses some questions raised around the intent criterion.
3. Section A asks the boards if they would like to retain the simultaneous settlement criterion and, if so, whether the boards would like to retain the proposed definition of simultaneous settlement or amend the definition to take into account current settlement practices.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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4. Section B briefly discusses questions raised by respondents on the intent criterion, including whether ability must be proved and how intent can be proved.

Section A: Simultaneous settlement

Background

5. The proposed criteria for offsetting in the ED requires an entity to offset a recognised financial asset and a recognised financial liability and to present the net amount in the statement of financial position when the entity:

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(b) intends either:
(ii) 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.¹

6. The proposals define simultaneous settlement as follows:

C11 Realisation of a financial asset and settlement of a financial liability are simultaneous only if settlements take place at the same moment (ie there is exposure to only the net or reduced amount). When this condition is met, the cash flows are, in effect, equivalent to a single net amount and the net amount also reflects the entity's expected cash flows from settling the separate financial instruments. Thus, if settlements take place over a period (even though during this period there is no potential for any change in the value of the financial asset and financial liability, and the period between settlements of the instruments is brief), it is not simultaneous settlement because settlement is not at the same moment. Similarly, realisation and settlement of an asset and a liability at the same stated time but in different time zones is not simultaneous settlement.

¹ ED paragraph 6(b)

7. The fundamental requirement in the ED is that an entity must have a right of set-off and the intention to settle net to present a recognised financial asset and financial liability net in the statement of financial position.
8. However, entities may have an unconditional and legally enforceable right and desire to settle net, but may not have the operational capabilities to effect net settlement. These entities would settle the positions gross such that the outcome is not distinguishable from net settlement. As a result the ED included simultaneous settlement, as a practical exception to net settlement. Simultaneous settlement was intended to capture payments that were essentially equivalent to actual net settlement.

C12 Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. For example, in some centrally cleared financial markets with a central counterparty or in face-to-face exchanges, the rules of the exchange or clearing house may grant both the clearing house or the exchange and the members (or participants) a right to set off amounts due and payable to either party. The procedures of the clearing house or exchange may, in addition, provide that the amount to be paid or received for different products be settled gross. However, such payments may be made simultaneously. Hence, even though the parties may make payment or receive payment separately for different product types, settlements occur at the same moment and there is exposure only to the net amount.

Practice today

9. IAS 32 *Financial Instruments: Presentation* also includes a requirement for simultaneous settlement and defines simultaneous as occurring ‘at the same moment’:

*Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is **no exposure to credit or liquidity risk**. In other circumstances, an entity may settle two instruments by*

*receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. **Accordingly, realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.**² – emphasis added*

10. Based on feedback received (as detailed in Agenda Paper 5/13A-May 2011) there is an overwhelming disagreement with the definition of simultaneous settlement in the ED. Many respondents argued that simultaneous settlement is interpreted in various ways in practice today by IFRS preparers and the ‘at same moment’ requirement is inconsistent with settlement practices.
11. For example, many preparers and accounting firms have interpreted IAS 32 to mean that settlement through a clearinghouse always meets the simultaneous settlement criterion. In addition, other than as described in paragraphs 40 and 41 below, settlement of two positions by exchanging gross cash flows at exactly the same moment (simultaneously) rarely occurs in practice today.
12. The ED clarifies that simultaneous is ‘at the same moment’ and discusses the use of a clearinghouse only as one example of a settlement system that may meet the simultaneous criterion.
13. Thus some constituents argue that the proposed requirement (related to simultaneous settlement) is more restrictive than the similar IFRS offset requirement. They also argue that it is not operational and ignores settlement systems that effectively meet the offsetting principles without being ‘at the same moment.’
14. Many constituents believe that settlements through some central clearing parties or CCPs effectively equal net settlement. Their rationale is that once the settlement process commences, the entity is not exposed to counterparty or liquidity risk over and above the net amount and therefore the process is equivalent to net settlement. Respondents therefore requested that the boards reinstate the wording in IAS 32 paragraph 48, or broaden the definition of simultaneous settlement to cover such settlement processes.

² IAS 32 paragraph 48

15. Gross settlement of financial asset and financial liability positions also tends to be common for receivables and payables under repurchase and reverse repurchase agreements. Some constituents have therefore requested the boards include criteria similar to those in FASB ASC Topic 210 *Balance Sheet* paragraph 20-45-11³. ASC Topic 210-20-45-11 allows (but does not require) an entity to offset receivables and payables under repurchase and reverse repurchase agreements if all of the following conditions are met:

- a. The repurchase and reverse repurchase agreements are executed with the same counterparty.*
- b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.*
- c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.*
- d. The securities underlying the repurchase and reverse repurchase agreements exist in book entry form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian. Book entry securities meeting the criterion in this paragraph exist only as items in accounting records maintained by a transfer system operator. This requirement does not preclude offsetting of securities held in book entry form solely because other securities of the same issue exist in other forms.*
- e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraphs 210-20-45-14 through 45-17, and the entity must have associated banking arrangements in place as described in those paragraphs. Cash settlements for securities transferred shall be made under established banking arrangements that provide that the entity will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be probable that the associated banking arrangements will provide sufficient daylight overdraft or other intraday*

³ Formerly FASB Interpretation (FIN) No. 41 *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39)

credit at the settlement date for each of the parties. The term probable is used in this Subtopic consistent with its use in paragraph 450-20-25-1 to mean that a transaction or event is likely to occur.

f. The entity intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both the cash inflows resulting from the settlement of the reverse repurchase agreement and the cash outflows in settlement of the offsetting repurchase agreement.

16. The securities transfer system referred to above in paragraph 15(e) effectively is a transfer system that will not transfer securities until it receives instructions and ensures the entity always has at least the net amount payable available in its cash on deposit, so that an entity will only have exposure to the net amount.

Settlement systems

17. There are two main types of settlement systems: net settlement and gross settlement systems.

Net settlement systems

18. Under net settlement systems, settlement of transactions (payments) occurs on a net basis. The parties or the processing agent will calculate the amounts to be paid or received by the parties (frequently by currency) as the sum of all amounts to be received less all the amounts to be paid to that party. The amount resulting from the offset of the payables and receivables by counterparty (offset often by currency) represents the amount that counterparty owes or is due.
19. Assets and liabilities that are settled through these systems meet the net settlement criterion in the ED and hence will not be discussed further in this paper.

Gross settlement systems

20. In a gross settlement system, settlement of amounts due or payable by a counterparty or parties occur in one of the following ways:

- (a) on a transaction by transaction basis (without netting receivables and payables) on a particular date/period between two counterparties;
- (b) on a transaction by transaction basis (without netting receivables and payables) continuously throughout a designated period (usually a specific value date) ;
- (c) on an intraday batch basis (where a subset of the amounts receivable and payable are settled net) at pre-specified times in a day/period or
- (d) at the same moment on a particular date between two counterparties.

The following paragraphs further analyse these settlement systems. Paragraphs 23 through 39 analyse how six hypothetical transactions of an entity (ie Counterparty A) due on the same date may be settled under the settlement systems described in paragraph 20(b) and (c).

(a) Settlement on a transaction by transaction basis (without netting receivables and payables) on a particular date

- 21. Under this type of payment system parties settle amounts to be paid or received for different transactions individually on a gross basis. The parties may or may not have a right to set off the amounts due from or payable to either party.
- 22. In systems of this nature, settlements do not take place at the same moment and the parties may be exposed to the gross amounts. Settlement risk arises when the timing of payments or deliveries by counterparties to each other are not synchronised. This is sometimes called Herstatt risk⁴. Substantial credit losses as well as substantial liquidity pressures may result from counterparty default.

⁴ Herstatt risk arose from the incident with a German bank, Bankhaus Herstatt, which had a large trading book of foreign exchange transactions. The banking supervisor closed the bank at the end of the German banking day (approximately 10.30 am in New York). Unfortunately, a number of institutions had made payments in Deutsche Marks to Herstatt on foreign exchange transactions. These institutions expected the dollar leg of these transactions to settle in New York during the New York banking day. However, Herstatt's US correspondent bank was stopped from making payments in New York during the New York upon the closure of the bank and the non-defaulting institutions were forced to scramble to replace what had been delivered. So the New York banks lost the full value of their

(b) Settlement on a transaction by transaction basis (without netting receivables and payables) continuously throughout a designated period (usually a specific value date)

<i>31 Dec 20X1</i>		Asset A	Asset B	Asset C	Liability D	Liability E	Liability F
<i>Liability E settles</i>						-100	
<i>Intraday credit balance</i>	-100						
<i>Liability F settles</i>							-60
<i>Intraday credit balance</i>	-160						
<i>Asset B settles</i>			60				
<i>Intraday credit balance</i>	-100						
<i>Liability D settles</i>					-70		
<i>Intraday credit balance</i>	-170						
<i>Asset A settles</i>		160					
<i>Intraday credit balance</i>	-10						
<i>Asset C settles</i>				40			
<i>Final balance due to CTPTY A and amount that must be posted by its counterparty</i>	30						

23. Real time gross settlement system (RTGS) is the real time settlement of payments individually on a transaction by transaction basis. The system effects settlement continuously (ie in real time) rather than periodically provided that the parties have sufficient funds to cover payments.
24. RTGSs differ in their approach to payment processing when a party does not have sufficient funds to cover amounts due in a particular transaction. Some

Deutsche Mark payments and never received the corresponding dollar inflows. See further detail in Agenda Paper 5B/Memo 15B.

RTGSs would reject the transaction and return them to the parties as unsettled. The rejected transaction may be resubmitted at a later date or time for processing when there are sufficient funds. Other RTGSs may keep the failed transaction in an internal queue pending a time that the payer has sufficient funds in its accounts to cover the payment instead of rejecting them outright. Most typically, RTGSs include the extension of central or commercial bank intraday credit ie the bank provides the necessary funds to cover any shortfall in payer's accounts (e.g. Fedwire).

25. All three approaches in paragraph 24 are combined in many RTGSs.
26. In an exchange of value (payment versus payment) scenario, RTGSs can contribute to the reduction of credit risks that may arise. As an RTGS provides for final transfer of funds at any time during the day (subject to availability of sufficient funds), a payment leg can take place at the same moment as the delivery leg so that one leg only takes place if the other leg also takes place. RTGS therefore provides a basis for delivery or payment vs. payment mechanisms, thereby contributing to the reduction of settlement risks in securities, repos and foreign exchange transactions.
27. An RTGS may however pose a liquidity constraint on the parties involved. An RTGS requires continuous availability of settling funds and thus the parties would have to have sufficient funds either at the respective central bank or commercial banks throughout the value date.
28. Moreover, settlement through an RTGS requires that the parties have accounts at the same central bank or commercial bank to mitigate the attendant settlement risk. Where this is the case, the transactions would be effected by the central or commercial bank in a book entry form.
29. It is preferable to use a central bank in such systems as a commercial bank (irrespective of the criteria for selection and monitoring) introduces an additional layer of credit and liquidity risks. For example, if the commercial bank conducting settlement collapses, the parties may not have immediate access to their funds or ultimately receive the full value of their funds.
30. Using a central bank avoids the problem highlighted in paragraph 29. Using a central bank results in a direct claim on the central bank by the party that is due

to receive payment. Central banks have the lowest credit risk and the highest liquidity with regard to their currency of issue,

31. Use of a central bank increases the probability that there will be sufficient funds available to cover any settlement risk or intraday credit requirements.
32. This type of settlement system is contemplated in the US GAAP guidance for offset of repurchase and reverse repurchase agreements (ASC Topic 210-20-45-11) as described in paragraph 15e and excerpted below:

It must be probable that the associated banking arrangements will provide sufficient daylight overdraft or other intraday credit at the settlement date for each of the parties. The term probable is used in this Subtopic consistent with its use in paragraph 450-20-25-1 to mean that a transaction or event is likely to occur. [emphasis added]

Daylight overdraft or other intraday credit refers to the accommodation in the banking arrangements that allows transactions to be completed even if there is insufficient cash on deposit during the day provided there is sufficient cash to cover the net cash requirement at the end of the day. That accommodation may be through a credit facility, including a credit facility for which a fee is charged, or from a deposit of collateral.

(c) Intraday batch settlement

31 Dec 20X1	Batch total	Asset A	Asset B	Asset C	Liability D	Liability E	Liability F
Batch 1 (10am)	(160)					(100)	(60)
Intraday credit balance	-160						
Batch 2 (noon)	(10)		60		(70)		
Intraday credit balance	-170						

Batch 3 (3pm)	200	160		40			
Total due to CTPTY A	30						

33. Batch settlement is the settlement of groups of payments at one or more discrete, often pre-specified times during the processing day.
34. Due to the volume of daily activities and processes, many transactions executed through a central clearing counterparty settle based on a batch process whereby positions that settle on a given day will be processed at different points during the day as it is not operationally feasible to settle all transactions for each customer 'at the same moment'.
35. The assets and liabilities that have been offset can be processed at slightly different times during a 'processing window.' However, because the assets and liabilities are all submitted for processing at the same point, cannot be cancelled, and there are no potential changes in cash flows, this has been analysed by many constituents as being sufficient to be regarded as equivalent to net settlement and, consequently, argue that it should qualify for offset. They argue that as the settlement process cannot be broken once commenced, settlement risk has been eliminated and there is only exposure to the net amount, which needs to have been posted or made available by the counterparty in the net liability position.
36. One characteristic of batch processing is that although each process is a separate and single settlement mechanism, several batches may settle throughout the day. The counterparties will not know which transaction or position will settle in which batch.
37. For example, Counterparty A has six positions facing the CCP as noted in the beginning of this section. Three are derivative asset positions totalling CU 260 and three are derivative liability positions totalling CU (230). As they are all going to settle on the same day through a batch settlement Counterparty A would like to show a net position of CU 30. For simplicity assume no

discounting. The positions could settle in batches in one of a variety of different ways:

	Batch total	Asset A	Asset B	Asset C	Liability D	Liability E	Liability F
Batch 1 (10am)	(160)					(100)	(60)
Batch 2 (noon)	(10)		60		(70)		
Batch 3 (3pm)	200	160		40			
Total	30						

38. As a result of the timing and order in which positions will be batch processed above, although it is in an overall net asset position, Counterparty A could default on the first two batches of payments if it does not have sufficient cash in its depository account to cover those settlements and even though it will receive funds later in the day via the third batch processing. Because of this, CCPs that batch process typically also require an intraday credit facility that will cover the entity's position if there are not enough funds in the entity's account so it will not default on the transactions that settle first. Without an intraday credit facility an entity could default merely based on the order in which items are selected for processing.
39. As a result, some have suggested that offsetting should be permitted or required for batch processing when:
- (a) financial assets and financial liabilities to be settled that day are submitted for processing at exactly the same point;
 - (b) once submitted for processing, the transactions cannot be cancelled or altered;
 - (c) there is no potential for changes in the cash flows of the assets and liabilities once they have been submitted for processing unless the processing fails;

- (d) if the processing of a receivable or payable fails, then the transfer of any security also fails;
- (e) processing is carried out through the same settlement bank; and
- (f) there is an intraday credit facility to cover an entity's position if needed until the settlement process is complete.

(d) Settlement gross at the same moment on a particular date between two counterparties

- 40. The Herstatt incident referred to in paragraph 22 led to the creation of CLS⁵ Bank, which provides a perfect example of simultaneous settlement (at the same moment) of foreign exchange transactions using payment vs. payment structure.
- 41. These systems are set up such that payments due and receivable are made at the same moment (e.g. through continuous linked settlement). Where settlement is at the same moment, although the parties make and receive payment separately for different product types or transactions, the parties are exposed to only the net amount.

⁵ CLS stands for "continuous linked settlement"

Evaluation of settlement systems under the offsetting principles in the ED

42. The ED establishes a principle for offsetting financial assets and financial liabilities, namely that:

...an entity shall offset a recognised financial asset and recognised financial liability only when:

- (a) on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has 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**
- (b) the amount, resulting from offsetting the financial asset and financial liability, reflects an entity's expected cash flows from settling two or more separate financial instruments.⁶**

43. The following is an evaluation of how transactions settled under the different gross settlement systems could be treated based on the principles in the ED.

(a) Settlement on a transaction by transaction basis (without netting receivables and payables) on a particular date

44. In these systems, settlements do not take place at the same moment, there is no common settlement or central bank and there are no intraday credit facilities (or there is not a high likelihood that an intraday facility would be honoured). In these systems the parties may be exposed to the gross amounts.
45. As detailed in paragraph 22, when the timing of payments or deliveries by counterparties to each other are not synchronised (ie settling at different times, through different systems or in different jurisdictions and different time zones), substantial credit losses as well as substantial liquidity pressures may result from the default of a counterparty. These systems do not meet the principle of offsetting in the exposure draft.

⁶ ED paragraph 4

(b) Settlement on a transaction by transaction basis (without netting receivables and payables) continuously throughout a designated period (usually a specific value date)

46. Other gross settlement systems (RTGSs) (see paragraphs 23 to 32) effect settlement of payments on a transaction by transaction basis throughout the day or period. Settlement is effected continuously (ie in real time) rather than periodically, provided that the parties have sufficient funds to cover payments.
47. An RTGS that provides for transfer of funds continuously throughout the day would likely meet the offsetting principles (ie net settlement) as set out in the ED, provided there is sufficiently reliable intraday credit facility (either through a central bank or commercial bank) and the net amount payable is required to be posted at the beginning of the payment processing. Use of a central bank would increase the probability that sufficient funds are available throughout the payment/settlement date.

(c) Intraday batch settlement

48. Intraday batch settlement systems (see paragraphs 33 to 39) effect settlement of payments at designated periods in a day. Settlement is effected periodically during a 'processing window' and assets and liabilities may be processed at slightly different times. However, once assets and liabilities are submitted for processing they cannot be changed or cancelled.
49. Because the order of payments or settlement of transactions is not known in advance in an intraday batch settlement system, it also requires an intraday credit facility that can cover an entity's position (if needed) until the settlement process is complete. An intraday batch settlement system with an intraday credit facility would likely meet the offsetting principles as set out in the ED provided that there is a high likelihood that an intraday credit facility is available and will be honoured until the settlement process is complete and the party in the net liability position is required to post the net amount at the beginning of the payment processing.

(d) Gross at the same moment on a particular date between two counterparties

50. As analysed in paragraphs 40 and 41, some gross settlement systems result in settlement of transactions on an individual basis such that payments receivable and payable are made at the same moment. Where settlement is at the same moment even if the payments are made separately for different product types or transactions, the parties are exposed to only the net amount (ie credit and liquidity risk is eliminated) These systems meet the proposed simultaneous settlement criterion in paragraph 5.

Board considerations

51. Based on the information in this paper, the boards could choose to:
- (a) retain the proposed definition of simultaneous settlement and related wording as set out in the ED;
 - (b) eliminate the simultaneous settlement requirement altogether;
 - (c) adopt and clarify paragraph 48 of IAS 32 for simultaneous settlement;
 - (d) adopt the provisions included in current US GAAP guidance ASC Topic 210-20-45-11 (formerly FIN 41) as described in paragraph 15; or
 - (e) include a settlement principle that would allow settlement mechanisms that meet the principles set out in the ED (ie single settlement processes⁷) to qualify for offsetting if all other criteria are met.

(a) Retain the definition of simultaneous settlement and related wording in the ED

52. As noted in paragraph 13, based on feedback during outreach activities, many constituents think the proposed requirements (related to simultaneous

⁷ A process that provides for both the settlement of the underlying contracts and payment of variation margin in a single payment. See further discussion in Agenda Paper 1B/Memo 14B -May 2011

settlement) are very restrictive and are not operational. The staff does not recommend this approach.

(b) Eliminate the simultaneous settlement requirement

53. As noted in paragraph 8, the ED includes simultaneous settlement as a practical exception to accommodate situations akin to net settlement. If gross settlements occur at the same moment, it results in the same net exposure in effect. This option, if adopted by the boards, would tighten the offsetting requirements and potentially significantly reduce netting, especially as many preparers may have the unconditional, legally enforceable right and desire to net settle but may not have the operational capabilities to effect net settlement. This may cause particular problems for preparers / regions with less sophisticated systems. The staff does not believe this approach is appropriate and hence does not recommend this approach.

(c) Adopt and clarify the criteria in paragraph 48 of IAS 32 for simultaneous settlement

54. As noted in paragraph 14, many constituents prefer the simultaneous settlement guidance in IAS 32. Their rationale is that once the settlement process commences, the entity is not exposed to counterparty or liquidity risk other than for the net amount and therefore the process is equivalent to net settlement. They therefore have requested that the boards reinstate the wording in IAS 32 paragraph 48 as it has worked well in practice today.
55. IAS 32 paragraph 48 indicates that clearing through a clearinghouse or an exchange may result in cash flows that are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk⁸. However, this wording in and of itself may not be comprehensive enough to develop a guidance for mechanisms that effectively replicate net settlement.

⁸ IAS 32 paragraph 48

(d) Adopt the provisions included in current US GAAP guidance⁹

56. The boards can also look to current US GAAP guidance ASC Topic 210-20-45-11 (formerly FIN 41) as described in paragraph 15 in developing a principle to include such mechanisms.
57. As noted in paragraph 15, US GAAP indicates specific criteria for offsetting payables and receivables arising from repurchase and reverse repurchase agreements. This guidance would most likely meet the offsetting principles in the offsetting ED today, namely, on the basis of its rights and obligations the entity has a right or obligation for the net amount, and the net amount reflects the entity's expected cash flows from settling two or more financial instruments.
58. As such, the staff considered recommending inclusion of the current US GAAP requirements for offsetting repurchase and reverse repurchase agreements as part of the criteria or application guidance for net or simultaneous settlement.
59. However, many view the specific criteria in US GAAP as being too rules based and potentially excluding some systems that would meet the offsetting principles. Some jurisdictions do not meet the specific criteria in US GAAP today and yet their settlement process eliminates or results in insignificant settlement risk (primarily liquidity and credit risk) and in effect replicates net settlement.

(e) Include a settlement principle that would allow settlement mechanisms that meet the principles set out in the ED to qualify for offsetting if all other criteria are met.

60. Certain settlement mechanisms, even if technically not at the same moment, effectively result in a similar net exposure as in net settlement or at the same moment settlement. The distinguishing factors in these systems are:
 - (a) Financial assets and financial liabilities that meet the right of offset criterion are submitted for processing at exactly the same point [= intent and same settlement date];

⁹ ASC Topic 210-20-45-11 (formerly FIN 41)

- (b) Once submitted for processing, the transactions cannot be cancelled or altered [=no liquidity or credit risk];
- (c) There is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing unless the processing fails [=no potential change in cash flows];
- (d) If the processing of one asset or liability that is offset against another fails, then the processing of the related security used as collateral also fails [=always net exposure /similar to a securities transfer system or delivery versus payment (DvP)];
- (e) Processing is carried out through the same settlement depository [=DvP or same depository account] and
- (f) There is a high likelihood that an intraday credit facility is available and would be honoured until the settlement process is complete [=no settlement (liquidity/credit) risk].

Staff recommendation

- 61. The staff recommends that the boards broaden the definition of simultaneous settlement to include gross settlement mechanisms with features that eliminate credit and liquidity risk (or result in insignificant credit or liquidity risk) and under which processing of receivables and payable occur in a single settlement process¹⁰ that is effectively akin to net settlement (as detailed in paragraph 60).
- 62. This would be consistent with IFRS presentation for repurchase and reverse repurchase transactions today (cash flows that are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk) and would be consistent with the practice of presenting receivables and payables from repurchase and reverse repurchase agreements net when using a settlement mechanism that meets the criteria in paragraph 60 and the criteria in ASC Topic 210-20-45-11 (formerly FIN 41) guidance.

¹⁰ A process that provides for both the settlement of the underlying contracts and payment of variation margin in a single payment. See further discussion in Agenda Paper 1B/Memo 14B -May 2011

63. A comparison of the staff recommendation and current US GAAP requirements is set out below:

US GAAP ASC Topic 210-20-45-11 (formerly FIN 41)	Basis for guidance	Interaction with staff recommendation
<i>a. The repurchase and reverse repurchase agreements are executed with the same counterparty</i>		A separate and distinct criterion within the ED addresses this requirement.
<i>b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.</i>	This was included in US GAAP to clarify that repurchase and reverse repurchase arrangements with open or unstated maturities do not satisfy offsetting criteria. This requirement does not negate the underlying condition that the reporting entity “intends to set off”.	A separate and distinct criterion within the ED addresses intent to set off.
<i>c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.</i>	FIN 41 Basis for Conclusions states that this requirement is important to FIN 41 because a master netting arrangement effectively consolidates individual contracts into a single agreement between the parties in the event of default. And, the failure to make one payment under a master netting arrangement would entitle the other party to terminate the entire arrangement and to demand the net settlement of all contracts.	To the extent that the parties have a global netting arrangement with payment netting selected (ie a Global Master Repurchase Agreement or GMRA) the proposals in the ED (legally enforceable right at all times) would address this requirement. In addition, master netting agreements will be discussed in conjunction with the unconditional right of set-off criterion and unit of account guidance.
<i>d. The securities underlying the repurchase and reverse repurchase agreements exist in book entry form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian. Book entry securities</i>	This is a key element because it provides control over the securities (ie a security cannot be traded from the account of the securities custodian to a new custodian without a “book entry” transfer of the security over the securities transfer system).	The staff believes that the characteristic described in paragraph 60(d) would adequately replace this requirement (that is, that (d) if the processing of one asset or liability that is offset against

<p><i>meeting the criterion in this paragraph exist only as items in accounting records maintained by a transfer system operator. This requirement does not preclude offsetting of securities held in book entry form solely because other securities of the same issue exist in other forms.</i></p>		<p>another fails, then the processing of the related security used as collateral also fails [DvP]).</p>
<p><i>e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraphs 210-20-45-14 through 45-17, and the entity must have associated banking arrangements in place as described in those paragraphs. Cash settlements for securities transferred shall be made under established banking arrangements that provide that the entity will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be probable that the associated banking arrangements will provide sufficient daylight overdraft or other intraday credit at the settlement date for each of the parties. The term probable is used in this Subtopic consistent with its use in paragraph 450-20-25-1 to mean that a transaction or event is likely to occur</i></p>	<p>The Basis for Conclusions of FIN 41 describes this requirement as a key element necessary to permit offsetting.</p>	<p>The staff understands that the characteristics described in paragraph 60(d) and (f) would adequately replace this requirement (that is, (d) if the processing of one asset or liability that is offset against another fails, then the processing of the related security used as collateral also fails, and (f) there is an intraday credit facility available until the settlement process is complete).</p>
<p><i>f. The entity intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both the cash</i></p>		<p>The staff believes that the characteristic described in paragraph 60 (e) would adequately replace this</p>

<i>inflows resulting from the settlement of the reverse repurchase agreement and the cash outflows in settlement of the offsetting repurchase agreement.</i>		requirement (that is, (e) processing is carried out through the same settlement depository).
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Question 1: Simultaneous settlement

Do the boards agree with the staff recommendation in paragraph 61, namely, to broaden the definition of simultaneous settlement to include gross settlement mechanisms with features that:

- a) eliminate or result in insignificant credit and liquidity risk and
- b) under which processing of receivables and payable occur in a single settlement process?

If no, what would the boards like to include for simultaneous settlement?

Section B: Intent

64. As indicated in paragraph 5, the proposed criteria for offsetting in the ED would require an entity to offset a recognised financial asset and a recognised financial liability and to present the net amount in the statement of financial position when the entity:

6 (b) intends either:

- (ii) 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.¹¹**

65. The ED provides application guidance around intent as follows:

C7 An entity’s intention to settle net or settle simultaneously may be demonstrated through its past practice of executing set-off or simultaneous settlement in similar situations, its usual operating practices or by reference to the entity’s documented risk management policies. An entity’s intentions with respect to settlement of particular assets and liabilities may, however, be influenced or restricted by its usual operating practices, industry practice, the requirements of the financial markets, and other circumstances that may affect the ability to settle net or to settle simultaneously. The requirement for an intention to settle net or to settle simultaneously is assessed from the reporting entity’s perspective.

C9 Some contracts and master netting agreements provide for automatic set-off of payments due to or from the parties if they occur on the same day and are in the same currency. Also, in a centrally cleared financial market with a central counterparty, the rules of the clearing house typically provide for automatic netting and cancellation of offsetting contracts. For such contractual

¹¹ ED paragraph 6(b)

arrangements, the entity's intention is considered to have been demonstrated at the date of entering into the contracts.

C10 An entity's intention to settle simultaneously must be demonstrated, for example, through its past practice of executing simultaneous settlement in similar situations, by its normal operating practices or by reference to the entity's documented risk management policies.

66. Some constituents disagree with the requirement that an entity must intend to settle net or to settle simultaneously. They believe that when a right of set-off exists the entity only has exposure to the net position whether or not they settle net. They agree with the argument in paragraph BC54 in the ED that intent (especially management intent) is subjective and difficult to substantiate. They believe that intent would be difficult to apply consistently in practice and is subject to abuse, because an entity could state intent to get a certain accounting treatment. There is also some concern about the auditability of intent based on management's assertions.
67. There have also been some questions about how intent fits in with settlement through a CCP. They believe that if net or simultaneous settlement through certain CCPs is a fact, an entity's intent should not make a difference. Some refer to paragraph C7 which states that intent must be assessed from the reporting entity's perspective. If the entity intends to net but the clearinghouse cannot operationally net or simultaneously settle, the entity should not be penalised and should still show the positions net on the statement of financial position.
68. Paragraphs BC55 and BC56 in the ED clarify that without intent, the amount and timing of an entity's future net cash flows are not affected, and therefore without the intention to offset the net position would not meet the offsetting principles expressed in the ED.
69. Others note that while the ED includes some application guidance around intent (paragraphs C7-C10), it does not explicitly state that intent means the entity will or must do something in the future.

Staff recommendation

70. Some staff believe that the current wording in the application guidance is sufficient and does not require further clarification. Specifically, the guidance stating that “*an entity’s intention to settle net or settle simultaneously may be demonstrated through its past practice of executing set-off or simultaneous settlement in similar situations, its usual operating practices or by reference to the entity’s documented risk management policies*” is self-explanatory. If an entity demonstrates that it intends to net based on, for example, its past practice, and proceeds to subsequently settle positions gross at different moments, it will have negated its future ability to prove intent based on past practice.
71. However, to clarify the above questions around intent, the wording in the application guidance in paragraph 70 could be moved to the main standard.
72. Other staff prefer that the boards address this concern by including additional wording in the application guidance—namely, either:
- (a) include wording that intent means **ability** (ie the entity not only has the legal right but the necessary processes in place) to settle net or settle simultaneously, or
 - (b) include wording that intent means an entity **can and will** settle net or settle simultaneously. However, as the notion of intent already exists in other accounting guidance and is readily understood, this wording may introduce a higher hurdle, create more diversity in practice and bring into question the issue of tainting.
73. There are four approaches the boards can consider to address this issue:
- (a) make no changes to the proposed criteria or guidance;
 - (b) include wording that *an entity’s intention to settle net or settle simultaneously may be demonstrated through its past practice of executing set-off or simultaneous settlement in similar situations, its usual operating practices or by reference to the entity’s documented risk management policies* in the main body of the standard;

- (c) include additional application guidance to clarify that intent means **ability** (ie the entity not only has the legal right but the necessary processes in place) to settle net or settle simultaneously or
- (d) include wording that intent means an entity **can and will** settle net or settle simultaneously.

Question 2: Intent

Which approach in paragraph 73 would the boards like to choose to clarify the intent criterion? Specifically, would the boards prefer to:

- (a) make no changes to the proposed criteria or guidance;
- (b) move the current wording from the application guidance to the main standard;
- (c) include additional application guidance to clarify that intent means **ability** (ie the entity not only has the legal right but the necessary processes in place) to settle net or settle simultaneously or
- (d) include application guidance to clarify that intent means an entity **can and will** settle net or settle simultaneously?

If none of the above, what other options would the boards like to pursue?