



## Staff Paper

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Project **Offsetting Financial Assets and Liabilities**

Topic **Cover Note - Unit of account and collateral**

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### Purpose

1. At the 17 May, 2011 joint meeting, the boards discussed the feedback received on the proposals in the ED (Agenda Paper 5/Memo 13A – May 2011). Based on the feedback received, the boards requested further analysis of the following issues before deciding on a way forward:
  - (a) Unit of account
  - (b) Treatment of collateral /margin
  - (c) Simultaneous settlement criterion
2. At the June 1, 2011 education session, representatives of the International Swap and Derivatives Association (ISDA) and clearing houses will explain further the issues raised in comment letters on the treatment of collateral in the ED. In addition, the staff will provide the Boards with background on unit of account and treatment of collateral/margin. A decision making paper that contains alternatives for addressing these two issues will be brought to a future Board meeting. A paper on simultaneous settlement criterion also will be brought to a future Board meeting.

### Unit of Account

3. Respondents raised seven general ways that they thought the guidance could be applied:

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- (a) to a portfolio of financial assets and financial liabilities (when each of the instruments comprise of a single cash flow (see Agenda Paper 1B/Memo 14B - Appendix B – Group 1)
  - (b) to identifiable cash flows of financial assets and liabilities (a portion of a financial asset and a portion of a financial liability (Agenda Paper 1B/Memo 14B Appendix B – Group 2);
  - (c) to individual financial assets and financial liabilities (ie offsetting a portion of a financial asset against an entire financial liability and vice versa) (Agenda Paper 1B/Memo 14B - Appendix B – Groups 3)
  - (d) to a portfolio of financial instruments (each comprising of multiple cash flows) with coinciding payment dates (Agenda Paper 1B/Memo 14B - Appendix B - Group 4)
  - (e) to a portfolio of financial assets and financial liabilities when the instruments consist of multiple cash flows (without a variation margin system) and non coinciding payment dates
  - (f) to a portfolio of financial assets and financial liabilities and the instruments consist of multiple cash flows (with a variation margin system) and non coinciding payment dates
  - (g) a portfolio of derivative financial assets and financial liabilities (under a master netting agreement)
4. The issue of unit of account is more complex in the context of financial instruments with multiple cash flows. This issue is not only pertinent in the derivatives market. It applies to all instruments with multiple cash flows eg plain vanilla debt instruments with a multi period principal amortising profile.
5. Paragraphs 5 – 15 of Agenda Paper 1B/Memo 14B provide a detailed analysis of the issue of unit of account. Appendix B of Agenda Paper 1B/Memo 14B sets out some examples of scenarios reflecting the units of account stated in paragraph 3 (a) – (d).
6. Item (f) in paragraph 3 (portfolio of financial assets and financial liabilities where the instruments consist of multiple non-coinciding cash flows, with variation margining) is addressed under the collateral section (section B) of Agenda Paper 1B/Memo 14B, as the issue of unit of account and collateral are related when it comes to offsetting portfolios of financial assets and financial liabilities. Questions relating to this issue are dealt with similarly in this paper.

7. Some industries (eg energy producers and traders) would apply offsetting criteria to identifiable cash flows to reflect the way they do business and achieve offsetting today. For other industries (eg banks), applying the offsetting criteria to identifiable cash flows would be impractical and burdensome and would not necessarily reflect the way they do business. Those banks would prefer an approach that treats all derivatives under a master netting agreement as a single unit of account for purposes of offsetting.
8. Some believe that if the boards pursue an offsetting model focusing on cash flow exposure, then the unit of account should by default be the individual cash flows of the financial instruments. However, they acknowledge that offsetting of individual cash flows can be impractical at times. Hence, they recommend offsetting of individual cash flows should be made mandatory except where it is impractical to do so (and then it can be applied at instrument or portfolio level if the offsetting criteria is met in that respect).

**Question 1: Unit of account**

- (a) Are there any alternatives for addressing unit of account that are presented in Agenda Paper 1B/Memo 14B that should not be presented in the memo/agenda paper for the future decision making meeting?
- (b) Are there any alternatives for addressing unit of account that are not presented in Agenda Paper 1B/Memo 14B that should be presented in the memo/agenda paper for the future decision making meeting?

**Collateral in derivative markets**

9. The most common tool used to manage credit risk in derivative markets are right of offset and collateral.

10. The ED states that an entity cannot offset recognised financial assets or liabilities against the related collateral pledged or obtained because the collateral is a separate asset or liability. The ED states that the collateral for an amount owed is irrelevant to the question of whether assets and liabilities should be presented separately or offset on the statement of financial position<sup>1</sup>. In addition, the ED specifically refers to ‘margin accounts’ for futures and other derivatives as a form of collateral that cannot be net<sup>2</sup>.
11. However, as detailed in AP 5/Memo 13A (May 2011 joint meeting), a number of respondents, mainly financial institutions, disagree with the proposed treatment of certain collateral.
12. Paragraphs 16 - 67 of Agenda Paper 1B/Memo 14B, provide a detailed analysis of the margining processes on selected CCPs and in the bilateral OTC market, current accounting for derivative trades through such CCPs and on bilateral OTC markets (under both US GAAP and IFRS), the key differences in the applicable margining systems and when offsetting collateral and related financial instruments will meet the offsetting principles in the ED.

***Offsetting of portfolio of financial assets and liabilities (with variation margin or collateral) – Paragraph 6(f)***

13. Appendix D of Agenda Paper 1B/Memo 14B sets out some basic examples of portfolios of financial instruments that the boards would need to consider in developing guidance for offsetting.
14. As noted in Agenda Paper 1B/Memo 14B, a single process (as demonstrated in Appendix D) for variation margin and settlement of the underlying contracts ensures the variation margin required after settlement of the underlying contracts is netted against the settlement flows on the underlying contracts and hence it eliminates the loss of principal, settlement risk and the consequent credit and liquidity problems (and it is consistent with the principles in the ED).
15. Others would note that credit risk exists (for any change in fair value not yet settled) in both single settlement processes and non-single settlement processes.

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<sup>1</sup> ED paragraphs C14 and BC62

<sup>2</sup> ED paragraph C14

In both systems, the parties would be exposed to fair value changes as variation margin is calculated and paid with at least a day lag.

**Question 2: Collateral/Margin**

Is there any information about collateral that was not included in Agenda Paper 1B/Memo 14B or covered in today's Education session that the Boards want included in the decision making paper to be presented at a future meeting?