Appendix C to Agenda Paper 8A from the September 2011 IASB meeting

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Staff Paper

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Project **Offsetting Financial Assets and Liabilities**

Topic **Unit of account and treatment of collateral**

Purpose of the paper

1. This paper discusses how the Board might address the concerns raised about the unit of account for applying the proposed offsetting criteria and the proposed prohibition of offset of collateral and the related financial asset or financial liability.

2. **This paper is only relevant if the Board decides to pursue Alternative A in Agenda Paper 6A – ie replace the offsetting guidance in IAS 32 with the approach proposed in the ED (with the revisions proposed in the papers to be discussed at this meeting) . Hence should the Board decide to retain the IAS 32 offsetting guidance or to pursue the ED approach without modifications, this paper would not be discussed.**

3. This paper is structured as follows:

    (a) Section A addresses unit of account.

    (b) Section B provides background information about settlement and collateral processes in derivative markets (summary of information

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previously presented in Agenda Paper 1C/Memo 14C – Week commencing 30 May 2011).

(c) Section C addresses the ED's proposed treatment of collateral and application of the proposed offsetting criteria to groups of financial assets and liabilities.

(d) Section D summarises the staff's recommendation and includes questions for the Board to consider.

Section A: Unit of Account

ED Proposals

6 An entity shall offset a recognised financial asset and a recognised financial liability and shall present the net amount in the statement of financial position 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.

In all other circumstances, financial assets and financial liabilities are presented separately from each other according to their nature as assets or liabilities.

10 For the purposes of this [draft] IFRS:

(a) Offsetting is presentation of one or more financial assets and financial liabilities as a single net amount in the statement of financial position.

(b) A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount all or a portion of an amount due from the creditor or a third party.

……...

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

4. Paragraph 6 of the ED requires an entity to offset a recognised financial asset and a recognised financial liability if they meet the proposed criteria. The ED defines offsetting as the presentation of one or more financial assets and

financial liabilities as a single net amount but, as noted above, defines the legal right of set-off as the right to eliminate all or a portion of an amount due to a creditor by applying against that amount all or a portion of an amount due from the creditor or a third party.[1]

5. As the ED does not specify the unit of account that offsetting should be applied to (and appears to suggest at least three possible units of account) many respondents have requested clarification on the unit of account for offsetting (and whether the unit of account – the instrument –should be pierced when applying payment netting). They have also asked whether netting can be done on a portfolio basis (when payment netting is elected and/or a variation margin mechanism is present).

6. **Under the ED, offsetting is mandatory if the offsetting criteria are met and hence it is important to clarify the unit of account to which offsetting criteria should be applied.**

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

Portions of financial instruments

(a) to identifiable cash flows of financial assets and liabilities (a portion of a financial asset and a portion of a financial liability) (see Appendix 1 – Group 2).

Individual financial instruments

(b) to individual financial assets and financial liabilities (ie including offsetting a portion of a financial asset against an entire financial liability and vice versa) (see Appendix 1 – Group 3).

Groups of financial instruments

(c) to a portfolio of financial assets and financial liabilities (when each of the instruments comprise of a single cash flow) (see Appendix 1 – Group 1)

(d) to a portfolio of financial instruments (each comprising of multiple cash flows) with coinciding payment dates (see Appendix 1 – Group 4).

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[1] ED paragraph 10 (a) and (b)

(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 (see Appendix 2 – Examples 1 and 2)

(g) to a portfolio of derivative financial assets and financial liabilities (under a master netting agreement)

8. 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.

9. Items (c) - (g) in paragraph 7 (offsetting group or portfolio of financial assets and financial liabilities) are addressed in more detail under section C, as the issue of unit of account and collateral are related when it comes to offsetting portfolios of financial assets and financial liabilities.

Portions of financial instruments

10. Some industries (eg energy producers and traders) would prefer to apply the offsetting criteria to identifiable cash flows to reflect the way they do business and achieve offsetting under IFRS today. For other industries (eg banks), applying the offsetting criteria to individual identifiable cash flows (portions of financial assets and financial liabilities) within contracts would be impractical and burdensome and would not necessarily reflect the way they do business.

11. Some believe that if the focus of the offsetting model is the entity's 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 that 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).

12. The staff believes that there is no conceptual reason why the offsetting criteria cannot or should not be applied to individual cash flows (a portion of a financial asset and a portion of financial liability) and in most cases will yield a more representative amount of the future cash flows of an entity.

13. However the staff believes that offsetting should focus primarily on the presentation of an entity's assets and liabilities in its statement of financial position. The staff believes that piercing the unit of account to permit or require offsetting of portions of an entity's financial assets and liabilities would override other unit of account guidance in IAS 39, *Financial Instruments: Recognition and measurement* and may create measurement issues when determining the amounts or portions of assets and liabilities to be offset or not offset.

14. If the application of the offsetting guidance to individual cash flows is excluded, entities in some industries (eg utilities and energy companies) that report under IFRS and currently apply the guidance to individual cash flows of financial instruments and achieve offset today would no longer be permitted to do so. However, if application of the offsetting guidance to individual cash flows of financial instruments is permitted, the staff believes that the board would also need to provide an option to permit entities with operational constraints not to apply this approach. Hence diversity in practice will result due to operational differences between entities.

15. Due to the complexity of this approach (see Appendix 3) and the reasons set out in paragraphs 13 and 14, the staff does not recommend permitting or requiring the application of the offsetting criteria to individual cash flows of financial instruments.

Individual financial instruments

16. Arguably, most respondents agree that offsetting can be done on this basis and the staff believes there is no question as to whether the offsetting guidance should or can be applied at this level. The staff notes that this approach is consistent with the recognition criteria for financial instruments (ie the unit of account is the individual agreement or transaction).

17. For the reasons set out in paragraphs 13 and 14, the staff recommends that any offsetting guidance that the Board would adopt should **at least** recognise that the guidance can be applied to individual financial instruments, including a portion of a financial asset against an entire financial liability and vice versa.

Groups of financial instruments

18. Some respondents believe that an entity should be able to offset a group of financial instruments if all of the proposed offsetting criteria are met:

    (a) There is an enforceable right of offset in the form of payment netting[2], and

    (b) The entity intends to settle the group of financial instruments net or simultaneously.

19. The staff notes that an entity will fail the 'intention to settle net or simultaneously' criterion unless the instruments have the same payment/settlement dates (for both interim and final payments). Hence, except when the instruments (in a group) have identical or coinciding payment dates, a group of financial instruments will not meet the offsetting criteria. Under this view, items in paragraph 7(c) and (d) of this paper may meet the offsetting criteria.

20. The staff believes that other groups of financial instruments will also meet the offsetting criteria if a specific type of variation margin system is in place (see section C of this paper). The staff believes that in those circumstances, the variation margin system operates such that an entity can demonstrate an intent to settle net and the core principle in the ED and the offsetting criteria are met (see section C), that is:

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

[2] Generally, payment netting applies to only payments due on the same date and in the same currency

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

Under this view, offsetting of some groups of financial instruments in paragraph 7(f) and 9(g) of this paper would be acceptable but items in paragraph 7(e) would not be acceptable.

Section B: Collateral in derivative markets

21. The organisation of derivatives markets presently takes one of three forms:

    (a) Bilateral OTC markets

    (b) Bilateral OTC market with central clearing party (CCP)

    (c) Exchange-based market

22. Under bilateral OTC markets, all functions related to a trade (trading, execution, confirmation, clearing, margining and settlement) are done on bilateral basis (ie between the parties to the trade).

23. Conceptually, both bilateral OTC market with clearing (CCP) and exchange-based market lead to the same ultimate economic result; the CCP is the counterparty and responsible for management of the contracts until their fulfillment in both cases.

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

Collateral – Bilateral OTC market and trades with central clearing parties (CCPs)

25. In trades with a CCP, the CCP will have rules covering what assets are allowed to serve as collateral, how much of a 'haircut' (ie discount to market price) should be given to specific assets in determining their value as collateral, how often margin calls should take place and how the collateral payments (due or receivable) should or will be made. In the bilateral OTC market, collateral arrangements between parties are negotiated in a separate document (from the transaction confirmation), a credit support annex (CSA) or deed.

26. Different CCPs operate in similar but not identical manner. CCPs are structured differently when it comes to risk management. Practical issues such as payment and collateral timings, legal arrangements and the balance of risks intended to be covered by the different types of collateral are arranged differently and hence the overall risk management approach differ from CCP to CCP. Risk management processes for derivatives dealers in the bilateral OTC market also differ from dealer to dealer. However, the main objective is still the same (to reduce counterparty liquidity and credit risk).

27. The margin or collateral types required by CCPs include:

    (a) Initial margin

    (b) Variation margin

    (c) Intra-day margining

    (d) Participant's contribution to the default fund

28. Similar margining tools that are employed by CCPs may be present in some of the OTC bilateral arrangements but typically are a variation of the CCP structure.

Initial margin

29. Initial Margin (IM) is required to be posted at the inception of a trade or a trading relationship and it is designed to ensure that the CCP has sufficient funds to cover potential losses in a default in normal market conditions (for example, price risk or failure by the clearing member to provide variation margin).

30. In the bilateral OTC market, parties often request upfront collateral ('independent amount') from their clients, which is usually held throughout the life of the group of derivatives, as a security against the credit risk of that client. This is analogous to the initial margin required by CCPs.

Variation margin

31. In addition to the initial margin, CCPs rules provide for a variation margin (to cover current exposure or fair value of the contracts). CCPs typically mark to

market participants' positions at the end of each day, and calculate gains and losses accrued since the last mark-to-market determination (virtually on a daily basis). Therefore the variation margin consists of funds to cover losses (profits) on open positions.

32. Margins may be calculated on a gross or net basis. Under gross margining members are required to deposit margin sufficient to cover their gross positions. Under net margining the long and short positions are netted against each other and the margin required to be posted is based on the net positions. Most CCPs use a net margining system.

33. Variation margins are usually calculated at the end of each business day by the CCP, and then collected the next business day.

34. In a bilateral OTC market, in addition to the independent amount, the CSA or similar arrangements may call for variation margin payments between the parties. Generally, the CSA provides a variation amount based on:

    (a) The secured party's exposure; plus

    (b) The aggregate of all independent amounts applicable to the party that has delivered collateral, if any; minus

    (c) All independent amounts applicable to the party that is holding collateral, if any; minus

    (d) The threshold of the party that has delivered collateral

35. Exposure is typically deemed to be the mid-market mark-to-market value of transactions in the portfolio between the parties. The threshold amount is a defined fixed or variable amount that changes with the credit rating of the party concerned. The threshold represents the amount of credit risk that the party is willing to bear before requiring collateral from a counterparty.

Intraday margin

36. Usually the CCP calls for margin on an end-of-day basis. The calculation of the required amount of margin is based on the end-of-day price of the position (may be on gross or net position) of the clearing member. The CCP may, however,

call for an intraday margin to mitigate intraday risks. There are three types of intraday margin, namely, a routine intraday margin call (usually based on market prices and positions since the end of the last day or combined with update prices), a non-routine call that automatically occurs if market prices change sufficiently and a selective margin call, that requires the deposit of additional collateral by one or more clearing members, whose variation losses or initial margin deficits have reached a certain threshold.

37. A CCP may choose to pay out any intraday profits to clearing members, net the intraday profits against any increases in end of day margin (thus reducing the next margin call) or pay part of the profits to the clearing member and keep the remaining as an additional protection.

38. Some bilateral OTC contracts provide for intraday margin calls.

39. With the likely exception of initial margin, all margin provided to CCPs is likely to be required in cash due to the rapidly-changing derivatives exposure and therefore the high velocity of value required through margin accounts. By contrast, initial margin is typically delivered either in cash or in the form of securities that have high credit quality or can be sold easily.

40. It is estimated that approximately eighty percent of collateral in the bilateral OTC market is cash, approximately ten percent is government securities and other non-cash financial instruments comprise the remaining ten percent.

Defaulter's own contribution to the default fund

41. In many instances, each participant is required by the CCP rules to maintain a deposit (ie contribution to a default fund) to be used solely to cover any losses that might be incurred by the CCP as a result of the failure of any participant to perform its obligations. This amount is typically used further down in the waterfall (ie if variation margin or initial margin is not sufficient to cover such losses). Some clearinghouses that were counterparties to Lehman indicated that the initial margin and the variation margin amounts sufficiently covered their outstanding positions on Lehman's default.

Analysis

42. There are some significant differences between the bilateral OTC market and some of the CCP structures –

    (a) It is estimated that about a third of bilateral OTC contracts are not collateralised whereas collateralisation is a key feature of all CCPs. (The world's largest dealers in the bilateral OTC derivatives market report that eighty percent of their overall trade volume is subject to collateral agreements)

    (b) The legal rights of the parties in a bilateral OTC contract may differ significantly from the rights of parties in a CCP arrangement, in particular, whether the party making variation margin payments has the right to insist on the return of the variation margin paid (if the obligations under the associated financial instruments are met).

    (c) Margin payments under bilateral OTC contracts are often only required after an initial trade size is reached.

    (d) Some CCPs combine variation margin payments and the settlement of the underlying contracts in a single process whereas in almost all OTC bilateral contracts the settlement of variation margin and the underlying contracts are kept separate and the variation margin does not form part of the settlement of the underlying contracts. This is also true for some CCPs.

    (e) Weekly and monthly valuation and exchange of collateral is very common in the bilateral OTC market whereas on almost all CCPs the collateral cycle is daily.

    (f) In the bilateral OTC market, an entity would have to notify the other party within a certain time period (within the day) for collateral requested to be paid the following day. If a collateral request is made after that specified time, the party required to post the collateral has the right to post the requested collateral the following day (hence a possible two or more days' lag). On the other hand, on CCPs, such time limits do not apply or are rare.

(g) On most CCPs, variation margin can only be settled in cash whereas OTC bilateral contracts allow for variation margin to be settled in non-cash form as well.

Section C: Collateral and Groups of financial instruments

ED Proposals

9 An entity shall not offset, in the statement of financial position, assets pledged as collateral (or the right to reclaim the collateral) or the obligation to return collateral obtained and the associated financial assets and financial liabilities.

C14 Many financial instruments, such as interest rate swap contracts, futures contracts and exchange traded written options, require margin accounts. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets (typically liquid assets). Margin accounts are assets or liabilities that are accounted for separately. Similarly, if an entity sells collateral pledged to it and thus recognises an obligation to return the collateral sold, that obligation is a separate liability that is accounted for separately. An entity shall not offset in the statement of financial position recognised financial assets and financial liabilities with assets pledged as collateral or the right to reclaim collateral pledged or the obligation to return collateral sold.

BC62 The boards believe that the collateral for a debt is irrelevant to the question of whether assets and liabilities should be presented separately or offset in the statement of financial position. The credit risk that an entity faces in relation to settling a liability may be negligible or non-existent because of the collateral for the debt, but this is not a sufficient reason to require offsetting in the statement of financial position. The boards note that users are interested in information about an entity's performance and financial position rather than simply credit risk.

BC63 The boards concluded that offsetting the payables and receivables related to cash collateral would make 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. They therefore concluded that cash and other financial instrument collateral should not be offset against recognised financial assets and financial liabilities.

43. 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. In addition, the ED specifically refers to 'margin accounts' for futures and other derivatives as a form of collateral that cannot be net[3].

44. However, as detailed in Agenda Paper 5/Memo 13A – May 2011, a number of respondents, mainly financial institutions, disagree with the proposed treatment -

    a. They note that the proposed guidance on offset of collateral is more restrictive than IAS 32 today. For example, some clearinghouses may require their members to provide or receive cash (variation margin) on a daily basis in response to change in the fair value, for the effect of discounting (decay) and settlement of the underlying contracts based on the net position in specific asset classes or products (and currencies). This is intended not only to ensure that the net position is always cash-collateralised, but to cover any payments due on that day so that the positions are never settled separately.

    b. Collateral or margin should not be precluded from the scope of offsetting in all cases as drafted in the ED since offsetting the collateral and the related assets and liabilities may meet the proposed offsetting criteria.

       '[Paragraph C14] could be read as a general exception from applying the offsetting criteria to collateral obtained or pledged in respect of financial assets and financial liabilities. We do not believe that such an exception would be appropriate. Thus, it should be clarified that the offsetting criteria also apply to margin accounts and that margin accounts should be netted with other positions if the general criteria are met.' (CL#25)

    c. Some, if not all, types of cash collateral or margin posted for derivative instruments, such as exchange traded futures contracts, legally constitute settlement of the derivative position.

[3] ED paragraph C14

'We believe that variation margin should not be considered collateral and that settlement of variation margin should be reflected in the fair (carrying) value of the derivative contract.' (CL#107)

d. Collateral or margin should be offset more generally against derivative positions, regardless of its legal form because the net presentation reflects the economic substance (credit risk and liquidity risk) of the arrangement, as permitted under US GAAP or as interpreted in practice under IAS 32.

'[W]e do not believe it is appropriate that the legal form of margin as either settlement or collateral should be the basis for balance sheet presentation, but rather that economic substance should be the guiding principle. The offset of the collateral against the derivative balance provides users with the most accurate risk and liquidity profile of an entity and would be consistent with the presentation for futures contracts.' (CL#36)

45. The staff agrees that where variation margin or collateral posted qualifies (legally) as settlement of the related contracts, there is no question of offset. The staff believes that in that case the contract (or at least part of the contract) is extinguished and hence it is a derecognition issue. However, the ED did not distinguish such collateral from other types of collateral. The staff proposes that such distinction should be made explicit in any final standard.

46. Also, the staff agrees that the prohibition of offset of collateral and related financial asset or financial liability in the ED in some instances contradicts the core principle in the ED.

47. In the ED, the boards concluded that offsetting a financial asset and a financial liability in the statement of financial position is consistent with the objective of financial reporting, is appropriate and reflects the financial position of an entity if :

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

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

48. The boards concluded that the net amount represents the entity's right or obligation and the amount, resulting from offsetting the asset and liability, reflects an entity's expected future cash flows from settling two or more separate financial instruments, if (a) the entity has the ability to insist on a net settlement or enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event), (b) that ability is assured, and (c) the entity intends to receive or pay a single net amount, or to settle simultaneously[4].

Analysis

49. The key questions are:

 (a) In what circumstances do offsetting 'collateral' and financial assets **and/or** financial liabilities meet the offsetting principle in the ED?

 (b) Are there other circumstances when offsetting 'collateral' and related financial assets **and/or** financial liabilities will not be consistent with the offsetting principle but offsetting in those scenarios would provide useful information?

Initial margin or independent amount and contributions to the default fund

50. The CCP (or the party in an bilateral OTC market) holding the initial margin (or independent amount) only has the right to offset the initial margin (or independent amount) against the e counterparty's obligations if the counterparty defaults or is unable to perform its obligations. Hence the right to offset this type of margin or collateral is no different from that pertaining to the general type of collateral eg a mortgage over a real estate property. Under the ED, the right to offset this type of margin would qualify as a conditional right and would not satisfy the net settlement or simultaneous settlement criteria. Thus,

[4] Paragraphs BC17 and BC 18

initial margin (or independent amount) generally will not meet the offsetting principle in the ED.

51. A CCP only has the right to keep or to use a participant's contribution to the default fund to offset the counterparty's obligations if the counterparty defaults or is unable to perform its obligations. Hence the right to offset this type of margin or collateral is also no different from the general type of collateral eg a mortgage over a real estate property. Under the ED, the right to offset this type of margin or collateral would also qualify as a conditional right and would not satisfy the net settlement or simultaneous settlement criteria. Thus, a participant's contribution to the default fund generally will not meet the offsetting principle in the ED.

52. Moreover, offsetting such amounts (independent amount/initial margin and contributions to the default fund) against the related financial assets or financial liabilities would not necessarily reflect the financial position of the entity.

53. The staff recommends, should the Board agree to pursue the approach in the ED, that collateral that the parties can offset against the counterparty's obligations **only if** the counterparty defaults or when the counterparty is unable to perform its obligations (eg initial margin/independent amount and contributions to the default fund) **should not** be allowed to be offset against the related financial asset and/or financial liability. Under the ED, the right to offset these types of margin or collateral would qualify as a conditional right and do not meet the net settlement or simultaneous settlement criterion nor the unconditional right of set-off criterion.

Variation margin and intraday margin

54. Whether variation margin or collateral meets the principles in the ED, will depend on:

    (a) the legal nature of the collateral arrangement (eg whether collateral paid or received is or can be construed as partial settlement of the amounts due under the contract(s) and whether the collateral provider has the legal right to demand return of collateral posted)

(b) the rights of the parties (eg whether the right to offset the collateral and the open positions is conditioned on a future event)

(c) whether the variation margin forms or will form part of the settlement of the underlying contracts, and

(d) whether there is a single process for the settlement of both the underlying contracts and the payment of variation margin or they are conducted in different processes.

55. Based on the factors in paragraph 54 and the principles in the ED, offsetting the variation margin against **<u>either</u>** the asset **<u>or</u>** liability position will meet the offsetting criteria in the ED if:

    (a) the party making the variation payment has no right to insist on the return of the variation margin paid and the party holding the collateral has no obligation to return the amounts posted as collateral, and

    (b) the variation margin forms or will form part of the settlement of the underlying contracts.

56. It is very common under a bilateral OTC contract (with the standard CSA) that once there has been proper performance of the underlying derivative transactions, the party who has paid the variation margin is entitled to recover an amount of collateral of like kind and like value from the secured party. Hence such arrangements would not meet the principle in the ED and the offsetting criteria.

57. Whether an intraday margin or collateral will meet the principles in the ED will depend on the factors set out in paragraph 54.

58. Based on the above analysis, the staff recommends that if collateral or margin posted or received meets the conditions in paragraph 55, an entity should be allowed to offset the collateral or margin and the related financial asset **<u>or</u>** financial liability.

Offsetting of a group or portfolio of financial assets and liabilities

59. The key question is whether by virtue of a variation margin mechanism, an entity can demonstrate an intent to settle net (assuming the parties have an unconditional and legally enforceable right of set-off) and thus the core principle and the offsetting criteria in the ED are met, that is -

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

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

60. As noted in paragraph 18, some believe that under the proposed approach, an entity can offset a group of financial instruments if all of the following conditions are met:

    (a) There is an enforceable right of offset in the form of payment[5] netting, and

    (b) the entity intends to settle the group of financial instruments net.

61. As noted in paragraph 19, an entity will fail the 'intention to settle net or simultaneously' unless the instruments have the same payment/settlement dates (for both interim and final payments). Hence except when the instruments (in a group) have identical or coinciding payment dates, a group of financial instruments will not meet the offsetting criteria.

62. Also, the staff believes that a group of financial instruments will meet the offsetting criteria if a specific type of margin system is in place. The staff believes that in those circumstances, the variation margin system operates such that an entity can demonstrate an intent to settle net and the core principle and the offsetting criteria in the ED are met. That is,

[5] Generally, payment netting applies to only payments due on the same date and in the same currency

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

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

63. The staff believes that offsetting a group of financial assets **and** financial liabilities **and** related variation margin will be consistent with the principles in the ED and the offsetting criteria are met, if:

(i) an entity has an unconditional right of offset (eg payment netting clause) and hence all amounts due on the underlying contracts on a specific date are settled net;

(ii) the arrangement includes a variation margin mechanism and variation margin is posted or called on a daily basis;

(iii) the party in receipt of the variation margin has no obligation to return the amount posted and the party posting the variation margin has no right to insist on return of the amount posted as variation margin (ie the variation margin will form part of the settlement of the underlying contracts);

(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 not conditioned on a future event, the default, bankruptcy or insolvency of the counterparty; and

(v) the settlement of the underlying contracts and variation margin are combined in a single payment process (ie settlement of interim and final amounts are combined with variation margin flows and a net amount is paid or received).

64. Where the above conditions are met, the amount that is shown on the balance sheet at any date will:

(a) be truly representative of the entity's net exposure and

(b) reflect a day's change in fair value of the portfolio of instruments, for which variation margin has not been paid or received.

65. The right of offset (payment netting) ensures that amounts due on each date are settled net (ie there are no gross flows). Payment netting is typically restricted to payments due to or from the parties if they occur on the same day and are in the same currency. Thus, unless the parties settle contracts in different currencies net in a specified currency, the above condition will ensure that netting will not be achieved across currencies (ie there will be netting sets/groups for different currencies).

66. Daily variation mechanism that forms part of the settlement of the underlying contracts or financial instruments (and not conditioned on a future event) addresses the issue of maturity mismatch or non coinciding cash flows and thus the entity can assert an intention to settle net.

67. A non-single settlement process avoids the situation where the payment of one amount (settlement of underlying contracts) occurs on a particular date but the receipt of the other leg (the variation margin) occurs a day (or more) later. The risk to an entity is that it will pay out on the underlying transactions and not receive its variation margin in return. Settlement risk arises when the timing of payments or deliveries by counterparties to each other are not synchronised. This is sometimes called Herstatt risk. This issue became more prominent after the Herstatt incident in 1974.

68. In this case, a German bank, Bankhaus Herstatt, which had a large trading book of foreign exchange transactions, was closed by its banking supervisor 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 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 Deutsche Mark payments and never received the corresponding dollar inflows. The risk of

making payment but not receiving countervalue has since been known as Herstatt risk (BIS – 1996). There have since been other incidents – Drexel in 1991, the collapse of BCCI in 1991, the collapse of Barings in 1995 and Lehman Brothers in 2007.

69. The Herstatt incident (see paragraph 68) led to the creation of CLS bank, which provides a perfect example of simultaneous settlement (at the same moment) of foreign exchange transactions using payment vs payment structure.

70. This incident has forced parties to recognise the perils of having to settle transactions through different systems or in different jurisdictions and different time zones. The amount at risk during the settlement period (lag) could exceed a bank's capital. Because this risk may involve the full value of transactions falling due, substantial credit losses as well as substantial liquidity pressures may result from the default of a counterparty or the failure to complete the settlement of the variation margin.

71. A single process (as demonstrated in Agenda Paper 1C/Memo 14C (Week commencing 30 May 2011)) 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.

72. Some CCPs combine variation margin payments and the settlement of the underlying contracts in a single process whereas in all bilateral OTC contracts the settlement of variation margin and the underlying contracts are kept separate and the variation margin does not form part of the settlement of the underlying contracts. This is also true for some CCPs.

73. Hence, it is not automatic that all trades through central counterparties and OTC transactions would achieve offset under this approach. Whether such trades will achieve offset will depend on whether the arrangement between the CCP (or the counterparties) meet the conditions in paragraph 63.

74. Based on the above analysis, the staff believes that offsetting a group of financial assets and financial liabilities and related variation margin (as a single

group) is consistent with the principle and the criteria in the ED when the conditions in paragraph 63 are met.

75. The staff recommends, should the Board decide to pursue the approach in the ED, to require offset of financial assets **and** financial liabilities **and** the related variation margin when the conditions in paragraph 63 are met.

76. The staff notes that there might be diversity in practice, as some entities will apply the guidance to individual financial instruments whilst others will apply to groups of financial instruments. The staff believes this is appropriate as in either case the amounts on the balance sheet will represent the entities' assets and liabilities.

77. The approach outlined in paragraph 63 would enable offsetting of more groups of financial assets and financial liabilities. As noted in paragraph 65, the conditions outlined paragraph 63 may not be achieved across currencies (ie there may be netting sets/groups for different currencies).

78. CCPs generally require variation collateral or margin to be posted or collected by currency or product type. Many derivative dealers in the bilateral OTC market either use different legal entities for different product types or have separate master netting agreements and credit support annexes for different product types.

79. However, variation margin in the bilateral OTC market may be determined and posted based upon the net fair value of all of a counterparty's derivative exposures. Thus, the recommended approach outlined in paragraph 63 may result in units of account for some bilateral OTC arrangements, for offsetting purposes, that differ from the manner in which variation margin is determined. In this scenario, if variation margin is posted for all trades in a single currency, an entity will have to allocate variation margin to each unit of account to determine the amounts to offset.

Section D: Summary of staff recommendations

80. The staff sets out below a summary of the recommendations made by the staff in addressing the comments received on unit of account and the treatment of collateral. The staff recommends that:

(a) application of the offsetting criteria to individual cash flows of financial instruments (the option in paragraph 7(a) of this paper) should not be allowed or required due to the complexity of that approach (see paragraph 15).

(b) any offsetting guidance that the board would adopt should **at least** recognise that the guidance can be applied to individual financial instruments, including a portion of a financial asset against an entire financial liability and vice versa, that is, the option in paragraph 7(b) of this paper (see paragraph 17).

(c) offset of a group of financial instruments that have identical or coinciding payment dates be required (the options in paragraphs 7(c) and (d) of this paper) if they meet the offsetting criteria. (see paragraphs 18 and 19)

(d) a distinction should be made explicit in any final standard that when variation margin or collateral posted qualifies (legally) as settlement of the related contracts, there is no question of offset. The staff believes that in that case the contract (or at least part of the contract) is extinguished and hence it is a derecognition issue (see paragraph 45).

(e) collateral that the parties can offset against the counterparty's obligations only if the counterparty defaults or when the counterparty is unable to perform its obligations (eg initial margin/independent amount and contributions to the default fund) **should not** be allowed to be offset against the related financial asset or financial liability. Under the ED, the right to offset these types of margin or collateral would qualify as a conditional right and do not meet the net settlement or simultaneous settlement criterion nor the unconditional right of set-off criterion (see paragraph 53).

(f) if collateral or margin posted or received meets the conditions in paragraph 55 (ie the party making the variation payment has no right to insist on the return of the variation margin paid and the party holding the collateral has no obligation to return the amounts posted as collateral and the variation margin forms or will form part of the settlement of the underlying contracts), an entity should be required to offset the collateral

or margin and the related financial asset **or** financial liability (see paragraph 58).

(g) the offsetting criteria should be applied to groups of financial instruments (financial assets and financial liabilities) and the related variation margin that meet the conditions in paragraph 63 of this paper. The staff believes that in those circumstances, the variation margin system operates such that an entity can demonstrate an intent to settle net and the core principle in the ED and the offsetting criteria are met (see paragraphs 19, 20 and 75). Thus the financial assets and financial liabilities and the related collateral should be presented net in the statement of financial position.

Question for the boards
Do the boards agree with the staff recommendations in paragraph 80? If not, why?