IASB/FASB Meeting November 2010

IASB Agenda reference 3C

FASB Agenda reference 8C

Staff Paper

Project	**Offsetting of financial assets and liabilities**
Topic	**Offsetting with the Conditional right of offset**

Background

1. At the September 2010 meeting, the Boards discussed whether and when offsetting of financial assets and liabilities is appropriate or provide useful information. The Boards concluded that the following factors may be helpful in determining when offsetting provides useful information on the face of the statement of financial position or in the notes:
   (a) whether the parties need to have the ability to offset or settle net
   (b) whether the parties need to demonstrate an intent to settle net
   (c) whether the amounts owed under the respective contracts ought to be settled on the same date or be settled simultaneously
   (d) whether the financial asset and liability ought to have the same maturity
   (e) whether the financial asset and liability ought to have the same underlying risk
   (f) whether offsetting should be on the basis of bilateral or multilateral netting arrangements.

2. At the October 2010 meeting, the Boards discussed:
   (a) description of each of the factors mentioned in paragraph 1;
   (b) possible interactions among those factors; and
   (c) a framework for analysing the usefulness of offsetting.

3. The Boards indicated that an entity should be able to offset a recognised financial asset and liability if the entity has an unconditional right of offset and intends to settle net. The Boards also decided to consider whether there are any other circumstances under which it may be appropriate to offset.

4. A common understanding of these factors including conditional and unconditional right of offset was also discussed. Conditional right of offset, on a conceptual level, focuses on expected outcome in the event of default or termination of the contract (worse case scenario). An example is close-out netting which is a contractual mechanism, that may enable unilateral termination of a financial contract (or financial contracts governed by a master agreement), in the case of a bankruptcy or other event stipulated in the agreement, and at the same time the netting of their replacement values into a final balance, usually referred to as the "termination amount".

Purpose

5. For the purpose of discussing alternatives for a model to be used for offsetting, the staff has split the right of offset into considerations based on whether the right of offset is unconditional or conditional. The first consideration, as to whether netting would be appropriate, is addressed in the paper on unconditional right of offset (Paper 3A). This paper, however, addresses when offsetting would be appropriate given the conditional right of offset and provides the Boards with three related alternatives to consider.

6. Based on the Boards' deliberations, the staff has identified the following alternatives for the Boards' consideration:
   - (a) Alternative 1:
     - (i) Conditional right of offset
   - (b) Alternative 2:
     - (i) Conditional right of offset AND

(ii) Same risks or critical terms OR same instrument

(c) Alternative 3: No netting with conditional right of offset.

Alternative 1

7. This alternative would allow netting when an entity has a conditional right of offset.

8. This alternative is based on the premise that the net presentation discloses the amount of credit risk under that arrangement. Given a master netting arrangement, presentation of the aggregate fair values of the individual contracts executed under that arrangement would not provide more information about the uncertainty of future cash flows from those contracts than net amounts would.

9. Under this alternative, the amounts of all financial assets and financial liabilities that are executed with the same counterparty that are subject to a legally enforceable master netting arrangement, or similar netting arrangement, would be offset, regardless of their other characteristics (for example, maturity, underlying type of primary risk, etc.) This approach is based on the notion that offsetting based on the counterparty credit risk provides more useful information to users.

10. Proponents of this approach note that presenting individual financial assets and liabilities gross (ie without offsetting) does not necessarily provide more useful information about the timing or direction of cash flows. For example, presenting contracts on a gross basis does not provide information on the timing of the potential future cash flows for an entity that has a contract that has a $100 asset value with entity B, and a second contract that has a $40 liability value.

11. They also argue that an entity that can legally offset, in an event of default or bankruptcy, under a master netting agreement is in a significantly different financial position than one that cannot legally offset. Offsetting based upon credit risk portrays this different financial position by reporting the net credit position in the statement of

financial position. Additionally, U. S. and international regulators focus on net credit risk in their analysis.

12. Counterparties typically post or receive cash collateral based upon their net position. For example, if entity A has a contract that has a $100 asset value with entity B, and entity B has a separate contract that has a $40 asset value with entity A, and both are subject to a master netting arrangement, then A typically receives cash collateral from entity B on the net $60 position with entity B. Assume the terms call for $45 cash collateral (the terms of cash collateral arrangements between entities will vary); the statement of position would reflect a net balance of $15. As entity A and B settle each contract, the amount of cash collateral posted changes as well. For example, if entity B were to pay entity A $60 so that the net position is $0, entity B will then receive back its cash collateral of $45, for a net cash flow of $15. Thus, it could be argued that this approach provides a more relevant portrayal of expected cash flows that is possible on the statement of financial position both at the date of the statement of financial position and in the event of default. Without offsetting in this manner, reporting entity A would present a $100 derivative asset, a $40 derivative liability, and a $45 collateral posting liability. This type of presentation could make it more difficult for users of the financial statement to predict the future net cash flow of $15 if in fact the netting were to actually occur.

13. Additionally, the Boards should consider paragraph OB8 from the Conceptual Framework ED which states, “individual primary users have different, and possibly conflicting, information needs and desires. The Board, in developing financial reporting standards, will seek the information set that will meet the needs of the maximum number of primary users.”

14. Proponents of this approach note that a principle for offsetting would have to be created in order to restrict the population of items to be offset to those whereby the resulting offset provides users with more useful information about (i) the amount and uncertainty of future cash flows (liquidity and market risks) and (ii) the economic

position of the reporting entity (credit risk) as of the balance sheet date in comparison to if the amounts were not offset. This would more closely align the approach with the Conceptual Framework and eliminate the inclusion of assets and liabilities that are cash flows in one direction (i.e. accounts payable and accounts receivable) as offsetting in these cases would accurately portray credit risk to the detriment of cash flow or liquidity information. On balance, it would appear for these instruments that liquidity information appears more useful than the credit information. It is noted that neither gross or net information on the face of the balance sheet provides more relevant information about the timing of cash flows, however, for these instruments (i.e. accounts payable and accounts receivable), gross information provides the amount of future cash flows. Derivatives, however, are recorded at a fair market value or a net present value of future cash flows; therefore, even gross presentation would be based on the net cash flows of each transaction. For example, an interest rate swap portfolio has a fair value based on net present value of future cash flows; neither gross or net presentation would provide better information about the amount and/or timing of those cash flows. However, net presentation of all contracts with the counterparty would provide you information about the related credit risk.

15. A disadvantage of this approach is that offsetting based on credit risk could misrepresent the amounts by which the instruments being offset under master netting arrangements are actually settled. It is not common, other than in an event of default or bankruptcy, that the instruments offset under master netting arrangements actually settle net.

16. Opponents of this approach argue that counterparty risk is a measurement rather than a presentation issue and hence mitigation of credit risk per se should not be the basis for offset. For example, the guidance in proposed Accounting Standards Update: Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (Issued 06/29/10) includes guidance proposing that the effect of a net credit position be used as the basis for determining credit valuation adjustments when there is a legally

enforceable right to set off one or more financial assets and financial liabilities with the counterparty in the event of default (for example, because the reporting entity has entered into a master netting agreement with that counterparty).

17. They also argue that under the Boards joint Conceptual Frameworks the purpose of the statement of financial position is to provide information about financial position of an entity (i.e. the elements of financial statements). They believe that the net balance is important but should be disclosed. They emphasise that in addition to the elements of financial statements, financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement such as disclosures about the risks and uncertainties affecting the entity, information about geographical and industry segments and the effect on the entity of changing prices**.** They argue that such conditions are best recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements (ie in measurement).

18. They also disagree with the notion that netting on the basis of a master netting agreement provides information about the timing, amount and uncertainty of future cash flows. They believe that collateral arrangements may provide some indication of future cash flows under various portfolios but that condition does not arise because of the existence of a conditional right of offset such as close out netting provision in a master netting agreement.

19. Opponents of this view also argue that conditional rights of offset are present in many other arrangements, for example, non recourse debt arrangements and in banker/customer relationships. The staff notes that under Basel II (and under the proposed revisions) conditional rights of offset and other similar rights such as customer deposits and loans are allowed for offset (ie treated similarly) in determining counterparty exposure and for calculating capital adequacy. Thus they argue that there is no conceptual or practical reason for singling out contracts

governed by an MNA for offset, in accounting, whilst denying similar arrangements similar treatment.

20. They also argue that although offsetting on the basis of absence or mitigation of a particular risk may provide a partial outlook of the risks faced by an entity, it might not provide a complete representation. For example, netting on the basis of mitigation or elimination of credit risk may mask the presence of other risks and the presentation or communication may not be complete.

21. The opponents of this view believe that aggregating the asset and liability positions of several of such instruments could further reduce users' ability to understand the risk exposures of an entity arising from such contracts. If these positions are aggregated, users cannot, for example, determine which side of contracts an entity holds and therefore the risks the contracts pose. Investors can better assess these risks if they know which side of such contracts an entity holds.

22. They also believe that, under existing and proposed guidance, when an entity enters into a contract that effectively hedges its exposure to a particular risk, the entity is not required or permitted to present the asset and the liability in that hedge relationship net on the face of the statement of financial position. Hence they question why net presentation should be allowed or required where a master netting agreement reduces an entity's credit exposure (one type of risk) on financial contracts.

23. Opponents also believe that net presentation (of the gross fair value of the outflows and the inflows) on the face of the statement of financial positions reduces users ability to understand the implied economic leverage position of an entity.

24. They argue that gross market values do provide some measure of the financial risks from derivatives. These are all open contracts that are either in current gain or loss position at current market prices and thus, if settled immediately, would represent claims (or liabilities) on counterparties or on the entity. Gross market values are correlated to the notional amounts of the derivative contracts: the larger the notional amount, the larger the gross market value from prices changes, all other things being

equal. They argue that zero gross exposure is different from zero netted exposure, where the latter may still entail significant counterparty, operational or other risks1.

25. The opponents of this approach also reject the idea that the net balance (current exposure) represents the credit exposure of an entity. Although, current exposure provides a snapshot of credit exposure at a single point in time, there is a fundamental difference between derivatives and unconditional payables and receivables. The nature of derivative contracts is such that their market values can fluctuate substantially, even over relatively short periods of time. Because the credit exposure of derivatives can fluctuate dramatically, measuring exposure at a single point in time does not yield an accurate assessment of the credit exposure of a derivative portfolio. Thus, they argue that net fair value of derivative positions does not represent the net credit exposure of the entity. This view is consistent with how both market participants and supervisors measure credit risk - total credit exposure is calculated as the sum of current and potential exposure.

26. They also argue that, credit exposure (net fair value of derivative positions) does not take into account the probability that given that a particular institution fails to deliver, other institutions in the system would also fail to deliver (a major concern arising from the recent financial crises). This is based on the fact that financial institutions are usually linked, either directly, through the interbank deposit market and participations in syndicated loans, or indirectly, through lending to common sectors and proprietary trades.

27. Financial institution distress dependency tends to rise in times of distress since the fortunes of institutions decline concurrently through either contagion after idiosyncratic shocks or through negative systemic shocks.

28. Derivative markets are seen as particularly vulnerable to systemic shocks. The value of derivative positions can change rapidly. The huge volume of derivative trading and the enormous open positions misrepresent the true liquidity of the derivative

[1] *Consultative Document - Strengthening the resilience of the banking sector - BIS*

markets when they are under stress. Moreover derivative markets are dominated by a few large firms. Thus the failure of one firm and the response of others can lead to endogenous adverse changes in asset values and to rapid changes in market liquidity.

29. Thus some argue that in presenting these positions gross most interconnections will show up in the balance sheet. They argue that gross presentation would thus give a better picture of the exposure of the bank itself to counterparty risk. For example, a bank has a large amount of derivatives contracts outstanding, but without any significant net exposure. It could still make very large losses in case important counterparties fail and netting arrangements do not work or the pricing of the contracts is distorted, as happens typically in a systemic crisis.

Alternative 2

30. This alternative would allow conditional right of offset netting when all of the following conditions exist:
    (a) Conditional right of offset AND
    (b) Same risk or critical terms OR same instrument

31. This alternative is based on the notion that it is not appropriate to offset financial assets and financial liabilities unless all of the following risks are eliminated: (i) counterparty risk in the event of default (30(a)) and (ii) underlying market risk (30(b)) because doing so would not faithfully represent the types of risks that an entity is exposed to or the timing of the cash flows.

32. For example, assume an entity had an interest rate risk derivative with a $100 asset fair value and a foreign currency exchange risk derivative with a $60 liability fair value that settle simultaneously. If those financial statements were reported as a net $40 interest rate risk asset on the balance sheet, there would be no visibility of the foreign currency risk that an entity is exposed to.

33. The conditions which are required to exist to achieve offsetting in the financial statements, as noted above, would essentially economically negate any counterparty or market risk, however, the staff believe that the opportunities for offset may be limited given the conditions that need to exist.

34. However, this approach is consistent with how contracts are handled or aggregated on exchanges and in clearing systems. In such scenarios net positions are determined on instrument by instrument basis (ie based on risk type). This approach is also partly consistent with how financial institutions manage risks. Financial institutions manage not only credit but market risk as well and with the objective of minimizing both type of risk.

Alternative 3

35. The third alternative is to not allow any netting if the entity does not have an unconditional right of offset. This alternative is based on the view that offsetting related to the conditional right of offset may reduce financial statements users' ability to compute key financial metrics. Additionally, some believe that netting on the basis of mitigation or elimination of a particular risk will mask the presence of other risks resulting in incomplete or inaccurate financial statements. Aggregating the asset and liability positions of several of such instruments may further reduce users' ability to understand the risk exposures of an entity arising from such contracts, for example, their ability to determine which side of contracts an entity holds and therefore the risks the contracts pose.

36. A disadvantage of this approach is that gross presentation is based on the net present value of individual transaction, that is fair value, and therefore does not provide meaningful information from a credit, liquidity or market perspective.

Staff Analysis

37. The staff notes that both Alternative 2 and Alternative 3 would be a significant change from current U.S. GAAP. Currently, an entity would be able to offset similar to Alternative 1. Detailed current requirements for offset under U.S. GAAP are included in Agenda paper 3A (IASB)/ 8A (FASB), paragraph 11.

38. Additionally, the Boards should also consider the IASB/FASB Joint Board Meeting Paper 8A (FASB Agenda Reference 3A) for a more fulsome discussion of the usefulness and appropriateness of offsetting. The Boards should also consider the User Outreach as documented in the IASB/FASB Joint Board Meeting Paper 8C (FASB Agenda Reference 5). The staff view is split with certain members of the team supporting Alternative 1 and others supporting Alternative 2, (although they believe alternative 3 is a more conceptually robust approach).

Question for the Boards:
Do the Boards support any of these alternatives when the conditional right of offset exists? If not, how does the Board wish to proceed?