Project **Derecognition**

Topic **Education Session - Offsetting of financial assets and financial liabilities**

152. DSR-Sitzung am 03.01.2011

152_04b_IASB_AP11_Offsetting

## Introduction

1. This paper discusses offsetting of a financial asset and a financial liability and presentation of the net amount on the face of the statement of financial position.

2. The paper also examines the differences in offsetting requirements under IFRS and US GAAP. This paper does not provide any recommendations for aligning the guidance under IFRS and US GAAP.

3. The purpose of this paper is to provide a comprehensive analysis of the issue and an informed basis for deciding a way forward.

## Why a paper on offsetting?

4. Offsetting (netting) is a presentation rather than derecognition issue. However some respondents to the Exposure Draft ED 2009/3 Derecognition ('ED') requested that the Board revisit the offsetting guidance on financial assets and liabilities as part of the Derecognition project (developing a replacement guidance for derecognition of financial instruments). Below are some of the comments on the issue –

   *"Finally, we would like to address the important issue of Replacement Value Netting which in our view has similar effects as derecognition. The different netting requirements between USGAAP (FIN 39) and IFRS lead to uncomparable balance sheets. Therefore we urge the IASB to allow netting similar or identical to US-GAAP."* ***Comment Letter 44***

   *"Our last concern is related to the divergence with the US GAAP (we are particularly disappointed the IASB did not address the issue of netting requirements when proposing a new derecognition standard. These requirements are indeed very different in IFRS compared to US GAAP, and lead*

*to un-comparable balance sheets) and the ED 10 Consolidation."* ***Comment Letter 40***

*"The issue of netting financial instruments is not addressed by the Board in this ED; indeed, our understanding is that it is not currently addressed in any financial instruments-related project that is on the technical agenda. We would like to escalate the sense of urgency and importance of this topic vis-à-vis recognition and presentation of financial instruments as well as, of course, convergence of accounting standards. Divergences in accounting standards for netting financial assets and liabilities, including netting of financial assets with related obligations to return collateral, significantly affect balance sheet comparability and related regulatory capital requirements. The differences in global accounting rules that exist today have created an unlevel playing field that directly impacts the ability of banks to compete effectively on the basis of equal capital, ceteris paribus.*

*While we recognise that the netting of financial instruments is a presentation issue rather than a derecognition issue, the practical effect of netting is similar to the effect of derecognition. Therefore, we strongly encourage the Board to add to the derecognition project a supplement agenda item that will provide converged guidance on netting of financial instruments. We think that existing divergences between the two Boards could potentially be removed without significant delays."* ***Comment Letter 42***

5. The staff understands that the differences in reported numbers due to differences in the accounting guidance for offsetting under IFRS and US GAAP represents the single largest reconciling item between US GAAP and IFRS. Hence many of the constituents that the staff met, as part of the extensive outreach on the ED, argued strongly for the Boards to work on a common solution or guidance.

6. The staff also believes that there is some diversity in practice in this area. For example, the application of the 'to realise the asset and settle the liability simultaneously' requirement in paragraph 42 of IAS 32, *Financial Instruments: Presentation*. Some consider amounts recognised as payables and receivables under sale and repurchase agreements ('repos') and amounts recognised as receivables and payables under reverse repos can be offset if particular conditions are met. Others consider that offset in such a situation is not required or permitted by IAS 32 and hence recommend that the Board revisit the issue.

7. The staff notes that some of the respondents that argued that repos and reverse repos are financing transactions also advocate the offset of repos and reverse

repo positions (as well as the fair value of derivative positions and cash collaterals supporting those positions).

## The Issue

8. Offsetting, in accounting, is the presentation of financial assets and financial liabilities on a net basis in the primary financial statements. Offset is a presentation issue (how a financial asset and liability should be presented in a statement of financial position or how other elements should be presented in a primary financial statement). In contrast recognition and derecognition addresses whether an asset or liability exists and whether continued recognition in the primary financial statement is appropriate.

9. Offsetting does not give rise to recognition of a gain or loss. However, the derecognition of a financial instrument results in the removal of a previously recognised item from the statement of financial position and may result in recognition of gain or loss.

10. Although conceptually different, offset that results in a net amount of zero and derecognition resulting in no gain or loss are indistinguishable in their effect on the primary statements. (Likewise, not recognising assets and liabilities of the same amount in financial statements achieves similar reported results).

11. Offsetting has traditionally been required when there is both a right <u>and</u> intention to offset because doing so reflects an entity's expected future cash flows from settling two or more financial instruments. The view is that offsetting in such situations, in effect, represents in the statement of financial position that the entity has a single financial asset or financial liability.

## Offsetting (netting) accounting guidance

12. The guidance in both IFRS and US GAAP for offsetting (netting) of financial assets and financial liabilities are broadly similar (except for some derivative and repurchase agreements). Generally, under both IFRS and US GAAP, an entity can only net a recognised financial asset and financial liability if the entity have a legally enforceable (unconditional) right to set off and intends to set off those positions.

### *A. IFRS Guidance*

13. IAS 1, *Presentation of Financial Statements*, paragraph 32 states that –

> ‘An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS’

14. Paragraph 33 of IAS 1 further explains that –

> ‘…Offsetting in the statements of comprehensive income or financial position or in the separate income statement (if presented), except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity’s future cash flow’

15. IAS 32 paragraph 42 however states that –

> ‘A financial asset and financial liability shall be offset and the net amount presented in the balance sheet when and only when, an entity:
>
> (a) currently has a legally enforceable right to set off the recognised amounts; and
>
> (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.’

16. IAS 32 paragraph 48 explains that –

> ‘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’

### *B. US GAAP*

17. Paragraph 7 of APB Opinion 10[1] states that –

> "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists"

18. Paragraph 5 of FASB Interpretation No 39[2] further explains that –

> 'A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:
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> a. Each of two parties owes the other determinable amounts.
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> b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
>
> c. The reporting party intends to set off.
>
> d. The right of setoff is enforceable at law.
>
> A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.'

### *C. Differences between US GAAP and IFRS requirements*

19. There are some key differences between the guidance under IFRS and US GAAP. Firstly, under IFRS where the offset criteria are met an entity is <u>required</u> to offset the financial asset and liability. US GAAP however <u>permits</u> offset in the specified conditions and thus treats offset as an accounting policy choice (if the offset criteria are met).

20. Secondly US GAAP allows for offset for some arrangements (under some specified conditions) where the ability to set off is conditional and there is lack of 'intent' to offset or such intent is conditional. US GAAP:

    (a) allows for offsetting of the fair value recognised for forward, interest rate swap, currency swap, option, and other conditional or exchange

[1] ASC 210-20-05-1
[2] ASC 210-20-45-1

contracts (and the related right to reclaim cash collateral or the obligation to return cash collateral) if they are executed with the same counterparty under a master netting arrangement. (FIN 39)[3]

(b) allows for offsetting of amounts recognised as payables under repurchase agreements and amounts recognised as receivables under reverse repurchase agreements if specified conditions are met. The key conditions are the existence of a daylight overdraft or other intraday credit feature in banking arrangements associated with settlements and the transfer system; that the securities exist in "book entry form"; and the arrangement ought to be under a master netting agreement. (FIN 41)[4]

21. IAS 32 prohibits offset where the right of offset is conditional or enforceable only on the occurrence of some future event. However some of the requirements under paragraph 20(b) are similar to the requirement under IAS 32 that allows for offset when an entity intends to realise the asset and settle the liability simultaneously.

22. One conceptual difference between the IFRS guidance and US GAAP exceptions outlined above is that the expected outcome in the event of default or termination of the contract drives the US GAAP accounting (FIN 39 and 41 exceptions). IFRS, on the other hand, focuses on circumstances that are expected to arise both in the normal course of business and in default or termination.

## Offsetting (Netting) – Some important considerations

### A. Economic implications of offsetting (netting) arrangements

23. Netting arrangements allow market participants to

(a) reduce counterparty credit risks and

(b) manage market risk

[3] ASC 815-10-45-5
[4] ASC 210-20-45-11

24. Netting arrangements reduces the credit risk exposures of market participants, relative to what the exposures would be were the same parties liable for their gross exposures on the same set of underlying contracts.

25. Netting arrangements also provide counterparties the ability to transfer and manage specific market risk more efficiently, while minimizing their exposures to counterparty credit risk.

26. Such mechanisms permit the management of existing market risk exposures by taking on offsetting contracts with the same counterparty. These arrangements eliminate the need to negotiate the termination value of existing contracts.

27. For example, over the counter contracts are generally not traded and in the absence of legal netting mechanisms, an entity that wishes to discontinue a contract would be in a disadvantageous position. If it seeks to buy out (or sell) its position, it has to do so with the original counterparty and would hence be in a relatively weak bargaining position. On the other hand if it entered into an offsetting position with someone else, it may have to post collateral with both counterparties and hence create a new credit exposure. This would therefore result in an overall (new and original counterparty) increase in credit exposure.

28. With netting and the offsetting position being undertaken with the original counterparty, the no longer desired market risk is eliminated and no additional counterparty risk is assumed.

29. For a regulated financial institution, position netting may also have regulatory capital implications.

**B. Legal considerations**

30. The right to offset is a legal right, and the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered (to ascertain whether the right of set-off is enforceable). To understand the economic implications of offsetting, it is necessary to understand the legal rules that provide and underpin those rights. The staff has set out in appendix 1 a summary of the legal basis for offset.

## C. International Swaps and Derivatives Association (ISDA) Master Agreement

31. The contractual agreements documenting and governing derivative transactions have been standardised to a great extent by the financial industry and ISDA. The financial industry utilise in almost all cases, the terminology, definitions and forms of agreements developed by ISDA (please see appendices 2 and 3 for a summary of the ISDA Master Agreement Framework and a copy of the ISDA Cross Product Master Agreement) [appendix 3 omitted from observer note].

32. Offset legislation covering derivatives has been adopted in most countries with major financial markets and ISDA has obtained legal opinions supporting their Master Agreements in most jurisdictions.

33. Some respondents and many of the constituents we met in our extensive outreach effort argued that netting should be allowed for financial contracts governed by the ISDA Master Agreement. Those respondents are in favour of the exceptions under US GAAP for some contracts governed by master agreements but recommended extending offsetting to all master agreements that have the essential features discussed under contractual set off in appendix 1, namely -

    (a) **Netting by novation**: A provision that ensures that the master and all transactions under it form a single agreement. By this mechanism multiple individual transactions are subsumed under the general Master Agreement forming a single legal contract.

    (b) **Payment netting**: This provision ensures **automatic offset** of payments in the same transaction due on the same day and in the same currency. This provision may be applied to cash flows resulting from multiple transactions where payments again occur on the same date and in the same currency, if parties so elect in the schedule or in the confirmation.

    (c) **Close out netting:** A close out netting provision ensures that on default or termination of the agreement each included transaction is closed-out (i.e. terminated) at its mark-to-market value. The mark-to-market amount is netted against the mark-to-market value of the other terminated transactions entered into the Master Agreement. A net payment is then made at this time. The party that is out-of the-money is obligated under the master agreement to pay the net amount to the in-the money party.

## Accounting Issues to be addressed

### *A. Right to set off*

34. Offsetting has traditionally been required or permitted for financial assets and liabilities with another party. As explained earlier, both US GAAP and IFRS guidance on offsetting (netting) requires a right of setoff. Under IFRS, the right of set off must be unconditional whereas US GAAP makes exception for some conditional right of setoff.

35. The question here is whether the right of setoff can be conditional on a future event, for example, only in the default or insolvency of a counterparty to the contract. This has implication for collateral posted as part of financial transactions as the party that receives the collateral has stated right to liquidate the collateral on default.

36. The argument against offsetting a financial asset and a financial liability where there is a conditional right to offset is that, it runs against the 'basis' for offsetting. The basis for offsetting is that where there is both a right and intention to offset, doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. Doing so also reflects, in effect, that the entity only has a single financial asset or financial liability. Thus some argue that if that right is conditional on a future event, until such an event occurs, offset of the two positions would not be representationally faithful.

### *B. Single agreement provisions in Master Agreements*

37. Others argue that, for contracts governed by a master agreement, conditional set off rights do not impair the representational faithfulness of the financial statement if such positions are netted.

38. The ISDA Master Agreement consolidates the master and all transactions under it into a single agreement. That is, multiple individual transactions are subsumed under the general Master Agreement forming a single legal contract.

This provision (netting by novation) discharges mutual obligations and replaces them with a net obligation.

39. In effect, the parties only have a single financial asset or financial liability as the case may be. Thus some argue that even where the right of offset is conditional, a master agreement with netting by novation (a single contract provision), the financial asset and financial liability created should be offset and presented net.

40. It is debatable what the economic effect of such provisions is i.e. is it a derecognition/recognition issue, a netting issue or a question of measurement?

***C. Intention to set off***

41. The general principle under both US GAAP and IFRS is that offsetting a financial asset and a financial liability is permitted, if in addition to a right offset, the entity intends to settle on a net basis. The argument is that in the absence of an intention to exercise the right to settle net, presentation of the asset and liability on a net basis would be inappropriate as the amount and timing of an entity's future cash flows are not affected.

42. Others argue that the right to set off is of itself a sufficient condition for presenting net a financial asset and a financial liability. They argue that if a right of setoff is enforceable, the financial asset and financial liability together form a single asset or liability regardless of how the parties intend to settle the two positions.

43. They also argue that intention to settle net is subjective and difficult to substantiate. It also begs the question why any party with a right of set off would prefer to make and receive gross amounts (if the amounts outstanding are in the same currency and fall due on the same date).

***D. Automatic set off provisions in master agreements***

44. The typical ISDA master agreement provides for **automatic offset** of payments in the same transaction due on the same day and in the same currency. As such an agreement requires automatic netting, it is doubtful if intention to net settle is necessary in such circumstances. Consequently some argue that for master agreements with such clauses, all positions in the same currency and with the same maturity dates should be offset.

**Question for the Board:**

a) Does the Board want to address this issue as part of the derecognition project? Why or why not?

b) If the Board does want to address this issue as part of the derecognition project, does the Board require further information or analysis to be able to decide a way forward? If so what additional information or analysis would you require and why?

## APPENDIX 1: Summary of the legal basis for offset of financial assets and liabilities

45. Under law, offset arises when the amounts due from the several contracts, which may involve obligations to pay under one contract and a right to receive under another, are summed together and the several obligations to pay or be paid are combined into a single obligation for the net amount.[5]

46. There are two legal foundations for offsetting of contracts – set-off (court netting) and netting (contractual set off).

47. Although set-off and netting ("contractual set off") are conceptually equivalent (and in effect), their legal treatments are different. Set off is offsetting effected by a court whereas netting ("contractual set-off") is offset on the basis of a contract (where there would otherwise not be reason for set-off).[6]

### *Set-off (effected by court)*

48. Set-off is a legal technique whereby cross-claims are discharged to produce a net claim. It represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other. This netting is not based on a contract, but results directly from law.

49. There are two types of set-offs - solvent set-off and insolvency set-off. Solvent set-off refers to the legal basis for set-off at common law and in equity that are available outside formal insolvency proceedings. Insolvency set-off is only available in formal insolvency proceedings in circumstances prescribed by the applicable insolvency legislation. Solvent set-off may take two main forms - independent set-off and transaction set-off.

50. **Independent set off** is a procedural device designed to avoid circuity of actions and it enables the parties to have their various disputes tried in one action instead of two or more. To avoid a circuity of action, such counterclaims can be

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[5] *Goode, R.*, Legal problems of credit and security, Third edition, Sweet & Maxwell, London (2003)
[6] *Wood, Philip.*, Title Finance, Derivatives, Securitisations, set-off and Netting, 1st ed, London, Sweet & Maxwell (1995)

asserted as a defence or by the voluntary act of the parties, because it is grounded on the absurdity of making A pay B when B owes A.

51. **Transaction set-off** is a cross-claim arising out of the same transaction as the claimant's claim or one so closely connected that it operates in law or in equity as a complete or partial elimination or satisfaction of the claimant's claim. The cross claim is so closely connected that it would be unconscionable for the claimant to insist on satisfaction for his claim without giving credit for the claim made against him by the other party. Transaction set-off is ultimately based on considerations of justice.

52. **Insolvency set-off** enables the insolvent's creditor to use his indebtedness to the insolvent as a form of security. Instead of having to prove with other creditors for the whole of his debt in the insolvency, he can set off unit for unit what he owes the insolvent and prove for or pay only the balance.

***Contractual set-off***

53. This is a set-off right created by contract and governed by the terms of the contract. The parties to the contract stipulate for themselves the criteria for set-off, such as whether mutuality is required whether contingent debts may be set off, and when the set-off takes effect.

54. There is diversity of terms used in describing netting. The terms adopted in this section are based primarily on the Angell Report of the Bank for International Settlements (a leading reference on netting).[7]

55. Similar to setoff, there are two types of contract netting rules: those that apply in the course of ordinary business among solvent counterparties - (a) payment netting, (b) netting by novation (c) clearing and those that apply in resolutions of insolvent firms - (d) close-out netting.

[7] Group of Experts on Payment Systems: Report on Netting Schemes (Angell Report). BIS: Basle, 1989

(a) **Payment Netting:** Under payment netting provisions both contracting parties undertake to accept the net performance of the other party. It may apply only to amounts or deliveries due on the same date and only if the payments are in the same currency or are the same asset. The advantages of this type of netting include a reduction in transaction costs connected with the payment of the offsetting claims, lowering of risk of insufficient liquidity and occurrence of errors.

(b) **Netting by novation**: Netting by novation is a contractual provision whereby the parties agree that all contracts between them shall be consolidated into a single contract as soon as each new contract is entered into. Each new contract in a series or of a particular (type or currency) is amalgamated with any existing contract. Netting by novation therefore offers the opportunity of reducing credit risks by means of discharging mutual obligations and their replacement by a new net obligation. However in this case of novation, the obligations to be terminated do not need to be mature. This operation may repeat also several times up until the final settlement date agreed in advance. An advantage of netting by novation is that it reduces the counterparty's risks, and the existence of the net obligation represents an advantage also for the needs of capital adequacy reporting. Although typical of bilateral agreements, netting by novation may also be used at a multilateral level through a clearing house.

(c) **Close-out netting**: Close-out netting is a contractual mechanism, enabling 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". The cost of the replacement of individual positions in such transactions by new ones is determined, taking account of market prices. The market price set in this manner is then converted into one currency and the net position established. This process is intended to reduce exposures on open contracts if one party should become insolvent or a like event occurs before the settlement date.

(d) **Clearing facilities (mechanisms):** Clearing houses and exchanges provides a means of bringing together the claims of several entities, setting them off and determining their net value. Payment systems usually forms a part of the clearing systems. Typically the clearing house is a party to the individual claims and obligations. The clearing house therefore stands between each buyer and seller, guaranteeing the performance of each contract. The clearing house or exchange collects margin from each member to guarantee all participants transactions. However, as the clearing house is the holder of individual claims and obligations, the insolvency risk of one of the participants would be indirectly borne by all the participants with long positions. In effect, the risk of each individual transaction is mutualised across all clearing house or exchange participants.

### *Other netting mechanism – Collateral arrangements*

56. In most cases collateral posted against derivatives positions is under the control of the counterparty and may be liquidated immediately upon a covered "event of default". This arises both due to operation of laws governing financial transactions that recognise the right to liquidate collateral, and due to the nature of the collateral used—cash or securities delivered to the counterparty at the time the collateral is posted, and therefore under their immediate control. As such collateral posted in financial transactions serve a mitigating role in terms of counterparty risk management. Consequently, it sometimes argued that cash collaterals should be netted off against the fair value of derivative positions.

## APPENDIX 2: Description of ISDA Master Agreement Framework

1. The ISDA master agreement involves a pre-printed master agreement (either local jurisdiction single currency or multicurrency-cross-border), a schedule, and a form of confirmation.

2. Generically, these documents are often referred to together as an ISDA master and these documents, together, form a single agreement between the parties.

### *Master agreement*

3. The Master Agreement specifies the general terms of the agreement between counterparties with respect to general questions such as netting, collateral, definition of default and other termination events, calculation of damages (on default) and documentation. The master agreement contains the terms and conditions by which all (or as many as possible) relevant transactions between the parties are governed. Accordingly, one master agreement is entered into between a given market participant and each of its counterparties regardless of how many individual transactions are in place between it and each counterparty.

4. Multiple individual transactions are subsumed under this general Master Agreement forming a single legal contract of indefinite term under which the counterparties conduct their mutual business. Individual transactions are handled by confirmations that are incorporated by reference into the Master Agreement. Placing individual transactions under a single master agreement that provides for netting of covered transactions has the effect of avoiding any problems netting agreements may encounter under various bankruptcy regimes. Having only a single contract between each pair of counterparties to a Master Agreement also eliminates the problem of netting multiple contracts.

5. A copy of the ISDA cross product master netting agreement (2002 version) is attached as appendix 3.

### *Confirmation*

6. Confirmations provide the specifics of each trade between the two parties. The Confirmation also “confirms” the payment terms. It does not, however, contain the many important contractual terms and other elements found in a typical finance contract. Instead, these terms and provisions are documented in the

Master Agreement. Each Confirmation is incorporated directly into the Master Agreement itself, as opposed to being treated as an individual and distinct contract.

***Schedule***

7. The schedule is used to make certain elections and any modifications (additions and deletions) to the standard terms in the pre-printed form (Master Agreement).

***Other documents***

8. If appropriate, credit support documents (guarantees and pledge agreements) are also annexed to the master agreement. There are also definitional booklets which are incorporated by reference into the other documents.

9. The following offset provisions are available under the ISDA Master Agreement framework (see appendix 3 for a copy of the ISDA Master Agreement):

   (d) **Netting by novation**: Section 1(c) (Single Agreement) specifies that the master and all transactions under it form a single agreement. Multiple individual transactions are subsumed under the general Master Agreement forming a single legal contract of indefinite term under which the counterparties conduct their mutual business.

   (e) **Payment netting**: Section 2(c) entitled "Netting" addresses payment offset. This provision states that there will be <u>**automatic offset**</u> of payments in the same transaction due on the same day and in the same currency. Payment offset may be applied to cash flows resulting from multiple transactions where payments again occur on the same date and in the same currency, if parties so elect in the schedule or in the confirmation.

   (f) **Close out netting:** Section 5, 6 and 9 of the ISDA Master Agreement set out a detailed mechanism for close-out netting under the ISDA Framework. As part of the termination and close-out of an ISDA Agreement, each included transaction is closed-out (i.e. terminated) at its mark-to-market value. The mark-to-market amount is usually equal to the cost of replacing the individual terminated transaction and is calculated without taking into account that the counterparty is insolvent. After the amounts are determined, each close-out amount will then be netted against the mark-to-market value of the other terminated transactions entered into under an ISDA Master Agreement. A net payment is then made at this time. The party that is out-of the-money is obligated under an ISDA Agreement to pay the net amount to the in-the money party, regardless of who is the defaulting party.