

# ZENTRALER KREDITAUSSCHUSS

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## **Exposure Draft ED/2011/1 – Offsetting Financial Assets and Financial Liabilities**

Dear Sir David,

We are grateful for the opportunity to comment on the above Exposure Draft (ED) and wish to do so as follows:

We welcome the intention of the IASB and the FASB to achieve convergence of the requirements for offsetting financial assets and financial liabilities. This will eliminate the largest quantitative differences in amounts presented in balance sheets prepared in accordance with IFRSs and those prepared in accordance with US GAAP. We understand the proposal that financial assets and financial liabilities should be offset if they are subject to an unconditional right of set-off. In view of the in our opinion existing conceptual inconsistencies between the required balance sheet and note information we wish to expressly point out at this stage that we regard the general exclusion of offsetting where an entity has a conditional and legally enforceable right of set-off as inappropriate. With respect to this issue, we would have supported an approach that goes more in the direction of existing offsetting requirements<sup>1</sup> that allow net presentation for bilateral transactions executed under a master netting agreement

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<sup>1</sup> Like the existing offsetting rules under US GAAP, particularly FIN 39 and FIN 41.

such as that issued by ISDA. It is our view that derivatives transacted under master netting agreements should be reported net in the balance sheet, as they are in most cases fully collateralised to mitigate credit and liquidity risk.

We support in principle – also in view of the reasonable adjustment effort involved for IFRS users – the intention of the boards to largely retain the provisions of IAS 32. Even though the boards deny this, we have the impression, however, that the present proposals are more restrictive than the existing IAS 32 rules in some cases. The interpretation of the term “simultaneously” is an example. Whilst the term is not defined further in IAS 32, this is the case in the ED, thus making it more restrictive than in current practice. This concerns in particular contracts settled through a clearing house. If the term is interpreted narrowly, no more offsetting (e.g. of repurchase transactions) will be possible in future because these contracts are set off against each other in the clearing houses on a batch basis spread over the course of the day, i.e. they are not settled at exactly the same moment. A more restrictive approach than that pursued to date in practice is neither appropriate nor economically acceptable in our view.

Paragraph C14 in the ED states that margin accounts required by exchange-traded, centrally cleared and bilateral over-the-counter (OTC) derivative transactions are collateral and hence they are to be accounted for separately as assets or liabilities. We have concerns about the rules-based formulation of this principle. Firstly, we do not see the rationale behind precluding financial collateral from offsetting when an entity meets the offsetting requirements. Secondly, if the boards continue to preclude financial collateral from the offsetting framework, we are concerned about the broad generalisation to treat variation margin as collateral in the ED. Variation margin posted with certain exchanges or clearing houses constitutes a legal form of settlement in that it remains with the exchanges or clearing houses (in the absence of a change in the fair value of the transactions) to be used to close out and settle members’ net position.

We take a distinctly critical view of the proposed disclosure requirements. These go much further than the existing disclosure requirements and harbour the danger of information overkill for users of financial statements. We believe that, because of the need for uniform content of the balance sheet, income statement and note disclosures and the need to be economical with information, the fact that certain financial instruments are subject to a set-off arrangement should not be allowed to result in the disclosure requirements set in this respect being expanded unreasonably compared with the other disclosure requirements for financial

instruments set out in IFRS 7. We are therefore strongly against the disclosure requirements proposed in the ED for financial assets and financial liabilities which are basically subject to a set-off arrangement but one which does not meet the criteria for balance sheet offsetting.

May we point out in this context that the concrete contractual arrangements are based on the law of the countries in which the contracting parties are domiciled and that any explanation of the arrangements can thus only be comprehensible in the first place if this legal background is known in detail. This is made clear in our view by the legal complexity and the impracticability of a corresponding mandatory explanation requirement in the notes.

Irrespective of the above general remarks, we should like to reply specifically to the questions asked as follows:

**Question 1:**

**The proposals would require an entity to offset a recognised financial asset and a recognised financial liability when the entity has an unconditional and legally enforceable right to set off the financial asset and financial liability and intends either:**

- (a) to settle the financial asset and financial liability on a net basis or**
- (b) to realise the financial asset and settle the financial liability simultaneously.**

**Do you agree with this proposed requirement? If not, why? What criteria would you propose instead, and why?**

We understand the proposal made in the ED that a financial asset and a financial liability should be offset when an entity has an unconditional right of set-off and intends either to settle the financial asset and financial liability on a net basis or to realise the financial asset and settle the financial liability simultaneously. However, we take a highly critical view of the (narrow) interpretation in some cases of the criteria laid down by the boards.

The first criterion would limit the set-off to only unconditional right, but we believe that there are circumstances under which conditional right of set-off would merit the netting of a financial asset and financial liability in the balance sheet. Such circumstances could be found in the case of bilateral OTC transactions involving master netting agreements such as that issued by ISDA.

In the second criterion under the ED, the settlement of a financial asset and a financial liability would only be considered simultaneous if it occurs at the same moment. Market practitioners have interpreted this proposed requirement on simultaneous settlement to be more restrictive than the current IFRS provision contained in paragraph 48 of IAS 32. The guidance in paragraph C11 appears to prevent offsetting where settlement occurs with a central clearing house but in batches due to the volume of transactions and processing constraints. This would alter current practice on offsetting repos and reverse repos with central clearing houses. In this circumstance there is no exposure to credit risk or liquidity risk and the flows are in effect equivalent to a single net amount.

We believe that what the ED says about this criterion is contradictory, as paragraph C7 states that “the requirement for an intention to settle net or to settle simultaneously is assessed from the reporting entity’s perspective”. It follows therefore that there is no necessity to look into the clearing mechanism of each individual clearing counterparty (CCP). In paragraph C9, the ED states that the rules of a clearing house typically provide for automatic netting and cancellation of offsetting contracts and as such the entity’s intention to settle net is demonstrated. We support these above-mentioned statements in the ED, as we do not see any conceptual reasons to impose upon the reporting entity the onus to ensure that its counterparty, the CCP, has set up clearing and settlement mechanisms that fulfil the simultaneous settlement provision. We find this an unreasonable demand for reporting entities, since it would require tremendous efforts to undertake this task.

In a general context, we should like to point out that “simultaneousness” is an indistinct legal term. It is, however, not interpreted as narrowly as proposed by the IASB and the FASB in the ED. This means that over-narrow interpretation could actually have (unintended) knock-on effects on other areas. To allow practice-oriented application, the “simultaneousness” criterion should be geared to the customary market settlement arrangements.

As mentioned, paragraph C14 in the ED states that margin accounts required by exchange-traded, centrally cleared and bilateral over-the-counter (OTC) derivative transactions are collateral and hence they are to be accounted for separately as assets or liabilities. This guidance in paragraph C14 is confusing, since it could be interpreted to impose a rule that offsetting is not permitted even where the general principles of offsetting are met. In certain instances with central clearing houses the single net daily cash flow incorporates margin and the settlement of flows due on derivative contracts. Where this is combined with the legally enforceable right to set off, then current practice is to offset.

We believe that the use of collateral and margin accounts mitigates gross settlement risk significantly and not allowing their netting would ignore the economic substance of arrangements that involve the provision of collateral and margin accounts by the counterparties. Moreover, in the light of the recent financial crisis, there has been a move to have more bilateral OTC derivative trades settled through CCPs in order to reduce the counterparties' credit exposure and liquidity risk. We are concerned that the CCP initiatives would suffer a setback if transactions executed with CCPs are required to be presented gross in the balance sheet because the offsetting framework fails to recognise the netting eligibility of collateral and margin accounts, including imposing the unnecessary and unreasonable requirement for settlements to occur at the same moment in time. We therefore urge the boards to develop a principles-based approach for determining the offsetting requirements for collateral and margin accounts that best reflect the above-mentioned arrangements in the financial statements.

At this point, we wish to refer to the conceptual reservations outlined by us (see reply to question 4) concerning the intermingling of balance sheet and risk-related disclosure requirements proposed in the ED. To ensure consistency between balance sheet and note disclosures, the requirements for offsetting in the balance sheet should be geared either to predominantly cash flow-based criteria or to basically risk-related criteria. In the latter case, the offsetting criteria would then logically have to be adapted methodologically to the economic or prudential offsetting criteria.

**Question 2:**

**It is proposed that financial assets and financial liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of set-off. The proposals specify that an unconditional and legally enforceable right of set-off is enforceable in all circumstances (i.e. it is enforceable in the normal course of business and on the default, insolvency or bankruptcy of a counterparty) and its exercisability is not contingent on a future event. Do you agree with this proposed requirement? If not, why? What would you propose instead, and why?**

As already outlined, we believe that the general exclusion of offsetting based on conditional and legally enforceable rights of set-off is inappropriate.<sup>2</sup> Particularly in the case of derivative transactions, offsetting means that the credit risk attached to derivatives portfolios is presented better for several reasons. All derivative transactions are entered into within the framework of a legal contract and are all subject to the respective contractual provisions. The counterparty risk occurs at MNA (master netting agreement) level and is measured at portfolio level. In the event of default, only a claim arises, i.e. only a payment to settle the claim is made. The credit risk is managed at portfolio level and only the net exposure is hedged. The payment flows resulting from derivative transactions can be converted over time from assets into liabilities (and vice versa), so that offsetting does not result in a loss of decision-useful information. Offsetting is in line with the way the instruments are managed in the portfolio. In addition, liquidity is presented better through offsetting, as margin payments are determined and calculated on the basis of the net exposure.

We otherwise refer to our reply to question 1.

### **Question 3**

**The proposals would require offsetting for both bilateral and multilateral set-off arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of set-off may be present?**

We believe that offsetting should generally be possible between several contract participants/counterparties.

At the same time, we should like to point out that our understanding is that what paragraphs 8 and 9 of the ED say about master netting agreements and collateral should be seen in the same context as the “*multilateral arrangements*” explicitly mentioned in this question.

We assume that the general non-recognition of master netting agreements contained in paragraph 8 refers to the contracts customary at present in practice that do not definitely fulfil in all cases the stringent requirements for the unconditionality of an enforceable right to settle

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<sup>2</sup> With respect to this issue, we would have supported an approach that goes more in the direction of existing offsetting requirements according to FIN 39 and FIN 41 where derivatives are to be presented net if transacted with the same counterparty under a master netting agreement such as ISDA where it provides for net settlement through a single payment in the same currency in the event of default.

net or the possibility to offset at any time. We would therefore welcome clarification to the effect that, depending on the respective legal environment and the actual contractual arrangements, master netting agreements for example may fulfil the substantive requirements of the ED and that offsetting is consequently not generally ruled out.

Finally, we wish to point out that – particularly because of the experience made in the financial crisis – bilateral and multilateral set-off arrangements, especially with central counterparties/ clearing houses (CCPs), are gaining in importance as a means of effectively managing or preventing settlement risk and counterparty risk.

#### **Question 4**

**Do you agree with the proposed disclosure requirements in paragraphs 11–15? If not, why? How would you propose to amend those requirements, and why?**

In our view, the proposed note disclosures are too comprehensive and excessive compared with the other disclosure requirements for financial instruments.<sup>3</sup> They also create redundancies in relation to IFRS 7 (particularly IFRS 7.15 and IFRS 7.36-38).

We take a highly critical view of the note disclosures set out in paragraphs 12(d), 12(e), 12(f) and 12(g), since these would trigger a detailed note disclosure requirement despite the absence of a right of set-off in the balance sheet. According to paragraph 11 of the ED, the information disclosed should enable users of financial statements to understand the effect of rights of set-off and related arrangements on an entity's financial position. In the case of disclosures on rights of set-off that do not permit any balance sheet offsetting because at least one necessary condition for offsetting is not met, this informational purpose would not be achieved, however. Instead, pointless and – compared with the other disclosures under IFRS 7 – unreasonably expanded disclosures on items not shown in balance sheets are proposed for financial statement users. What is more, as mentioned earlier, any explanation of specific contractual arrangements would require a presentation not only of the contract but also of the concrete and usually country-specific legal background. Without this general legal knowledge, the information would not be comprehensible as such in the first place. For example, disclosure of a fictitious net amount of financial assets and financial liabilities that would be hypothetically obtained after taking into account set-off measures not permitted in the balance sheet (paragraph 12(e)) would not be of any help to financial statement users in our view. Instead, such disclosure would be counter-productive for conveying decision-useful information, as

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<sup>3</sup> See also EFRAG draft comments, paragraph 30.

presentation would not reflect the economic content of transactions. In addition, the new and internationally harmonised offsetting rules mean that an explanation of the conditional rights going beyond actual offsetting will no longer be necessary in any case for comparability purposes.

The disclosure requirements set out in paragraphs 12(a) and (b) take adequate account of the legitimate concern of financial statement users in being able to understand the offsetting carried out in the balance sheet. The balance sheet and the notes therefore together form a single unit reflecting the expected future cash flows and the associated credit risk and liquidity risk. Consequently, the fact that financial instruments are subject to a conditional right of set-off must not lead to corresponding note disclosure requirements. We therefore categorically reject the disclosures proposed in the ED in relation to financial assets and financial liabilities which cannot be offset in the balance sheet and call for their removal.

In this context, we should like to expressly point out that the expanded note disclosure requirements proposed in the ED lead to the intermingling of balance sheet and risk-related disclosures, something which we oppose for conceptual reasons. To ensure an appropriate separation in conceptual terms, we believe that either a predominantly cash flow-based approach or essentially risk-related reporting needs to be adopted, with the intended meaningfulness of reporting with regard to the balance sheet offsetting permitted being firmly pursued at the same time. In our view, if the offsetting criteria are designed on a cash-flow basis as proposed in the ED, the meaningfulness of the note disclosures is not consistent with financial statement presentation unless the expanded, risk-related disclosure requirements set out in paragraphs 12(d)-(g) are dropped.

Otherwise, to ensure consistency with internal risk reporting procedures, the balance sheet offsetting criteria would have to be adapted methodologically to the economic or prudential offsetting criteria.

In addition, we wish to point out with regard to the disclosure requirements set out in paragraphs 12(f) and (g) that such cases are already subject to disclosure requirements under IFRS 7. According to IFRS 7.14-15 and IFRS 7.36(b), collateral received must be described separately. We therefore believe that there is no need for the additional disclosures proposed in paragraphs 12(f) and (g) of the ED, so that we are strongly in favour of dropping these new requirements from the ED.



**Question 5**

- (a) Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements, and why?**
- (b) Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.**


Bearing in mind the proposed comprehensive disclosure requirements, we believe that prior-year comparative figures should not have to be indicated in the notes in the year of first-time implementation. Disclosure of the legal rights applying the previous year would not, in our view, provide any useful information for financial statement users in the current year.

The first-time implementation rule should, we believe, be consistent with the other phases of IFRS 9, as the provisions of the standard must be seen in the context of full implementation of all IFRS 9 provisions. With this in mind, we are strongly in favour of dropping the comprehensive note disclosure requirements, particularly with regard to legal details and to financial assets and financial liabilities which are basically subject to a right of set-off but one which does not meet the conditions for balance sheet offsetting.

Particularly the information called for on conditional rights of set-off and the requirement to explain contractual arrangements that did not previously lead to offsetting are not available in financial accounting documents. Their disclosure has not been required so far, nor is it useful information for financial statement users in our view. Moreover, to determine the required data, existing analyses carried out for prudential or economic purposes can only be used to a very limited extent, as the information called for in the ED differs from the information gathered for other purposes.

Yours sincerely,  
on behalf of the Zentraler Kreditausschuss,  
Bundesverband deutscher Banken

  
Hans-Joachim Massen

  
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