



Draft Comment Letter

Comments should be submitted by 18 April 2011 to Commentletters@efrag.org

[XX April 2011]

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam

Re: Exposure Draft Offsetting Financial Assets and Financial Liabilities

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IASB Exposure Draft *Offsetting Financial Assets and Financial Liabilities* ('the ED'), issued by the IASB on 28 January 2011. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission, on endorsement of the definitive IFRS in the European Union and European Economic Area.

EFRAG welcomes the IASB and the FASB efforts to develop joint proposals for converged requirements for offsetting financial assets and liabilities. EFRAG is supportive overall of the IASB decision to use, as a basis for the converged requirements, the existing guidance for offsetting financial assets and financial liabilities in IAS 32 *Financial instruments: Presentation*, with some refinements.

Our major comments are outlined below:

- *Offsetting criteria:* We support the IASB's proposal to establish an overarching principle for offsetting financial assets and financial liabilities. We also agree with the proposal to retain the existing criteria in IAS 32 for offsetting financial assets and financial liabilities; namely, the existence of a legally enforceable right and the intention to settle the financial asset and the financial liability on a net basis or simultaneously. In addition, we agree with the proposal to clarify that the right to set off the financial asset and the financial liability must be unconditional and legally enforceable in all circumstances. These criteria are currently applied under the existing IAS 32, and we believe that they result in the faithful representation of the underlying economic event, being a *net* cash

inflow or outflow, and therefore ensure the relevance of the information provided to the users of financial statements.

- *Disclosures:* We agree with the proposal to require disclosures about rights to offset financial assets and financial liabilities of an entity and the related arrangements, including information about collateral and master netting arrangements. We understand that different groups of users may have different needs; and that some users may require information about gross positions for their analysis, regardless of the fact that the actual cash inflows or outflows occur as a net position. Therefore, we believe that the proposed disclosure requirements would meet the user needs. However, we urge the IASB to consider the proposals in the ED in the context of the existing disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*, taking into account the disclosure proposals made in other consultation documents in respect of accounting for financial instruments; and to ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.

Our detailed responses to the questions in the ED are presented in the Appendix to this letter.

If you wish to discuss our comments further, please do not hesitate to contact Chiara Del Prete, Ralitza Ilieva or me.

Yours sincerely,

Françoise Flores
EFRAG, Chairman

Appendix

Response to questions in the Exposure Draft

Question 1—Offsetting criteria: unconditional right and intention to settle net or simultaneously

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?

Notes for EFRAG's constituents

- 1 *The Exposure Draft Offsetting Financial Assets and Financial Liabilities (the 'ED') establishes a principle for the offsetting of financial assets and financial liabilities. The proposed principle requires an entity to offset a recognised financial asset and recognised financial liability only when:*
 - (a) *the entity has a right to, or obligation for, only the net amount; and*
 - (b) *the amount, resulting from offsetting, reflects an entity's expected cash flows from settling two or more separate financial instruments.*
- 2 *The ED is also amending the current offsetting guidance of IAS 32. Paragraphs 42 to 50 of IAS 32 require that a financial asset and a financial liability shall be offset when, and only when, an entity currently has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.*
- 3 *The ED amends these criteria, by:*
 - (a) *requiring that the right to set off should be unconditional, that is, it should be a right whose exercisability is not contingent on the occurrence of a future event;*
 - (b) *clarifying that the right to set off should be legally enforceable in all circumstances (including the normal course of business and in the case of default by, or the bankruptcy of, a counterparty).*
- 4 *The ED introduces guidance on how an entity should demonstrate its intention to settle net or simultaneously, in order to offset a financial asset and a financial liability in accordance with the offsetting criteria (paragraphs C7-C10 of the ED). Similar to paragraph 48 of IAS 32, even if the period between settlements of the instruments is brief, settlements are only considered to be simultaneous if they take place at the same moment.*
- 5 *The ED clarifies that margin accounts are a form of collateral for the counterparty or clearing house and are accounted for separately (paragraphs 9 and C14 of the ED).*
- 6 *The board observed that the offsetting criteria will not be consistent with Basel Framework requirements, as defined by the banking regulators (paragraphs BC64 and BC65 of the ED). The board observed that the difference in the criteria is inevitable, given the different purposes of the prudential regulation.*

EFRAG's response

EFRAG supports the IASB's proposal to establish an overarching principle for offsetting financial assets and financial liabilities.

EFRAG also agrees with the proposal to retain the existing criteria in IAS 32 for offsetting financial assets and financial liabilities.

- 7 EFRAG supports the IASB's proposal to establish an overarching principle for offsetting financial assets and financial liabilities. EFRAG also supports the IASB decision to use, as a basis for the converged requirements, the existing guidance for offsetting financial assets and financial liabilities in IAS 32 *Financial instruments: Presentation*, with some refinements. In addition, we agree with the proposal to clarify that the right to set off the financial asset and the financial liability must be unconditional and legally enforceable in all circumstances. These criteria are currently applied under the existing IAS 32, and we believe that they result in the faithful representation of the underlying economic event, being a *net* cash inflow or outflow, and therefore ensure the relevance of the information provided to the users of financial statements.
- 8 Some argue that the accounting requirements for offsetting should be aligned with those of prudential regulation. EFRAG is strongly of the view that the objective of financial reporting is to provide decision useful information to various groups of users in making their decisions about providing resources to the entity. We believe that, in general, it is possible that accounting standards may be developed in such way that they satisfy the needs of both prudential supervisors and other groups of users, since they may share some interests. However, we consider that in this specific case, there are some significant differences, as the Basel Framework for prudential regulation focuses on depicting the net credit exposure of an entity to a counterparty, and therefore permits netting in a wider range of circumstances than IFRSs. EFRAG acknowledges that it may not be possible to reconcile such differences and believes that, where there are divergent interests, the needs of investors and creditors must take precedence over the wide range of measures that prudential regulators may require institutions to adopt.
- 9 The ED includes application guidance on periodic re-assessment of the right of set-off in paragraph C15. The guidance clarifies that conditional right can become unconditional, after that the contingent event occurs. However, a right to set off that is exercisable only before a specific date or that may be removed by a future event, does not meet the offsetting criteria. It is our understanding that the purpose of the application guidance is to *clarify* the requirements included in the main text, rather than to introduce important additional requirements. As currently drafted, the main text of the ED does not include any requirements in respect of re-assessment of the right of set-off; therefore, EFRAG believes it would be more appropriate to move them from the appendix to the main text.
- 10 EFRAG notes that paragraph 71 of IAS 12 *Income Taxes* and paragraph 116 of IAS 19 *Employee Benefits* include offsetting criteria, which are drafted in a way similar to the current offsetting criteria in IAS 32 for financial assets and liabilities. In addition, both standards (i.e. paragraph 72 of IAS 12 and paragraph 117 of IAS 19) specifically refer to this similarity. We suggest that the Board consider if any consequential amendments are needed to these two standards, since they both explicitly refer to the offsetting guidance in IAS 32.

Question 2—Unconditional right of set-off must be enforceable in all circumstances

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?

Notes for EFRAG's constituents

- 11 *The board explains that alternative approaches to the offsetting criteria in the ED have been considered and then dismissed (paragraphs BC29-BC56 of the ED).*
- 12 *One alternative considered was to require offsetting when an entity has a conditional right to set-off, as in the case of the master netting agreements. Paragraph 8 of the ED amends and improves the guidance in paragraph 50 of IAS 32. This paragraph clarifies that a master netting agreement between two counterparties (which provides for a single net settlement of a number of financial instrument transactions executed by the two counterparties) does not meet the offsetting criteria, because the right to set-off in this agreement is conditional.*
- 13 *The proposals require that a right of set-off must be legally enforceable in all circumstances; hence no offsetting would be permitted if such right of set-off disappears if one counterparty defaults.*

EFRAG's response

EFRAG agrees with the proposal to clarify that the right to set off the financial asset and the financial liability must be unconditional and legally enforceable in all circumstances.

- 14 EFRAG welcomes the clarification that the ED introduces in the requirements of IAS 32. The proposals clarify that, in order to meet the offsetting criteria, the right to set-off should be unconditional and legally enforceable in all circumstances. We agree that only if the right has these two characteristics, the entity has the ability to settle net or simultaneously and this ability is ensured.
- 15 We acknowledge that the net amount of the financial instruments executed within an agreement that provides for conditional right to set-off (such as those existing in a master netting agreement) helps in describing the net credit exposure of the entity to a counterparty, as such an agreement is currently used for mitigating the credit risk. Nevertheless, we agree with the board that this information is better presented in the notes to the financial statements and netting on the basis of one type of risk (credit risk) is not a sufficient condition for net presentation on the face of the statement of financial position. We agree with the board that net presentation on the face of the primary statement would in this case obscure other risks (counterparty, operational or market risks) and we observe that these risks are present also in the case of zero net credit exposure.
- 16 In addition, EFRAG believes that in order to be consistent with the objective of general purpose financial reporting, the amounts presented on the face of financial statements should faithfully represent the cash flows, which an entity expects in the ordinary course of the business (focusing on the liquidity profile of the transaction). Therefore, the offsetting of financial assets and financial liabilities would not be appropriate if the outcome of the transaction was contingent on a future event.

Question 3—Multilateral set-off arrangements

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?

Notes for EFRAG's constituents

- 17 *The proposals would require offsetting for arrangements that meet the offsetting criteria and could involve two parties (bilateral) or more (multilateral).*
- 18 *An example of a multilateral agreement is one involving a bank and a group of companies, in which each company in the group agrees that its credit balance may be the subject to set-off in respect of debit balances of other members of the group.*
- 19 *In respect of the multilateral arrangements, paragraph 45 of IAS 32 specifies that a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off, however it notes that these circumstances are unusual. The proposals in the ED do not change the current requirements, but move the reference to the 'unusual circumstances' from the body of the standard to the application guidance (paragraph C13 of the ED).*

EFRAG's response

EFRAG agrees with the proposal to keep the scope of the offsetting guidance unchanged and require offsetting for both bilateral and multilateral arrangements that meet the offsetting criteria.

- 20 EFRAG agrees with the proposal to keep the scope of the offsetting guidance unchanged and require offsetting for both bilateral and multilateral arrangements that meet the offsetting criteria (the unconditional and legally enforceable right to set off; and the intention either to settle on a net basis, or to realise the financial asset and settle the financial liability simultaneously).
- 21 We agree with the IASB's conclusion that although multilateral offsetting is likely to be unusual, there is no basis for explicitly excluding multilateral netting arrangements from the scope of offsetting if all the other criteria, including legal enforceability, are satisfied for the transaction.

Question 4—Disclosures

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?

Notes for EFRAG's constituents

- 22 *The ED requires an entity to provide information about rights of set-off and related arrangements (such as collateral agreements) associated with the entity's financial assets and financial liabilities and the effect of those rights on the entity's financial position. As a minimum the entity should disclose the following information by class of financial instruments:*
- (a) the gross amounts (before taking into account amounts offset in the statement of financial position and portfolio-level adjustments for the credit risk of each of the counterparties or the counterparties' net exposure to the credit risk of the entity);*
 - (b) showing separately,*
 - (i) the amounts offset in accordance with the offset criteria to determine the net amounts presented in the statement of financial position;*
 - (ii) the portfolio-level adjustments made in the fair value measurement to reflect the effect of the entity's net exposure to the credit risk of counterparties or the counterparties' net exposure to the credit risk of the entity; and*
 - (iii) the net amount presented in the statement of financial position;*
 - (c) the amounts of financial assets and financial liabilities that the entity has an unconditional and legally enforceable right to set off, but that the entity does not intend to settle net or simultaneously;*
 - (d) the amount of financial assets and financial liabilities that the entity has a conditional right to set off, separately by each type of conditional right;*
 - (e) the net amount of financial assets and financial liabilities after taking into account the effect of the items in (a)–(d);*
 - (f) for cash or other financial instrument collateral obtained or pledged in respect of the entity's financial assets and financial liabilities:*
 - (i) the amount of cash collateral (excluding the amount of cash collateral in excess of the amount in (b)(iii)); and*
 - (ii) the fair value of other financial instruments (excluding the portion of the fair value of such collateral that is in excess of the amount in (b)(iii));*
 - (g) the net amount after taking into account the effect of the items in (e) and (f).*
- 23 *The ED proposes to require presentation of this information in a tabular format, unless another format is more appropriate.*
- 24 *The ED also proposes to require a description of each type of conditional right of set-off separately disclosed, including the nature of those rights and how management determines each type. In addition, an entity would also be required to disclose the criteria it applies in aggregating similar rights of set-off.*
- 25 *If the disclosures are provided in more than a single note to the financial statements, an entity would be required to cross-reference those notes.*

- 26 When an entity measures financial assets and liabilities individually at fair value, it needs to take account of the credit risk (and other factors) specific to those financial assets and liabilities. When there is a difference in the credit rating between an entity and its counterparty, the financial assets and liabilities are affected to a different extent. When an entity is permitted to offset the financial assets and liabilities, the net asset (net liability) should reflect the credit risk assumption appropriate for the net exposure to credit risk. The disclosure described in paragraph 22(b)(ii) above, requires disclosure of this portfolio-level adjustment.

EFRAG's response

EFRAG agrees with the proposal to require disclosures about rights to offset financial assets and financial liabilities of an entity and the related arrangements, including information about collateral and master netting arrangements. However, we urge the IASB to ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.

- 27 We agree with the proposal to specify disclosure requirements about rights to offset financial assets and financial liabilities of an entity and the related arrangements, including information about collateral and master netting arrangements, to enable users of financial statements to understand the effect of those rights and arrangements on the entity's financial position. We also agree that information should be sufficiently disaggregated that it does not obscure important differences between the different types of rights of set-off or related arrangements.
- 28 We understand that different groups of users may have different needs; and that some users may require information about gross positions for their analyses regardless of the fact that the actual cash inflows or outflows occur as a net position. Therefore, we believe that both sets of numbers (gross and net) would be useful for users of financial statements. EFRAG believes that the proposed disclosures would enable users to see the link between the gross and the net amounts and the relationship between financial assets and financial liabilities. We agree that this information should be provided in the notes to the financial statements.
- 29 EFRAG notes that paragraphs 36(a) and (b) of IFRS 7 require disclosures related to an entity's credit risk, including information about collateral and other credit enhancements. EFRAG observes that currently the level of detail in disclosures about collateral and other credit enhancements, including the amounts that could be settled under a netting agreement, varies. Some entities may already provide disclosures similar to those proposed in the ED – however, not necessarily in the same format required by the ED. The different level of detail reduces comparability between entities and complicates analysis by users. Therefore, we broadly support the proposal to specify clearly the requirements for disclosures about financial assets and financial liabilities that the entity has a conditional right to set off. We believe that this requirement would increase consistency in the level of detail of information provided and would therefore improve the comparability between the entities.
- 30 However, the proposals in the ED would expand significantly the disclosure requirements in respect of one specific aspect of financial instruments, and taking IFRS 7 as a whole, this level of detail could be seen as disproportionate compared to the other disclosure requirements. We believe that the IASB should provide a rationale as to why such detailed disclosure requirements are needed for one specific aspect of financial instruments, whilst in respect of other topics, IFRS 7 sets out just general principles for disclosures. We also note that consultation documents on other active phases of the IAS 39 *Financial Instruments: Recognition and Measurement* replacement project propose other specific disclosure requirements. Therefore, we urge the IASB to consider the proposals in the ED in the context of the existing

disclosure requirements in IFRS 7, taking into account the disclosure proposals made in other consultation documents in respect of accounting for financial instruments; and to ensure that the level of guidance included in the standard remains consistent and balanced across topics.

Question 5—Effective date and transition

- (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.

Notes for EFRAG's constituents

31 *The ED does not provide an effective date.*

32 *The ED prescribes that the presentation and disclosure principles shall be applied retrospectively for any period presented that begins before the date of initial application.*

EFRAG's response

EFRAG supports the proposed retrospective application.

33 EFRAG's strong preference is that all new or amended accounting requirements should be applied retrospectively, because this significantly enhances the comparability and usefulness of the information provided. Therefore, we would support the proposed retrospective application.

34 We observe that the effective date of the proposals should not necessarily be aligned with the application of IFRS 9 *Financial Instruments*, but could be an earlier date.

35 The ED clarifies, but does not change, the current IFRS requirements for offsetting of financial assets and financial liabilities. In addition, it expands current requirements of IFRS 7 in respect of credit risk and specifies disclosure requirements about rights to offset financial assets and financial liabilities of an entity and the related arrangements, including information about collateral and master netting arrangements. The level of changes for each individual entity would depend on the level of detail currently provided in their financial statements.

Question to constituents – costs and benefits

36 Do you believe that the benefits resulting from the proposals would outweigh the costs related to it? Please provide arguments to support your view specifying the benefits and costs considered.

Question to preparers – transition

37 Please provide your estimate of how long your entity would reasonably require to implement the proposed disclosure requirements.