

29 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 amendments.

Our major comments are outlined below, while our detailed responses to the questions in the ED are presented in the Appendix to this letter.

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.

However, we recommend that the Board adopt a more principles-based approach to the offsetting requirements in the following two cases:

- We believe that the simultaneous settlement criterion, which requires settlement 'at the same moment', might be interpreted in a way that prevents offsetting in a wide range of circumstances. To ensure that the offsetting requirements can be applied in accordance with the underlying principle, we recommend that the Board consider requiring offsetting where there is no settlement risk.
- The ED prohibits offsetting of cash collateral against the associated financial assets or liabilities even in instances where all offsetting criteria are met. We believe that this is an unnecessary restriction that prevents entities from applying the principles underlying the offsetting requirements. Therefore, the Board should lift this restriction in circumstances where the criteria for offsetting are met.

Disclosures and effective date

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.

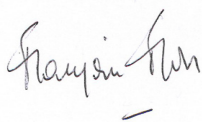
We understand that different groups of users may have different needs; and that some users may require information about rights to offset that may exist. Therefore, we believe that the proposed disclosure requirements would meet the user needs. In particular, we agree with the proposal to require disclosures 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 also note that the proposed disclosures regarding the portfolio-level adjustments for the credit risk are not relevant in terms of offsetting financial assets and financial liabilities. Instead, the information is more relevant for understanding the way the fair value of financial instruments is measured. If the Board were to retain the requirements in paragraphs 12(a) and 12(b), it should explain better why the required information is decision-useful.

Finally, we disagree with the requirements in paragraphs 12(a) and 12(b) to disclose grossed-up information about financial instruments that meet the offsetting criteria and that have been offset on the face of the statement of financial position. Where assets and liabilities are offset, the result represents a single asset or liability in accordance with the Framework.

If you wish to discuss our comments further, please do not hesitate to contact Chiara Del Prete, Ralitza Ilieva, Marc Labat 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?

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.

The Board should reconsider amendments to IAS 32 regarding 'simultaneous settlement' and the treatment of cash collateral and margin accounts.

- 1 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 amendments. 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.
- 2 The simultaneous settlement criterion is explained in paragraph C11 of the ED as requiring settlement 'at the same moment'. While we agree with this principle, we note that an overly restrictive interpretation might considerably narrow – compared to practice under IAS 32 – the range of circumstances in which offsetting is required. For example, this might prevent offsetting where settlement occurs with a central clearing house, because for operational reasons they may settle trades in batches rather than have a single settlement of all trades at the same moment. To ensure that the offsetting requirements can be applied in accordance with the underlying principle, we recommend that the Board consider requiring offsetting where there is no settlement risk.
- 3 The ED prohibits cash collateral, including margin accounts, to be offset against the associated financial assets or liabilities even in instances where all offsetting criteria are met. We believe that this is an unnecessary restriction that prevents entities from applying the principles underlying the offsetting requirements. Therefore, the Board should lift the restriction and require that financial assets or liabilities are offset in all circumstances under which the offsetting criteria are met.

- 4 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.
- 5 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.
- 6 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?

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.

- 7 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.

- 8 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.
- 9 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?

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.

- 10 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).
- 11 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?

EFRAG's response

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

We disagree with the requirement to disclose grossed-up information about financial instruments that meet the offsetting criteria and that have been offset on the face of the statement of financial position.

- 12 We have the following concerns about the disclosure requirements:
- (a) 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.
 - (b) 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.
- 13 We understand that different groups of users may have different needs; and that some users may require information about rights to offset that may exist. Therefore, we believe that for users of financial statements it would be not only useful to know the amounts netted according to the offsetting criteria, but also the amounts that would result from rights to offset that do not meet the offsetting criteria. For example, such information could be useful in assessing the credit risk profile of the entity. We agree that this information should be provided in the notes to the financial statements.

- 14 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.
- 15 Where assets and liabilities are offset, the result represents a single asset or liability in accordance with the Framework. Therefore, we disagree with the requirements in paragraphs 12(a) and 12(b) to disclose grossed-up information about financial instruments that meet the offsetting criteria and that have been offset on the face of the statement of financial position.
- 16 Furthermore, we note that the proposed disclosures regarding the portfolio-level adjustments for the credit risk are not relevant in terms of offsetting of financial assets and financial liabilities. Instead, the information is more relevant for understanding the way the fair value of financial instruments is measured. If the Board were to retain the requirements in paragraphs 12(a) and 12(b), it should explain better why the required information is decision-useful.

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.

EFRAG's response

EFRAG supports the proposed retrospective application. The effective date of the ED should be aligned with the effective date of IFRS 9.

- 17 EFRAG's strong preference is that all new or amended accounting requirements should be applied fully retrospectively, because this significantly enhances the comparability and usefulness of the information provided. Therefore, we would support the proposed full retrospective application.
- 18 As noted in our response to Question 4 above, the disclosure requirements proposed by the ED should be reconsidered in the overall context of the existing requirements of IFRS 7 and financial instrument disclosures proposed as part of the IFRS 9 *Financial Instruments* project. Therefore, we believe that the effective date of the proposals should be aligned with the effective date of IFRS 9 and IFRS 7 revised.