



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

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Sir David Tweedie
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30 Cannon Street
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Financial Instruments: Offsetting Financial Assets and Financial Liabilities

Dear Sir David

The Committee welcomes the opportunity to comment on the IASB's Exposure Draft (ED) *Offsetting Financial Assets and Financial Liabilities*. The Committee has a strong interest in high quality financial reporting by banking organisations. We encourage both the IASB and the FASB (collectively referred to herein as the "Boards") to continue developing a single set of high quality accounting requirements that would be beneficial to supervisors, investors and other users across the globe. Our interest is consistent with the April 2009 call by the G20 Leaders for "accounting standard setters to work urgently with supervisors to [...] achieve a single set of high-quality global accounting standards"¹ as an action to strengthen financial supervision and regulation.

This proposal is of particular importance to the Committee because a number of key regulatory ratios and measures are based on total assets or average total assets. The offsetting (or netting) of derivative assets and liabilities, in particular, has presented challenges with respect to comparing banks in different jurisdictions and developing common prudential guidance that can be applied in a global environment. For example, under Basel III's leverage ratio,² adjusted total assets in the denominator would be computed based on the existing Basel II netting requirements largely because accounting offsetting results currently differ significantly between jurisdictions. Therefore, the ED's proposed disclosure requirements are particularly important for facilitating regulatory adjustments of audited financial information to meet important supervisory goals.

¹ G20 Communiqué, *Declaration on strengthening the financial system*, London, 2 April 2009, available at www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

² The Committee will test a minimum Tier 1 leverage ratio of 3% during the parallel run period from 1 January 2013 to 1 January 2017. The Basel III rules, including the leverage ratio, are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010), which is available at www.bis.org/publ/bcbs189.htm.

The Committee supports the development of a converged standard that defines specific offsetting criteria and mandates offsetting when the criteria are met. We agree with the Boards' decision to retain an approach based on legal enforceability and the intention either to settle on a net basis or to realise the eligible assets and settle the eligible liabilities simultaneously. We believe that such an approach would provide users with useful information on future cash flows when such information is presented on the face of the balance sheet.

However, the guidance provided to operationalise the netting criteria requires further clarification. For example, it may be necessary for the Boards to explore further the nature and function of collateral and margin amounts associated with instruments meeting the offsetting criteria. In particular, we encourage the Boards to consider collateral and margin amounts together as part of derivative and repurchase transactions when they are managed by a central counterparty (CCP) clearing house since they are one component of the settlement of a transaction. We believe that, under certain circumstances, cash collateral, including margin amounts, and the associated financial instruments should meet the offsetting criteria, and that the Boards' conclusion in paragraph BC63 is too restrictive.

In addition, although the Committee agrees that the concept underlying simultaneous settlement is appropriate, we encourage the Boards to consider further the notion of simultaneous settlement to make it operational. Requiring that settlements take place "at the same moment" could be challenging.

Our responses to some of the specific questions outlined in the ED are set out in the Appendix below. We trust you will find these comments helpful.

These comments have been prepared by the Committee's Accounting Task Force chaired by Sylvie Mathérat, Deputy Director General at the Banque of France. If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Art Lindo at the US Federal Reserve Board (+1 202 452 2695), or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Nout Wellink', with a stylized, flowing script.

Nout Wellink

cc: Ms Leslie F Seidman, Chair, FASB

Appendix: Responses to specific questions

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?

We agree with the offsetting criteria revolving around legal rights and management intent. However, we note that the manner in which these criteria have been defined presents operational challenges. Nevertheless, we believe that the proposed approach could provide information that is useful for assessing the entity's ability to generate cash in the future, the nature and amounts of the entity's economic resources and claims against the entity.

To address operational challenges, we believe that the way the offsetting criteria are implemented deserves further clarification and that more detailed guidance would be necessary, in particular for transactions settled through CCPs and/or tripartite agreements. Further refinements are also needed to ensure derivative and repurchase agreement transaction positions, collateral, and margining amounts are reported consistent with the manner in which they are managed. However, we also note that it is important to distinguish certain amounts given or received as a guarantee against default (eg guarantee deposit) from those amounts that are not conditional on default and are used to settle or partially settle the underlying financial instruments.

For the financial statements as a whole, we believe that requiring information about both how derivative positions are managed (including consideration of rights and obligations resulting from derivative positions), and how certain payments are transmitted between counterparties is essential from an operational standpoint. Although we note that the intent to settle net may be a worthy criterion, it should consider the economic impact of collateral and margining amounts.

We note that the intent to realise the financial asset and settle the financial liability simultaneously is also a worthy criterion, but "simultaneously" should be defined in a more practical manner than "at the same moment" or "instantaneously". Although, we recognise the need to settle within the shortest practical period of time, simultaneous settlement, as currently defined, may not be operational because counterparties would find it overly burdensome to coordinate activities so precisely. This definition is particularly an issue where clearing houses are used. The Committee believes institutions generally should have the ability to satisfy the simultaneous settlement criterion for offsetting assets and liabilities when their counterparty is a well-managed clearing house with adequate risk management safeguards that completes settlements within the same day. This notion would be congruent with the G20 commitment to having standardised over-the-counter derivative contracts being

traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.³

The Committee would like to observe that any guidance that is developed should not preclude CCPs from performing their settlement in batches while taking into account their technical constraints.

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 (ie 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?

We agree with the proposed requirement that the right of set-off must be legally enforceable. As part of their outreach, we encourage the Boards to consider how the requirement that this right be unconditional would apply in various legal jurisdictions, including those of countries looking to move to IFRS, in order to avoid any unintended consequences.

We also believe that it is crucial to have the disclosure requirements on offsetting relating to both unconditional and conditional rights to set off (see our response to Question 4 below).

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?

As a general principle, we note that transparent and detailed disclosures on offsetting arrangements based upon differing criteria may provide a basis for reconciling various netting approaches applied across the globe. The Committee broadly agrees with the tabular disclosure of gross, accounting net and total net amounts. However, we note that neither gross nor net is sufficient for understanding derivatives in many circumstances and that appropriate qualitative disclosure is needed. We encourage the Boards to develop and refine these aspects of its proposal through further dialogue and outreach with its key stakeholders. We also note that financial institutions will face practical challenges with searching for all rights of offset with amortised cost assets such as loans and deposits that are scoped into this ED. Consideration should be given to keeping such kinds of netting disclosures to a reasonable level.

³ Leaders' Statement: The Pittsburgh Summit, 24-25 September 2009, <http://www.pittsburghsummit.gov/mediacenter/129639.htm>.

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.

The Committee notes that no effective date is specified in this proposal. Retrospective application would be acceptable as long as there is sufficient time provided for implementation.

The Committee would also like to take this opportunity to remind the Boards of our 31 January 2011 comment letter to the IASB on its *Request for Views on Effective Dates and Transition Methods* (hereafter referred to as the “Request for Views”).⁴ The Committee’s comment letter on the Request for Views noted (page 1):

“the potential impact of several expected International Financial Reporting Standards (IFRS) on the comprehensive set of supervisory reform measures known as Basel III, which were developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector. Basel III will be implemented in phases between 2013 and 2018.”⁵

The proposed requirements on asset and liability offsetting may affect supplementary prudential measures developed under Basel III. Accordingly, we recommend that such an accounting change should be introduced in a measured way in order to minimise the disruption to preparers, users and supervisory authorities.

⁴ This comment letter is available from the BIS website: www.bis.org.

⁵ The measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and strengthen banks' transparency and disclosures. The reforms target bank-level or microprudential regulation, which will help raise the resilience of individual banking institutions to periods of stress; and macroprudential system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time. These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system-wide shocks. Complete details on Basel III are available from the Bank for International Settlements website: www.bis.org.