

IFRS Developments

Offsetting of financial instruments

What you need to know

- ▶ The IASB has issued amendments to its current guidance in IAS 32 on offsetting financial assets and financial liabilities and has introduced new disclosure requirements in IFRS 7.
- ▶ The new disclosures are designed to address the single largest quantitative presentation difference between balance sheets prepared under IFRS and US GAAP, particularly in the financial services sector.
- ▶ The amendments also address certain inconsistencies in the application of the existing offsetting criteria.
- ▶ The amendments to IFRS 7 are to be retrospectively applied for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods.
- ▶ The amendments to IAS 32 are to be retrospectively applied for annual periods beginning on or after 1 January 2014. Earlier application is permitted. However, if an entity chooses to early adopt, it must disclose that fact and also make the disclosures required by the IFRS 7 amendments.

Overview

On 16 December 2011, the International Accounting Standards Board (IASB) issued the following amendments:

- 1 **Offsetting Financial Assets and Financial liabilities (amendments to IAS 32 *Financial Instruments: Presentation*)** – These amendments clarify the meaning of “currently has a legally enforceable right to set-off” and also clarify the application of the IAS 32 offsetting criteria to settlement systems (such as central clearing house systems) which apply gross settlement mechanisms that are not simultaneous.
- 2 **Disclosures – Offsetting Financial Assets and Financial liabilities (amendments to IFRS 7 *Financial Instruments: Disclosures*)** – These disclosures, which are similar to the new US GAAP requirements, would provide users with information that is useful in (a) evaluating the effect or potential effect of netting arrangements on an entity’s financial position and (b) analysing and comparing financial statements prepared in accordance with IFRSs and US GAAP.

Reasons for issuing the amendments

The differences in balance sheet offsetting requirements for financial assets and financial liabilities account for the single largest quantitative difference in amounts reported in statements of financial position prepared under IFRS and under US GAAP, particularly for entities in the financial services sector with large financial instrument and derivative portfolios. These large differences arise because the ability to offset under IFRS is more limited than under US GAAP, especially for derivatives entered into with the same counterparty under a master netting agreement. Such agreements commonly create a right of set-off that becomes enforceable only following a specified event of default or in other circumstances not expected to arise in the normal course of business and there is often no intent to settle net, consequently the offset requirements of IAS 32 are not met.

Following requests from users of financial statements and the recommendations of the Financial Stability Board, the IASB and the US Financial Accounting Standards Board (FASB) (collectively, the Boards) issued a joint exposure draft (ED) in January 2011. The proposals in this ED would have established converged offsetting requirements which would have significantly changed US GAAP requirements in line with those under IFRS. The ED also proposed additional disclosures relating to rights of set-off and the effects of such arrangements on an entity’s financial position.

In June, as a result of the feedback received on their joint proposals, the Boards decided to maintain their current offsetting models. However, they decided to develop converged offsetting disclosure requirements to assist users with reconciling the differences between IFRS and US GAAP.

In light of the decision to abandon the joint proposals, the IASB decided to retain the existing offsetting criteria in IAS 32. It also decided to amend the application guidance in IAS 32 to address inconsistencies in the interpretation of these criteria that were highlighted in the feedback it had received.

The amendments to the application guidance in IAS 32

Meaning of “currently has a legally enforceable right to set-off”

IAS 32 paragraph 42(a) requires 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 (...)”. However, IAS 32 did not previously provide extensive guidance on what was meant by “currently has a legally enforceable right to set off”

The feedback on the abandoned joint proposals highlighted inconsistencies in the interpretation of this criterion by IFRS preparers, in particular, whether a right of set-off that is enforceable only in the normal course of business, and which would disappear if one party defaults, would meet the above-mentioned criterion.

The amendments now clarify that rights of set-off must not only be legally enforceable in the normal course of business, but *must also be enforceable in the event of default and the event of bankruptcy or insolvency of all of the counterparties to the contract*, including the reporting entity itself. The Basis for Conclusions to the amendments clarify that the IASB believe the net amounts of financial assets and financial liabilities presented in the statement of financial position should represent an entity's exposure in the normal course of business and its exposure if one of the parties including the reporting entity itself will not or cannot perform under the contract. Accordingly, the enforceable right must exist for all counterparties, so that if an event occurs for one of the counterparties, including the reporting entity, the other counterparty or parties will be able to enforce that right to set-off against the party that has defaulted or gone insolvent or bankrupt.

The amendments also clarify that rights of set-off must not be contingent on a future event. The Basis for Conclusions indicates that the IASB believed that the passage of

time or uncertainties in amounts to be paid do not preclude an entity from currently having a legally enforceable right of set-off. However, if the right of set-off is not exercisable during a period when amounts are due and payable, then the entity does not meet the offsetting criterion. Similarly, a right of set-off that could disappear or is no longer enforceable on the occurrence of a future event, such as a ratings downgrade, would not meet this requirement.

How we see it

The clarifications will not change the level of offsetting achieved by most entities. However, it will be necessary to review settlement procedures and legal documentation to ensure that offsetting is still possible in cases where it has been achieved in the past. In certain cases, offsetting may no longer be achieved (for example, scenarios where the local bankruptcy law in the jurisdiction in which the reporting entity operates overrides netting contracts). In other cases, contracts may have to be renegotiated. The requirement that the right of set-off be available for all counterparties to the netting agreement may prove to be a challenge for contracts where only one party has the right to offset in the event of default.

Gross settlement systems which do not meet the ‘simultaneous realisation’ criterion in IAS 32

The IAS 32 offsetting criteria require the reporting entity to intend either to settle on a net basis, or to realise the asset and settle the liability simultaneously. IAS 32 indicates that the operation of a clearing house is deemed to constitute simultaneous settlement and it is only “in other circumstances” that the realisation/ settlement has to occur at the same moment for the offset requirements to be met.

Under the abandoned joint proposals, that distinction was not made and the requirement to simultaneously settle at the exact same moment would have applied in all circumstances. As a result, an entity that executes, for example, repurchase agreements (repos) and reverse repurchase agreements (reverse repos) with the same counterparty would not have been able to offset such contracts denominated in the same currency, and maturing on the same

day, unless they were settled at the same moment. This does not necessarily happen in practice due to processing constraints, which cause repos and reverse repos to be cleared in batches during the day.

The feedback on the abandoned joint proposal highlighted diversity in interpretation. In addition, respondents argued that ‘simultaneous’ is not operational and ignores settlement systems that are established to achieve what is economically considered to be net exposure, without involving settlement “at the same moment”.

In order to reduce diversity in practice, the amendments now clarify that *only* gross settlement mechanisms with features that eliminate or result in insignificant credit and liquidity risk and that will process receivables and payables in a single settlement process or cycle would be, in effect, equivalent to net settlement and, therefore, would meet the net settlement criterion.

The amendments include an example of a gross settlement system with characteristics that would satisfy the IAS 32 criterion for net settlement. In essence, these characteristics require that the financial assets and liabilities eligible for set-off are submitted for processing at the same point in time, the instructions cannot be revoked and the transactions to be offset will either both settle or both fail to settle, in which case they will be re-entered for processing until they do settle.

How we see it

Offsetting on the grounds of simultaneous settlement is particularly relevant for banks and other financial institutions which engage in large numbers of sale and repurchase transactions. Currently, transactions settled through clearing systems are in most cases deemed to achieve simultaneous settlement.

While many settlement systems are expected to meet the new criteria, potentially some may not. Any changes in offsetting may impact leverage ratios, regulatory capital requirements, etc.

Entities need to examine the operational procedures applied by the central clearing houses and settlement systems they deal with to determine if they meet the new criteria.

Interpretative issues the IASB decided not to address

In issuing the amendments to IAS 32, the IASB decided NOT to amend the application guidance to address the following interpretative issues:

The unit of account

Neither IAS 32 nor the abandoned joint ED specifies the unit of account to which the offsetting criteria should be applied. During the outreach performed by the IASB, it became apparent that there was diversity in practice regarding the unit of account that was used for offsetting in accordance with IAS 32.

Notwithstanding the concerns raised about piercing the unit of account, the IASB during its redeliberations acknowledged that presenting net the individual cash flows of the financial instruments would be a conceptually correct way of reflecting an entity's expected future cash flows from settling two or more separate financial instruments. However, the IASB felt that if the application guidance of IAS 32 was clarified to indicate that offsetting should be applied at the individual cash flow level, it would be necessary to consider an exemption from this requirement on the basis of operational complexity. This would result in the offsetting requirements still being applied differently between entities.

During redeliberations, the IASB acknowledged that although different interpretations of the unit of account are applied today, this does not result in inappropriate application of the offsetting criteria. Accordingly, the IASB concluded that the benefits of amending IAS 32 would not outweigh the costs for preparers and decided not to amend the application guidance to IAS 32 to address the unit of account.

How we see it

The IASB decision not to amend IAS 32 to address the diversity in practice regarding the unit of account used for offsetting, preserves the status quo. This means that offsetting can continue to be applied on the basis of individual identifiable cash flows (as is common in, for example, the energy industry) or on the basis of entire financial assets and liabilities.

Treatment of collateral obtained or pledged in respect of recognised financial assets and financial liabilities

Many central counterparty clearing houses require cash collateral in the form of variation margin to cover the fluctuations in the market value of 'over the counter' and exchange-traded derivatives. At present, entities can sometimes offset the market values of the derivatives against the cash collateral, on the basis that all payments on the derivatives will be made net using the cash collateral already provided. In effect, the collateral is represented as an advance payment for settlement of the cash flows arising on the derivatives.

The proposals in the abandoned joint ED specifically prohibited offsetting assets pledged as collateral (or the right to reclaim the collateral), or the obligation to return collateral obtained and the associated financial assets and financial liabilities. A number of financial institutions disagreed with such a general prohibition on offsetting collateral against recognised financial assets or financial liabilities. They noted that the proposed prohibition was more restrictive than IAS 32, which does not give special consideration to items referred to as 'collateral'.

As no particular practice concerns or inconsistencies were brought to the IASB's attention related to the treatment of collateral in accordance with IAS 32, and as the concerns that arose originated from the abandoned proposals in the joint ED, the IASB did not consider it necessary to add application guidance for the treatment of collateral.

How we see it

Consistent with existing practice, in some situations collateral will continue to be offset against recognised financial assets or financial liabilities, if the set-off criteria are met. This may be the case, for instance, if variation margin is used to settle cash flows on derivative contracts.

The amendments to IFRS 7

These amendments require an entity to disclose information about rights of set-off and related arrangements (such as collateral agreements). The aim of the Boards is to provide users of financial statements with information about the effect of such rights and arrangements on the entity's financial position that is comparable between IFRS and US GAAP. The new disclosures are required for all recognised financial instruments that are set off in accordance with IAS 32. These disclosures also apply to recognised financial instruments that are subject to an enforceable master netting arrangement or 'similar agreement', irrespective of whether they are set-off in accordance with IAS 32.

The 'similar agreements' referred to above include derivative clearing agreements, global master repurchase agreements, global master securities lending agreements, and any related rights to financial collateral. Examples of financial instruments that are not within the scope of these new disclosures are loans and customer deposits at the same institution (unless they are set off in the statement of financial position), and financial instruments that are subject only to a collateral agreement.

The amendments require entities to disclose, in a tabular format unless another format is more appropriate, the following minimum quantitative information. This is presented separately for financial assets and financial liabilities recognised at the end of the reporting period:

- (a) The gross amounts of those recognised financial assets and recognised financial liabilities;
- (b) The amounts that are set off in accordance with the criteria in IAS 32 when determining the net amounts presented in the statement of financial position;
- (c) The net amounts presented in the statement of financial position;

- (d) The amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in (b) above, including:
- (i) Amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in IAS 32; and
 - (ii) Amounts related to financial collateral (including cash collateral);
- And
- (e) The net amount after deducting the amounts in (d) from the amounts in (c) above.

Entities may group the above disclosures by type of financial instrument. Alternatively, an entity may elect to disclose the information required by items (a) to (c) above by type of financial instrument and the information required by items (c) to (e) by counterparty. If an entity provides the required information by counterparty, then counterparties are not required to be identified by name. To maintain comparability, the designation of counterparties must remain consistent from year to year for the years presented. Individually significant counterparty balances would be separately disclosed and the remaining counterparty balances would be aggregated into one line item. This alternative may be particularly relevant for financial institutions who manage their credit risk exposures by counterparty.

The amendments include implementation guidance illustrating ways in which an entity might provide the above quantitative disclosures.

To ensure that the disclosures reflect the maximum net exposure to credit risk, the amendments require the amounts disclosed above for financial collateral not offset to include actual collateral received, whether recognised or not. The effect of over-collateralisation of financial assets should be excluded so that, for example, an overcollateralisation on one asset does not mask an under-collateralisation on another. However, if the collateral is available to cover multiple contracts with the same counterparty, for example through a cross collateralisation agreement, this should be considered before determining the extent of any over-collateralisation.

In addition, the amendments require entities to provide a qualitative description of rights of set-off which do not result in net presentation that are disclosed in accordance with (d) above, including the nature of those rights. For example, an entity must describe any conditional rights of set-off that it holds. For instruments subject to rights of set-off that are not contingent on a future event but that do not meet the remaining criteria in IAS 32, the entity shall describe the reason(s) why the criteria are not met.

The amounts in (d)(ii) above refer to financial collateral, and so would exclude, for instance, land and buildings. For any financial collateral received or pledged, the entity shall describe the terms of the collateral agreement (for example, any restrictions to which the collateral is subject).

If the above quantitative and qualitative disclosures are not disclosed in a single note to the financial statements, the amendments require the information in the individual notes to be cross-referenced to each other. This is intended to increase the transparency of the disclosures and enhance the value of the information.

How we see it

In order to extract the necessary data to prepare the new disclosures, entities may need to modify their management information systems and related internal controls, including linking their credit systems to accounting systems. For example, the data needed to disclose amounts (including financial collateral) subject to master netting arrangements may not have been captured before. This task may be significant for some financial institutions. The option of reporting the information by counterparty could be particularly onerous, even though may provide more relevant information.

In light of the 2013 mandatory effective date, and the requirement to apply these disclosures retrospectively, we encourage entities, and in particular banks, to start evaluating the impact on their information systems and internal controls as soon as possible.

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