



# EACB Comments on IASB ED on Offsetting Financial Assets and Financial Liabilities

28 April 2011

**The European Association of Co-operative Banks (EACB)** is the voice of Co-operative Banks in Europe. It represents, promotes and defends the common interests of its 28 members and co-operative banks in general. Co-operative banks form decentralised networks which are governed by banking as well as co-operative legislation. The co-operative banks business model is based on three pillars: democracy, transparency and proximity. Through those pillars co-operative banks act as the driving force of sustainable and responsible development by placing the individual at the heart of their activities and organization. In this respect they widely contribute to the national and European economic and social objectives laid down in the Lisbon Agenda. With 63.000 outlets and 4.200 banks, co-operative banks are widely represented throughout the enlarged European Union playing a major role in the financial and economic system. In other words, in Europe one out of two banks is a co-operative. Co-operative banks have a long tradition in serving 160 million customers, mainly consumers, retailers and SMEs. They have also developed a strong foothold in the corporate market providing services to large international groups. Quantitatively co-operative banks in Europe represent about 50 millions members, 750,000 employees with a total average market share of about 20%.

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*The voice of 4.200 local and retail banks, 50 million members, 160 million customers*

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## Introduction

The members of the European Association of Cooperative Banks (EACB) are pleased to comment on the Exposure Draft on Offsetting Financial Assets and Financial Liabilities (ED/2011/1) jointly published by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in January 2011.

We took note of the requests from the G20 and the Financial Stability Board (FSB) to address the current differences between IFRS and US GAAP requirements for the netting of financial assets and liabilities. EACB agrees that providing a converged solution consistently applied both under IFRS and US GAAP is a very important aim to achieve.

In this respect, EACB supports the Boards' proposal to retain the existing offsetting criteria in IAS 32 Financial Instruments: *Presentation*, which did not raise concern during the recent financial crisis. We agree that the right to set off financial assets and financial liabilities must be unconditional and legally enforceable in all circumstances. This would provide clear and transparent information on the face of the financial statement of position to users. We agree that offsetting cannot result from a conditional event, i.e. from a default that might or might not happen in the future and that the balance sheet should not represent only counterparty risks. Moreover, we support the proposal to keep the scope of the offsetting guidance unchanged and to require offsetting for both bilateral and multilateral arrangements that meet the offsetting criteria.

However, we have a number of concerns about some of the ED's proposals:

- Cash collateral: we believe that, under certain circumstances, cash collateral and the associated financial instrument would meet the offsetting conditions. We would ask the Boards to clarify this point.
- Disclosures: we believe that some of the ED proposals might significantly increase the disclosures requirements for financial instruments without any relevant benefit on financial statements understanding. In particular, we disagree with presenting credit valuation adjustments made at a portfolio level separately from the gross amount of financial instrument since this is more a measurement related issue than an offsetting related issue. Therefore, we ask the Boards to ensure that the proposed disclosures remain consistent and balanced compared to IFRS 7 Financial Instruments: *Disclosures*.

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## EACB responses to the ED questionnaire

### 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 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?**

The members of the EACB support the Boards' decision to develop common offsetting criteria for financial assets and liabilities based on the current requirements of IAS 32 Financial Instruments: *Presentation*. These requirements did not raise particular concern during the financial crisis and remain satisfactory.

We agree that the right to offset is required in case of the existence of an unconditional and legally enforceable right to offset and the intention to settle the financial assets and the financial liabilities on a net basis or simultaneously. This enables the financial statement of position to represent properly the rights and obligations stemming from the entity's financial transactions. It will also reflect the entity's expected cash inflows and outflows. We therefore agree with the Boards that the proposed approach will 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.

Moreover, we acknowledge that an alternative approach based on conditional rights of offset would better represent the economic credit risk of the entity but we share the view that the objective of financial statement of position is not to provide only information on credit risk or an exposure contingent to a future event (i.e. default). The economic credit risk exposure is well suited in disclosures.

However, EACB members still have a concern regarding the treatment of cash collateral. The ED prohibits cash collateral including margin accounts to be offset with the associated financial assets or liabilities (see ED paragraph 9 and C14). However, many quoted derivatives with clearing houses give rise to a daily margin call, which is viewed as a net settlement of the financial position with the Central Counterparty (CCP) (i.e. position is reset at zero every day). We also



note that, under the existing IAS 32 requirements, the main accounting practice is to legally net the daily margin call against the fair value of derivatives. Thus, it is necessary to make a distinction between collateral given or received as a separate guarantee (e.g. guarantee deposit) and some margin call in cash, which are not separate guarantees but means of net settlements in substance cash flows of a derivative financial instrument. Therefore, we would ask the IASB to confirm that this prohibition does not prevent from netting a financial instrument with some cash collateral when the offsetting conditions are perfectly met.

Furthermore, regarding the intent condition to realise the financial asset and settle the financial liability and in order to avoid a differing use between IFRS and US GAAP preparers, we think that there should be explicit guidance regarding the meaning of “realise the financial assets and settle the financial liabilities *simultaneously*” that is close to current market practice. In fact, we do not see the difference between “simultaneously” and “at the same time”. We also consider that transactions with clearing house currently meet the simultaneous condition. We would like the Boards to explain if it has a different view.

## **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?**

Consistently with our answer to Question 1, we consider that the financial assets and liabilities presented on the statement of financial position should not be based on the potential occurrence of a future event (such as counterparty default).

Therefore, we agree with the Boards that a conditional right of set-off (such as a master netting agreement) is not sufficient to require a presentation on a net basis.



### 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?**

We agree by principle with the proposal to keep the scope of the IAS 32 offsetting guidance unchanged and to require offsetting for both bilateral and multilateral arrangements that meet the offsetting criteria.

Moreover, bilateral and multilateral offsetting arrangements with Central Counterparties (CCP) become more important to reduce the amount of counterparty risks.

### 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?**

The proposals include enhanced disclosures about underlying exposures subject to offset and credit mitigating arrangements that did not qualify for offset. In General, we would agree that disclosures about rights of set-off and related arrangement should be strengthen since IAS 32 current requirements are very limited. We also agree with the objective of this new disclosure requirements, i.e. to “enable users to understand the effect of those rights and arrangements on the entity’s financial position” (ED §11). Indeed, we consider that the proposed disclosure would help user to understand the economic credit risk exposures by taking into account mitigating agreement such as conditional netting agreement.

However, EACB members have the following remarks regarding the paragraph 12 of the ED: The proposed disclosure in §12 requires to show separately the gross amount of financial assets or liabilities and the portfolio-level before adjustment for credit risk of the counterparties. While we do not see any objection to present the gross amounts separately in the financial statements, we have some concerns with the fact to disclose credit-risk information. Portfolio-level adjustments made to incorporate the credit risk of the counterparties are typical in derivative valuation processes and have not historically been disclosed separately, as they have been considered a component of valuation as opposed to an offsetting adjustment. Therefore, we do not see the rational for requiring to disclose separately a valuation component next to credit risk mitigation



operations (such as physical collateral arrangement for instance). Consequently, we consider that portfolio-level credit risk adjustments are not relevant in a disclosure about rights of set-off and related arrangements.

Moreover, we also criticise the level of detail provided by these proposals. In fact, IFRS 7 §36 already requires entities to disclose credit risk exposure without taking into account any collateral or other credit enhancement and a description of collateral and other credit enhancements and their financial effect. The new disclosures proposed by the ED would also convey information on collateral. We recommend that the proposed disclosures should not be disproportionate compared to the existing disclosure requirements of IFRS 7. We would suggest to add an unique note dealing with this issue under IFRS 7 in order to achieve consistent disclosure requirement under IFRS.

### **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.**

- *EACB comments on 5a:*

We would not support a retrospective application for comparative financial statements. In fact, we do not consider that this information contains any relevant information for the users of the financial statements in the current year.

Extended disclosures should be applied in accordance with the other Phases of IFRS 9. In this respect, in our answer to the request for views on effective dates and transition methods, we have suggested that January 2015 be the effective date with no restatement of the previous years.

Moreover, we consider that specific transitional relief should be provided (e.g. similarly to the first time adoption of IAS 39 in 2005, restatement of comparatives should not be made mandatory for IFRS 9).

- *EACB comments on 5b:*

According to our initial assessment, we need a timeframe of about two years to implement the significantly expanded and specific disclosure requirements. Especially the information about “legally enforceable” and “conditional rights of sett-off” are not used in all of our members’ financial reporting systems yet.