

April 28, 2011

Sir David Tweedie, Chairman
International Accounting Standards Board
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United Kingdom

Leslie Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
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Via email: director@fasb.org

RE: IASB Exposure Draft: *Offsetting Financial Assets and Financial Liabilities*;
FASB File Reference No. 2011-100 *Offsetting*

Dear Sir David Tweedie and Chairman Seidman:

The American Bankers Association (ABA) appreciates the opportunity to comment on the IASB Exposure Draft: *Offsetting Financial Assets and Financial Liabilities*/FASB Exposure Draft: *Offsetting* (ED). ABA brings together banks of all sizes and charters into one association. ABA represents banks of all sizes and charters and is the voice for our nation's \$13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than \$165 million in assets. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities. Our members are active in the financial markets as banking institutions, trust companies, and broker/dealers. Therefore, our response not only comes with a perspective of a preparer and user of banking and broker/dealer financial statements, but also of preparers of financial statements of other entities for which we serve.

On its surface, the ED addresses a relatively basic question: Should certain financial assets and liabilities related to a specific counterparty be reported on a gross basis or a net basis? Put another way: In order to manage various risks, a bank enters into two separate agreements with another company. Under one of the agreements, the bank is owed ten dollars by the counterparty and, for the other agreement, the bank owes that same company nine dollars. Should the bank report ten dollars of assets and nine dollars of liabilities on its balance sheet or just one dollar of assets?¹

We do not agree with the conclusions reached in the ED. As described below, we believe the balance sheet should report the net information, supplemented with footnote disclosure about gross amounts. This will provide users with better context, as it is more closely aligned with how risks are managed.

¹ While there are several technical issues addressed in the ED, the main issue relates to the requirement that an entity report related assets and liabilities at their gross amounts unless there is an unconditional and legally enforceable right of set off and the entity intends either to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously. Conditional rights of offset, which are common in the banking industry and conditional upon default of either counterparty, do not meet the criteria for netting under the ED.

It appears that the primary reason for addressing this issue relates to the attempt to achieve convergence to a single set of high-quality, world-wide accounting standards. International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles in the United States (GAAP) currently differ on this point. Under IFRS, these assets and liabilities are generally “grossed up” on the balance sheet, while GAAP provides the option to allow these items to be reported on a net basis. While most IFRS and GAAP offsetting guidance applies agreements related to derivative instruments, the ED expands the question of offsetting to repurchase agreements and to customary trade date receivables applicable to brokerage operations.

The following questions are key considerations for resolving the offsetting issue:

- Does the entity manage the risks and obligations related to the counterparty on a gross or a net basis?
- Do users of the financial statements believe that the risks associated with the entity are reflected better on a gross or a net basis?

The answers to these questions appear relatively obvious to us – the most significant contracts that are generally presented net, such as derivatives and repurchase/reverse repurchase agreements, are managed on a net basis, and accounting for them on a net basis provides users with better information than would be provided on a gross basis. With this context, it is difficult to understand how the Boards reached the conclusion to converge on the IFRS gross up method. While we understand and support the need for users of financial statements to have information about both the gross and net amounts, the net amounts are the only amounts relevant in understanding actual risks to the company and, thus, are the only ones appropriate for balance sheet presentation. Gross amounts are appropriate only for footnote or parenthetical disclosure within the balance sheet.

Entities manage these risks and obligations related to the counterparty on a net – not gross – basis.

By far the most significant risk reflected in these derivative assets is credit risk. When there is a master netting agreement with a conditional right of offset in place, credit risk is not managed on a gross basis. Banks execute individual contracts under these agreements on a gross basis for operational efficiency purposes (cash and collateral are transferred based on the individual contract). However, the risk management programs are based on the net receivable or payable amounts.

From the perspective of a manager of financial liabilities, we pause to wonder why these liabilities would ever be managed on a gross basis. Reporting these liabilities on a gross basis seems to ignore the actual amount owed and even the collateral² that is transferred each day to

² In many cases, collateral is paid or received in the form of cash, which effectively mitigates virtually all liquidity and other market risks.

effectively reduce the actual exposure the counterparty has assumed. This is similar to acquiring treasury stock through open-market purchases and recording it as an asset.

Some argue that bankruptcy laws in various countries are not consistent as to how agreements with conditional rights of set off are treated. Therefore, they believe that the gross amounts should be reflected, as entities should be managing on the assumption that local courts may rule that there is less priority on the related claims. Although from a theoretical perspective this may sound logical, from a practical perspective, this argument falls short. First, in cases of bankruptcy, the priority of the creditor involved in an agreement with a conditional right of offset has not been challenged, even in some questionable jurisdictions. One should not assume that a local court will change precedence related to legal opinions about enforceability unless there is already a decision that does so. Further, risk of its ever happening is already factored into the fair value of the related instrument. Uncertainty regarding the future cash flows is not better reflected through the gross amounts and, in fact, presents a very different settlement amount than what will likely occur.

Entities manage these assets and liabilities by managing the net risk. Reporting these amounts at the net amount provides the most relevant information by addressing the substance of the relationship rather than simply the form.

Risks associated with the entity are reflected better on a net – not gross – basis.

The arrangements in question are entered into precisely for risk management purposes, whether the risks are credit risk, liquidity risk or other market risk. When analyzing the risk of a company, users of the financial statements normally use a leverage ratio as a key tool. These users include not only banking analysts, but also banking regulators.³ This ratio, based on capital and total assets, is rarely determined on a gross basis for these assets, and for good reason. The gross amounts simply do not reflect the practical risk inherent in the assets. Bankers have heard from the IASB staff that a net presentation would not adequately reflect liquidity and other market risks. However, it is credit risk that is the primary concern to users of financial statements. Further, the gross amount has no practical relation whatsoever to any risk, whether credit, liquidity or other market risk. In fact, liquidity risks will often be distorted by gross presentation, due to the movement of cash collateral. Unless the separate values of different risks are presented, gross presentation will also provide no clearer information on market risk than net presentation.

Gross reporting would dramatically balloon total assets without providing improved information about risks. In fact, it would reduce the quality of risk information as described above. For U.S. banks with large derivative dealer operations, gross reporting would have increased total assets

³ Among other metrics, leverage ratios are currently used by banking regulators in the U.S. to measure risk. The leverage ratio is based on GAAP asset amounts (which currently reports on a net basis for qualifying assets) and is subject to various minimum levels. Per 12 CFR 325.103 - Capital measures and capital category definitions, the definition of a “critically undercapitalized institution” is set by law to be equal to or less than 2 percent. It also appears that leverage ratios defined under the “Collins Amendment” of the Dodd-Frank Act are legally based on current U.S. GAAP. Leverage ratios proposed by world banking regulators under Basel II and Basel III accords understand assets to be assessed on a “net basis”.

by 50% to over 100% each quarter since 2008. Further, the quarter-by-quarter volatility of the added assets, with quarterly changes up to 30% of total assets, will add to confusion rather than improve the information provided. This volatility includes not just the increase or decrease in derivative activities, but it is also magnified by fair value changes. Reporting these assets and liabilities on a net basis removes irrelevant volatility from the balance sheet. Instead of using the balance sheet as the basis for their analysis, with the assets and liabilities reported at gross amounts, the analyst will need to turn to the footnote disclosures to obtain the net information that is the primary basis for their analysis.

For such an important metric to banking institutions, the amount that is used by the key financial institution analysts should guide how these amounts are reported on the balance sheet. Some have said that regulators can decrease their minimum leverage ratios by 50% to reflect the new accounting. However, changing the minimum leverage ratios does not solve the problem, since the ratios will then be irrelevant to those banks without large derivative activities and because the net information is also more relevant to other users of the financial statements. While bankers acknowledge that gross amounts are helpful for analysts to understand the general breadth of an entity's derivative activities, they know of no analysts in the U.S. who rely on the gross amounts to evaluate leverage or to estimate future cash flows.

Presenting such agreements at their gross amounts introduces unnecessary volatility into the financial statements that does not reflect the substance of the business. ABA recommends that both Boards re-evaluate the conclusions set forth in the ED to require that these agreements be reported net with footnote disclosure of gross amounts. Although gross amount information is useful, it is not the most relevant measurement for users of the financial statements. The gross amounts do not faithfully represent the risks involved nor do they help users to assess the relevant future cash flows of the organization. While this not does have an impact reported capital, it has a significant impact on leverage ratios, which are taking more prominence in prudential regulation.

Reflection of Risk Within the Conceptual Framework of IFRS

The conclusions in the ED appear to directly conflict with those expressed in the IASB exposure draft *Hedge Accounting* (HA). In HA, operating results from activities that effectively manage the various interest rate, liquidity, and credit risks are excluded from the key metric used by users of financial statements – net income. The proposed accounting for fair value hedges in HA changes where the effective portion of gains and losses on the hedging instruments is recorded from earnings to other comprehensive income (OCI).⁴ Within the context of IFRS, in which OCI is normally not “recycled”, these amounts will never be reflected through earnings.

With this in mind, however, the proposed grossing up of the assets and liabilities sends two very confusing signals to financial statement users. First, the instruments that effectively manage (and thus, reduce) risk are presented in a way that signals an elevation of risk (through the leverage ratio). Second, the gross balance sheet presentation in the ED signals to financial

⁴ The proposed accounting will be consistent with current accounting for cash flow hedges, in which the effective portion of gains and losses of cash flow hedges are already recorded through OCI.

statement users that these activities present increased risk to future earnings. This projected volatility is nowhere to be seen, however, because the proposed accounting in HA excludes it from operating income. Therefore, the balance sheet is telling the user that there is increased risk ahead, but its impact will not be seen in operating earnings.

ABA is not, at this time, questioning the presentation proposed in HA. However, we recommend that prior to finalizing a new standard on the offsetting of financial assets and liabilities, the IASB harmonize the reflection of risk between the balance sheet and income statement within the conceptual framework. If the ED is approved as proposed, this changes not only the accounting for financial assets and liabilities that are subject to offset, but also to the basics of financial statement analysis.

Technical Clarification – Simultaneous Settlement

In addition to the concerns that we have on the relevance and representational fairness of reporting the gross amounts, a significant technical clarification is needed in order to understanding the extent of work required to comply with the proposed accounting, as well as the actual impact.

The ED proposes that gross netting be required in situations when an entity either does not settle the eligible asset/liability on a net basis or does not settle them simultaneously. Application guidance provided in Appendix C of the ED notes that “simultaneous” settlement must occur “at the same moment,” further noting that the same stated time is not sufficient if it is in a different time zone. In practice, no matter the language in the agreement, these arrangements, including those with repurchase agreement transactions, are not settled in such a way. Normal settlement procedures often require an intra-day settlement. We believe it was not the intent of the Boards to require the cumbersome process of ensuring simultaneous – at the same moment – settlement. With this in mind, we recommend that clarification to the application guidance be provided to allow for, as a practical expedient, same day settlement.

Additional Implementation Guidance is Needed

As noted above, bankers are not only preparers and users of bank financial statements, but are also custodians and trust companies. Custody banks generally provide detailed reports on assets, liabilities and related collateral separately (including obligations to return collateral obtained and the right to reclaim collateral) for their custody clients.

Custody clients include ERISA benefit plans and trusts; mutual funds and other investment companies; and foundations, endowments and other not-for-profit organizations. Custody clients utilize the information to prepare their financial statements in accordance with the U.S. GAAP (or IFRS) guidance to which they are subject. With this in mind, we believe more descriptive guidance is required to address certain specific issues that may significantly impact implementation and to avoid unintended consequences. In Appendix A, we have used an example scenario to illustrate our concerns and give background to our questions. Similar questions were raised during our discussions with FASB and IASB staff, and we look forward to their resolution. Clarity within the finalized ASU will help to ensure that custody banks provide information appropriately so that custody clients are able to apply the new guidance consistently and as intended.

Thank you for your attention to these matters. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss this.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael L. Gullette". The signature is written in a cursive, flowing style.

Michael L. Gullette

Appendix A

Clarification Requested (Paragraphs 6 and 9)

The following questions relate to the application of paragraphs 6 and 9 of the ED to certain exchange-traded derivatives. Paragraph 6 indicates that offsetting is required and shall only be applied when an entity has an unconditional and legally enforceable right to set off the eligible asset and liability, and intends to either settle the eligible asset and liability net or to realize them simultaneously. Paragraph 9 indicates that an entity shall not offset assets pledged as collateral, the right to reclaim collateral, and/or the obligation to return collateral obtained, with associated eligible assets or liabilities.

Example Scenario

An entity enters an exchange-traded futures contract that increases in value at the rate of \$10 per day over 30 business days, for which daily marks-to-market are settled with the broker. As of the 30th business day, the entity has received \$290 in cash from the broker (daily variation margin settlements), with the 30th day's mark-to-market still pending. Under existing practice within U.S. GAAP, that contract is normally reported on the entity's balance sheet at \$10 (the value of the uncollected mark), with \$290 reported as cash. Additionally, within existing U.S. GAAP derivative disclosures, that same contract may also be reported by the entity at \$300 (the value of the open trade equity).

1. Initial Margin and Daily Variation Margin Settlement Amounts

Is the intent of paragraph 9 that the above-referenced futures contract should not be reported on the balance sheet at a value of \$10 along with \$290 cash, but rather at a value of \$300, along with \$290 cash and an offsetting obligation to return \$290 to the broker while the contract is open? In other words, are daily variation margin settlement amounts deemed collateral balances subject to paragraph 9 of the ED? Alternatively, if daily variation margin settlement amounts are deemed actual settlement payments, could the example contract still be reported on the balance sheet at \$10 without violating the intent of paragraph 9?

Clarity within the finalized ASU regarding application to scenarios such as the above will have broad benefit, especially as more OTC derivative transactions, including swaps, move to central clearing with initial margin requirements and daily variation margin settlements.

2. Interaction of Paragraphs 6 and 9

If variation margin settlement amounts are deemed collateral balances subject to paragraph 9 as in item 1 above, it seems a derivative contract and the obligation to return related variation margin settlement amounts could potentially meet the criteria in paragraph 6 for offsetting (e.g., futures contract closing provisions that include an unconditional and legally enforceable right of set off and intent of the parties to *virtual* simultaneous settlements). Is the intent of paragraph 9 to preclude offsetting, even for an eligible asset and the related obligation to return collateral that satisfied the offsetting criteria in paragraph 6?

3. Multiple Contracts with a Counterparty

One entity will often have concurrent open derivative contracts with a single counterparty or clearing broker. In such cases, exchanges of initial margin and/or daily variation margin settlement amounts may be processed net between the parties for all the open contracts. Is the intent of the ED that initial margin, variation margin settlement amounts, and any related rights to reclaim or obligations to return variation margin be reported separately by contract, even for multiple derivative contracts with a single counterparty where such balances are customarily exchanged on a net basis?