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By website: www.ifrs.org

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David

Exposure Draft on Offsetting Financial Assets and Financial Liabilities

We appreciate the opportunity to comment on the International Accounting Standards Board's Exposure Draft on Offsetting Financial Assets and Financial Liabilities.

Our comments on the specific questions raised in the exposure draft are attached. We would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely

Eva Wong
Secretary

Enc.

c.c: Hong Kong Monetary Authority
Hong Kong Institute of Certified Public Accountants

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Vice Chairmen The Hongkong and Shanghai Banking Corporation Ltd
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Responses of the Hong Kong Association of Banks ("HKAB") to the Specific Questions in the Exposure Draft of International Accounting Standards Board ("IASB") - Offsetting Financial Assets and Financial Liabilities

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?

HKAB's response: In a webcast hosted by the IASB on 31 January 2011, it was stated that the only change with respect to the offsetting criteria, compared to IAS 32, was to replace the notion of a currently enforceable right with that of an unconditional and legally enforceable right, and to clarify that such right must be enforceable at all time and in all circumstances.

Although the original intention of IASB may not necessarily have been to change the current offsetting requirements under IAS 32 for IFRS preparers, the clarification will affect how the offsetting requirements are interpreted in practice today. With the revised wording of "unconditional" and the clarification in the application guidance (see our further elaboration in Question 2), the offsetting criteria in the Exposure Draft ("ED") are much more stringent making it practically difficult for an entity to apply offsetting of financial assets and financial liabilities.

Furthermore, paragraph 10(f) of the ED indicates that only settlements that are executed at "the same moment" constitute "simultaneous", which forms part of the criteria for presenting net. Paragraph C11 goes on to explain that "realization and settlement of an asset and a liability at the same stated time but in different time zones is not simultaneous settlement". Since electronic transactions are usually processed in batches, even the simplest of transactions involving payments and receipts are not likely to pass the test of "simultaneous" settlement. This will significantly increase the number of transactions and balances which have to be presented gross and is contrary to the initial messages from the Board suggesting that the impact to existing IFRS appliers would be limited. It is not clear why a very restrictive principle – simultaneous – would be applied when assessing whether multiple transactions can be presented net. However, as indicated by paragraphs BC38 and BC39 in the Basis for Conclusion, multiple payments in a single financial instrument (like swaps) would not be subject to any of the offsetting criteria at all and would be recorded on a net basis. It is not clear why settling at "the same moment" should be critical to the offsetting criteria.

It is already not easy for IFRS preparers to meet the offsetting criteria specified in paragraph 42 of the current IAS 32. We would generally suggest keeping the scope of the current IAS 32 offsetting criteria unchanged, although additional flexibility around the application of simultaneous settlement would allow a more practical application of the proposed standard. We would recommend that simultaneous settlement be defined as occurring within the same day as it is generally impossible to settle any two transactions at the same moment regardless of whether those transactions occur between two independent parties or through a central counterparty. This will be both practical to apply and still reflect a significant reduction in counterparty credit risk.

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?

HKAB's response: We are of the view that the requirement that a right to offset must be "unconditional in all circumstances" is very restrictive and stringent. As stated in paragraphs C5 and C6, the issue of a right of set off may arise as a result of a provision in law (or a regulation), for example, the bankruptcy and insolvency laws of a jurisdiction may impose restrictions on, or prohibitions against, the right of set off in bankruptcy, insolvency or similar events. Accordingly, even if an entity has a legal right to set off under its contract, it has to consider the bankruptcy regime that governs the insolvency of the counterparties to determine whether the legal right to set off is "unconditional" and enforceable in all circumstances. An entity may need to seek appropriate legal advice to support it in assessing this criterion in this regard, which in our opinion is not realistic or cost effective. Furthermore, it may not be possible to get any legal advice for some developing jurisdictions which do not have any history or case law on bankruptcy. Hence, we would suggest reverting to the previous "currently enforceable right" in IAS 32.

Paragraph C15 includes guidance that if a right to set off is conditional to the occurrence of a contingent event, it should be reassessed for offsetting when the contingent event has occurred. Hence, the occurrence or non-occurrence of future events can enable a conditional enforceable right to become unconditional. We think that the requirement for reassessment of the right of set off when conditions have changed should be incorporated in the principles of the Standard and not in the guidance.

Paragraph BC37 to BC40 discuss the accounting treatment for a swap agreement is that of a single financial arrangement and offsetting is not applicable. As a swap is a common financial instrument, we would suggest these paragraphs be elevated from the Basis for Conclusions to the Application Guidance.

The existing IAS 39 also contains accounting treatment and application guidance for swaps and repos. As it is not certain whether the offsetting proposals will eventually be a self-contained draft IFRS or be part of draft amendments to an existing IFRS, we suggest to consider including a clause that accounting requirements in other IFRS will supercede that of the offsetting requirement if conflict arises. One example can be found in IFRS 27 which requires on consolidation, intragroup balances to be eliminated (which in effect can be regarded as offset) in full.

Lastly, transactions (eg sales and purchases, loan, interest, dividend etc) between different entities within a Group may not be cash settled but represented by "Amount due from / to group company". We would suggest the ED to clarify whether such intercompany balances can be presented in a net basis in the individual company's balance sheet.

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?

HKAB's response: We support the Boards' point of view that there is no basis for explicitly excluding multilateral netting arrangements from the scope of offsetting if all the other criteria, including legal enforceability, are met for the transaction because as long as the offsetting criteria are met, we believe there is no difference between bilateral and multilateral set-off.

Unconditional multilateral right of set-off is rare. However, financial institutions do have conditional multilateral right of set-off under the following circumstances:

- International banks may provide Notional Cash Pooling ("NCP") service to large corporate customers. The NCP service is applicable to savings and current accounts of all companies within the same customer group maintained with the bank. The credit and debit account balances of companies within the same group are combined (i.e., netted) and interest is calculated on the combined (net) balance. There are no actual fund transfers between the accounts and the combining of balances is only notional for the purpose of calculating interest. Under the NCP, companies within the same group have to enter into a cross guarantee agreement with the bank. By virtue of this cross guarantee, if any of the group companies defaults on its obligation to the bank, the bank could set off the defaulted amount against the balances of other group companies.

- Banks sometimes accept third party guarantee for loans granted. Under the guarantee agreement, in case of default by the borrower, the bank could set off any outstanding amount against the deposit balances held by the third party with the bank.

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 ED has significantly expanded the disclosure requirements in respect of offsetting.

To meet the needs of different users group who may have different needs on gross and net amounts, we are supportive of the proposal to provide gross to net reconciliations by class of financial instruments [paragraphs 12(a) and 12(b)] to the extent that it does not include assets and liabilities subject to potential offsetting but that have not met the criteria in the ED for netting.

However, we do not see the reason to disclose amounts which the entity has right to set-off but not intent to do [paragraph 12(c)] and amounts and details about an entity's conditional right of set off [paragraph 12(c) and paragraph 13]. While those conditions do not meet the offsetting criteria, the disclosure requirement would be very onerous for most, if not all, for financial institutions as well as many non-financial institutions. A typical relationship between a retail bank and a customer would involve multiple types of outstanding balances (for example, current and savings accounts, deposits, investment accounts, credit cards, short term loans, mortgages, etc.) In most instances, the financial institution will include in its lending contracts with the customers an overriding right to net these balances under conditions of default or bankruptcy of the customer. However, the financial institution would not expect or even intend to net settle unless on an exception basis. Such information, even though available within most financial institutions, is not collected routinely in the format to meet the proposed disclosure requirements. It is only collected in situations of default, in a different format, for those few customers who actually default. Implementation of the disclosure requirement is expected to be expensive as it would involve an extensive effort to take inventory of all relationships, identify and categorize the type of offsetting rights (both conditional and unconditional) at the individual contract level, gather information on all the gross and net balances together with reasons on why they are not presented net, keep track of all balances with conditional offset rights to determine when the rights become unconditional and reclassify them when they become so. If the purpose of the disclosures is to provide users of financial statements information on the net (credit) exposure the entity has, such information is already provided under the requirements of IFRS 7. It is questionable whether the benefits to some users from these additional proposed disclosures would out-weigh the significant costs involved in producing the information."

Paragraph 12(f) requires disclosure of information on collateral. Given that IFRS 7 already requires detailed disclosures of collateral information in paragraphs 14, 15, 36(a), 36(b) and 38, we would suggest IASB to combine the collateral disclosures in the ED with that in IFRS 7.

Subject to our comment on disclosure requirements above, we are of the view that only entities with offsetting financial assets and financial liabilities need to follow the detailed disclosure under paragraphs 11 - 14. Hence, we would suggest amending the wordings in Paragraph 15 which seems to apply to entities which does not apply offsetting but has pledged or received cash or other financial instruments as collateral.

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.

HKAB's response: We support the proposal to apply the amended accounting requirements retrospectively because this can enhance the comparability and usefulness of the information provided across periods.

Since the amended requirements shall be applicable to all items within the scope of IAS 39 Financial Instruments: Recognition and Measurement, and IAS 39 would be replaced by IFRS 9, and given the amount of time and effort required to comply with the presentation and disclosure requirements of the proposed standard, we would suggest its effective date should not be earlier than that of IFRS 9.