CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through email (director@fasb.org)

28 April 2011

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, CT 06856-5116

Dear Sirs,

IASB Exposure Draft of *Offsetting Financial Assets and Financial Liabilities* (File Reference No. 2011-100)

The Hong Kong Institute of Certified Public Accountants ("the Institute") is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

We welcome the IASB and the FASB efforts to develop joint proposals for converged requirements for offsetting financial assets and financial liabilities. Offsetting requirements account for the single largest quantitative difference between statements of financial position prepared under IFRS and under US GAAP for some enterprises. Although offsetting does not affect reported earnings, offsetting, or not offsetting, can have an enormous impact on reported assets and liabilities and significantly affect leverage and gearing ratios calculated from an entity's financial statements.

We are supportive overall of the IASB decision to use, as a basis for the converged requirements, the existing guidance for offsetting financial assets and financial liabilities in IAS 32 *Financial Instruments: Presentation*. However, with the more detailed criteria and guidance contained in the proposals, including those related to derivatives and cash collateral, the reporting under IFRS, particularly for banks and clearing houses, may be impacted greatly as the clarifications will affect how the offsetting requirements are interpreted in practice today. We understand that the intention of the IASB was not necessarily to change the current offsetting requirements for IFRS preparers, but rather to clarify some of the existing criteria. However, it is noted that the proposed stringent requirements may have unintentional consequences as they would pose a number of practical issues that we would like the Boards to reconsider and amend the effects of the "clarification" in the final Standard including:

(1) Requirement to simultaneously settle at the same moment

The ED states that realization of a financial asset and settlement of a financial liability is treated as simultaneous only when the settlement is executed at the same moment. This requirement is more emphatic than current practice as it only allows a financial asset and a financial liability to be offset if they are realized at the same second

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

(provided that an unconditional and legally enforceable right to set off exists). We do not believe that such simultaneity can exist as it is not operational in practice due to processing constraints even with a clearing house. In addition, we consider the proposed simultaneous settlement criterion, based on the moment in time at which an asset and liability are settled, is narrow and rules-based as well as operationally challenging.

(2) Right of set-off must be legally enforceable in all circumstances

We have concerns about the application of the "legally enforceable" criterion as proposed in the ED. We understand that the bankruptcy and insolvency laws of some jurisdictions 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, the position of the two parties with a netting arrangement is unclear and may be subject to judicial determination by the courts. This issue is particularly important for emerging countries where an international ISDA contract could be interpreted differently locally based on local rules and regulations which are influenced by the political environment. In such circumstances, the clarification that the right of set-off must be unconditional does not resolve the issue as to whether that right is legally enforceable in the event of bankruptcy.

(3) Offsetting of cash collateral against underlying derivative financial instruments

The ED states that an entity shall not offset financial assets, including cash, pledged as collateral or the obligation to return collateral obtained and the associated financial assets and financial liabilities. This proposed new requirement would impact the treatment of cash margin accounts related to derivative contracts (e.g. over the counter transaction). Under the proposals, such margin accounts are described as a form of collateral for the counterparty or clearing house. However, in effect, the cash collateral operates as deposit accounts with or from the counterparty that are used in the normal course of events to settle payments or receipts under derivatives or other transactions within the scope of the same master agreement. It is not clear from the ED why offsetting is prohibited on cash margin arrangements.

Our detailed responses to the above concerns are presented in the Appendix to this letter.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/jn

Encl.

Hong Kong Institute of CPAs

Comments on the IASB Exposure Draft of *Offsetting Financial Assets and Financial Liabilities*

<u>Question 1</u> – 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 support the IASB decision to use, as a basis for the converged requirements, the existing guidance for offsetting financial assets and financial liabilities in IAS 32. However, with the more detailed criteria and guidance contained in the proposals, including those related to derivatives and cash collateral, the reporting under IFRS, particularly for banks and clearing houses, may be impacted greatly as the clarifications will affect how the offsetting requirements are interpreted in practice today. In our view, it is preferred that the Boards keep the status quo by maintaining the current IAS 32 offsetting criteria, without embellishment, as they are working well today or the Boards should reconsider the application of certain key concepts to ensure that they do not have unintended consequences including:

(1) Requirement to simultaneously settle at the same moment

Paragraph 10(f) of the ED states that realization of a financial asset and settlement of a financial liability is treated as simultaneous only when the settlement is executed at the same moment. This requirement is more emphatic than current practice as it only allows a financial asset and a financial liability to be offset if they are realized at the same second (provided that an unconditional and legally enforceable right to set off exists). We do not believe that such simultaneity can exist as it is not operational in practice due to processing constraints even with a clearing house. We understand that it is common for clearing houses to clear contracts (e.g. repurchase and reverse repurchase agreements), in batches during the day so physical settlement is delayed even though settlement risk has been eliminated and there is only exposure to the net amount.

In addition, we consider the proposed simultaneous settlement criterion, based on the moment in time at which an asset and liability are settled, is narrow and rules-based as well as operationally challenging. We recommend that an offsetting model instead be based on a principle whereby offsetting is required in cases where credit risk is substantially eliminated. Such is the case for instruments settled with exchanges or centrally clearing houses that settle transactions in batches on the same date where the entity's credit risk for such transactions is usually negligible.

(2) Clear application guidance on offsetting criteria

Paragraph C1 of the Application Guidance states that offsetting should be applied when (a) the right of set-off is unconditional and legally enforceable and (b) the parties intend to settle net or to settle the gross amounts simultaneously. We note that paragraph C9 further explains that the rules of centrally cleared financial markets often involve automatic netting and cancellation of offsetting contracts. Under the proposals, the entity's intention would be considered to have been met upon entering into such contracts. We are concerned that paragraph C9 seems to imply that both the intention to settle net and to settle simultaneously is required to qualify for offsetting which is not consistent with the criteria set out in paragraph C1. We would like the Boards to provide further clarification on the application between paragraphs C1 and C9.

(3) Offsetting of cash collateral against underlying derivative financial instruments

Paragraphs 9 and C14 of the ED states that an entity shall not offset assets pledged as collateral or the obligation to return collateral obtained and the associated financial assets and financial liabilities. Under the proposals, cash margin accounts related to derivative contracts are described as a form of collateral for the counterparty or clearing house and should therefore be accounted for as separate assets and liabilities. However, in effect, such cash margin accounts may in certain cases (e.g. over the counter transaction), operate as cash deposit accounts with or from the counterparty that are used in the normal course of events to settle payments or receipts under derivatives or other transactions within the scope of the same master agreement. In these cases, there is a right of set-off between the amount receivable (or payable) in respect of the deposit against the amount payable (or receivable) in respect of the financial instrument to which it relates, and there is an intention to settle net. It is not yet clear how such form of transaction should be considered in terms of the ED. In our view, given the settlement mechanism of "over the counter" transaction is similar to derivative transactions executed with a clearing house which are generally settled intra-day, the Boards should consider providing an exception that such an offset is possible or we would recommend that the Boards clarify clearly that the term "collateral" is limited to amounts that are used as settlement only in the event of default.

<u>Question 2</u> – 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 welcome the clarification that the right of set-off must be "unconditional". We agree with the principle underlying the proposed approach for offsetting financial assets and financial liabilities as set out in paragraph BC9 that offsetting is appropriate only if :

(a) on the basis of the rights and obligations associated with the financial assets and financial liabilities the entity has, and

(b) the amount resulting from offsetting the asset and liability reflects an entity's expected future cash flows from settling two or more separate financial instruments.

However, we have concerns about the application of the "legally enforceable" criterion as proposed in the ED. 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, the position of the two parties with a netting arrangement is unclear and may be subject to judicial determination by the courts. This issue is particularly important for emerging countries where an international ISDA contract could be interpreted differently locally based on local rules and regulations which are influenced by the political environment. In such circumstances, the clarification that the right of set-off must be unconditional does not resolve the issue as to whether that right is legally enforceable in the event of bankruptcy.

In our view, the proposal of the right of offset must be "legally enforceable in all circumstances" is very restrictive and onerous. We would recommend that the right of offset is considered to be present if the enforceability of contractual terms of a financial instrument is highly probable based on past history and experience. We suggest that the determination of whether such right of offset exists should be performed on a contract by contract basis in light of the level of past history and experience as well as changes of legal rules and regulations.

<u>Question 3</u> – 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 with the Boards' conclusion that there is no basis for explicitly excluding multilateral netting arrangements from the scope of offsetting if all the other criteria are satisfied for the transaction.

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?

We note that the ED has significantly expanded the disclosure requirements in respect of offsetting. In our view, as the main purpose for this project was to address the differences in the offsetting requirements between IFRS and US GAAP, we do not believe that there is a need to disclose the gross amounts and the amounts offset on the balance sheet if convergence is achieved. If the Boards' rationale for requiring the proposed disclosure is to address different risks that may be mixed when a financial asset and financial liability are offset , we consider that there are adequate existing disclosures in respect of such financial risks such as liquidity risk, credit risk and market risk within IFRS 7.

In addition, 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 urge the IASB to consider the proposals in the ED in the context of the existing disclosure requirements in IFRS 7 to prevent duplication.

Further, we do not support the disclosure of amounts which the entity has the right to set-off but does not intend to do so [paragraph 12(c)] and amounts and details about an entity’s conditional right of set-off [paragraph 12(d) and paragraph 13]. While those conditions do not meet the offsetting criteria, their preparation cost would significantly outweigh the additional information value. To gather the required information, entities need to analyse all legal documentations and operational procedures. We understand that financial institutions operating in the banking industry, for credit risk management purpose, will usually include a "right of set-off" clause in the loan agreements signed with borrowers. This clause gives the lenders the right to set off deposits and other obligations owed to the borrowers upon an event of default by the borrower under the loan agreements. The term of this set-off clause may vary from agreement to agreement. As conditional set-off is not a usual kind of information captured in database, it is necessary to review all loan documents, which are numerous in number, to judge the existence and coverage of this set-off clause. This will involve heavy workload at considerable cost that appears to be disproportionate to any benefits that may be afforded to users. Further, we are not sure if such information will be useful for users of financial statements in making proper financial decisions.

Finally, we consider that as the disclosure of offsetting criteria is also applicable to a non-financial institution, it would be helpful if additional guidance and practical example is provided for preparers.

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.

(a) We support full retrospective application because this can enhance the comparability and usefulness of the information provided across periods.

(b) 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, we would suggest its effective date should not be earlier than that of IFRS 9, which we prefer no earlier than 1 January 2015.

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