



ISDA - INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

IASB/FASB - Exposure Drafts on Offsetting Financial Assets and Financial Liabilities

Friday, January 28, 2011

The International Swaps and Derivatives Association (ISDA) have closely followed the discussions on 'Offsetting of Financial Assets and Financial Liabilities' by the Accounting Standards Boards¹. ISDA is supportive of the Boards' efforts to simplify and enhance the accounting standards and we welcome the opportunity to comment on the Exposure Drafts.

The OTC derivatives industry continues to provide important risk management tools to derivative practitioners helping to achieve growth in the economy. The importance of derivatives is confirmed by the continued reliance of stakeholders before and after the 2007-09 economic crisis. The OTC derivatives industry serve a great variety of large, medium and small corporations, which use their products to manage interest rate, currency, credit and counterparty risks.

At present, offsetting rules are different depending on whether the entity is reporting under US GAAP which allows netting or under IFRSs which disallows it in most circumstances. ISDA believes that the new proposal to report derivatives gross rather than net on the balance sheet is counterintuitive and may lead to complexity in practice. Given that financial institutions manage their risks on a net portfolio basis, any requirement to report "gross risks" with an aim to better portray information about the business to the reader of the financial statements may mislead users of financial statements.

Consider a situation where an issuer trades derivatives with a counterparty with one long position and one short position that offset each other completely under a master netting agreement and which are fully collateralized. In this circumstance, it is accepted by all parties that the issuer has no risk at all and this fact should be recognized in the accounting requirements and derivatives should be reported net by counterparty, as it is the case in the current US GAAP. Accordingly, net presentation provides better information; gross presentation would not improve the reader's understanding and would lead to an overstatement of risks on the balance sheet.

ISDA has informed the Boards on the legal nature of the ISDA Master Netting Agreement, which is cohesive: individual transactions conducted under it form a single contract. Thus when a new trade is entered into, it modifies the entire agreement between the parties rather than forming a separate, divisible transaction. Therefore, individual derivatives are transacted and governed under one legal contract. If a default should arise, only one claim will arise for the net exposure that exists for the portfolio of derivatives under the ISDA Master Netting Agreement, with one cash sum ultimately paid to settle the claim. Net amounts are exchanged upon termination of all contracts under the master netting arrangement, and the right to set-off is upheld with respect to those entities to which a relevant opinion exists, as per the US GAAP conditions for netting.

Furthermore, it is highly desirable that the statutory accounting framework for financial institutions is consistent with the regulatory framework. It is therefore of note that the Basel II Capital Accord permits the use of net exposure for regulatory purposes where counterparties have a legally enforceable netting agreement, and this definition has been carried forward into the Basel III definition of leverage. This reflects a supervisory understanding that the net exposure represents the best – indeed the only valid – measure of the credit risk between the two parties for transactions conducted under the Master Netting Agreement. Similarly the Basel decision that net exposure

represents the best definition of leverage reflects the superiority of this measure as an assessment of leverage risk.

ISDA believes that the proposed guidance will give rise to significant operational challenges and would necessitate the implementation of significant changes to systems and data capture processes to thoroughly analyse payments between an entity and its counterparties. Based on the forgoing, we are of the view that the proposed offsetting guidance, as currently drafted, will lead to significant complexity and diversity in practice.

ⁱThe Financial Accounting Standards Board's (FASB) and the International Accounting Standard Board (IASB) (together 'the Boards') have published today a proposal to establish a common approach to offsetting financial assets and financial liabilities on the balance sheet (IASB's Exposure Draft ED/2011/1 and FASB's Exposure Draft of a proposed Accounting Standards Update of Topic 210 File Reference No. 2011-100)